7th February 2006

Reflective Commentary

This document seeks to correct errors in *The Economics of Financial Markets* (EFM) and to offer clarifications or updates to the exposition as the opportunity arises.

Chapter 3 – Predictability of prices and market efficiency

New reference: Richard H. Thaler (ed.) *Advances in Behavioral Finance*, vol. II, Princeton University Press, 2005. This is a valuable collection of previously published papers. Chapter 1, 'A Survey of Behavioral Finance' (by N. Barberis and R. H. Thaler) provides a particularly helpful review of market efficiency, together with material that is relevant also to illuminate chapter chapter 4 (section 4.3) and chapter 7 (section 7.1) of EFM.

New reference: S. A. Ross *Neoclassical Finance*, Princeton University Press, 2005. Chapters 3 'Efficient Markets' and 4 'A Neoclassical Look at Behavioral Finance: The Closed-End Fund Puzzle', provide natural next steps on these topics beyond EFM.

New edition: the second edition of R. J. Shiller *Irrational Exuberance* was published in 2005 (Princeton University Press). Look out, especially, for the new chapter 3 'The Real Estate Market in Historical Perspective'.

Chapter 7 – Arbitrage

New reference: S. A. Ross *Neoclassical Finance*, Princeton University Press, 2005. Chapters 1 'No Arbitrage: The Fundamental Theorem of Finance', and 2 'Bounding the Pricing Kernel, Asset Pricing, and Complete Markets' contain a concise analysis of arbitrage by the acknowledged leader in the field; full of perceptive insights.

Chapter 9 – Empirical appraisal of the CAPM and APT

The paper 'Bad Beta, Good Beta' by John Y. Campbell and Tuomo Vuolteenaho has been published in the *American Economic Review*, (2004) vol. 94, no. 5, pp. 1249–1275.

Chapter 10 – Present value relationships and price variability

The South Sea Bubble (EFM, p. 238) Here are three recent contributions:

Peter Temin and Hans-Joachim Voth (2004) 'Riding the South Sea Bubble' *American Economic Review* vol. 94 (5) December 2004, pp. 1654-1668

Richard Dale *The First Crash: Lessons from the South Sea Bubble*, Princeton University Press, 2004.

Richard Dale, Johnnie E. V. Johnson and Leilei Tang (2005) 'Financial markets can go mad: evidence of irrational behaviour during the South Sea Bubble' *Economic History Review*, vol. 58 (2) May 2005, pp. 233–271.

Chapter 16 – Futures markets III: applications

The CME weather futures (and options) contracts now value each CDD and HDD index point at \$20, not \$100 (page 395).

Chapter 17 – Swap contracts and swap markets

The final sentence on page 418 should read:

> If the notional principal is denoted by $N = £20$m, then, from A's perspective, each exchange takes the form $(£0.05N,\ \$0.072 \times N)$.

not

> If the notional principal is denoted by $N = £20$m, then, from A's perspective, each exchange takes the form $(£0.05N,\ \$0.072 \times 1.60 \times N)$.

The correction is needed because $0.072 = \frac{1}{2} \times 9\% \times 1.60$ already takes into account that N is valued in sterling ($£20$m) rather than dollars – it is an error to multiply by the exchange rate, 1.60, again.

Chapter 18 – Options markets I: fundamentals

There is an error in the brief explanation attached to Figure 18.1. The fourth sentence should read (correction in **bold**):

> The exercise of a *put* option involves the *sale* of the underlying asset, by the **option-holder** to the **writer**, at price X.

Chapter 20 – Option markets III: applications

The CME weather options on futures contracts now value each CDD and HDD index point at \$20, not \$100 (page 498).

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