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Office: Classroom: Office Hours:

Prerequisites

This course will be fast-paced and students are expected to have significant background in economics, statistics and finance. Yes, there will be math! But, no, you won’t be expected to derive Black-Scholes.

Specific prerequisites are:
• ECON 201, Introductory Macro
• ECON 202, Introductory Micro
• STAT 210, Introductory Statistics (Many other statistics classes can substitute for STAT 210. See complete list on Business Institutions Website)
• BUS INST 304, Introductory Finance (Substitutes include IEMS 326, ECON 360-1 and KELLG_FF 310)

Course Description

This goal of this course is to expose driven, inquisitive students to real-life examples of inefficiency in the public financial markets and build up a framework for thinking about the drivers of these inefficiencies. Students will explore how hedge funds evaluate these opportunities and capitalize on them to drive returns for their investors. The course will help students understand the concept of arbitrage and the limits of arbitrage opportunities.

There will be a particular focus on asking why outsized returns exist in specific cases of market inefficiency. Students will be exposed to a myriad of potential root causes including counterparty risk, liquidity risk and investor segmentation. Through the course, students will learn how to price and evaluate a wide variety of financial instruments including depository receipts, credit default swaps, convertible bonds and distressed debt.

The aim of the course is to give students several examples of bona fide market inefficiency and give them the tools to assess (and potentially capitalize on) future market opportunities in real-time.

Required Textbook/Readings


Required Readings: Various academic papers, sell-side research and Wall Street Journal/other articles
Optional (But Awesome, Nonetheless) Readings
Swedroe, The Quest for Alpha: The Holy Grail of Investing
Lowenstein, When Genius Failed: The Rise and Fall of Long-Term Capital Management
Lewis, The Big Short
Graham, The Intelligent Investor
Chancellor, Devil Take the Hindmost: A History of Financial Speculation
Hull, Options, Futures and Other Derivatives
Poundstone, Fortune’s Formula

Course Requirements and Grading
1. **Class Participation and Attendance (10% weighting).** It is important that you read the background materials before class so that we can cover material in as much depth as possible. I have intentionally made the readings focused so they should be very manageable – it is my expectation that every student will complete the readings before class each week. Classroom comments and questions should demonstrate knowledge of the topic being discussed and facilitate learning for the entire class. High quality comments, questions and contributions will improve everyone’s experience.

2. **Problem Sets/Cases (10%).** There will be 4 problem sets/cases assigned on course topics. These problem sets will be numerical examples of potential hedge fund investments. I have no issue with students working together on these problem sets, but each student will be responsible for understanding the material and will turn in an individual set of answers.

3. **Paper (20%)** Students will research an original paper on a topic relevant to financial market inefficiency. Sample topics include an in depth-look at a specific arbitrage opportunity and the reason it existed, the current opportunity set within financial markets, an exploration of a specific source of market inefficiency over time, or structural trends within the hedge fund industry. Papers are expected to be six to eight pages (double-spaced, additional pages may be added for charts and exhibits).

4. **Quizzes (30%)** There will be 3 closed book quizzes covering material from class notes, discussions and readings.

5. **Final Exam (30%)** Closed book exam.

Classroom Policy
Students should demonstrate respect for the professor and fellow students during the class period by refraining from distracting behavior such as side conversations or using laptops to surf the Web or check e-mail. Please also set your cell phones to silent and leave them in your bags during class time.
Summary Course Outline

Class # 1  September xx

Topics:  
Course Organization
Review of CAPM and Efficient Market Theory
Creating a Framework for Sources of Market Inefficiency

Reading:  
“Capital Asset Prices: A Theory of Market Equilibrium under Conditions of Risk” (1964)
“Common Risk Factors in the Returns of Stocks and Bonds” (1993)
Efficiently Inefficient, Chapter 9

Class # 2  September xx

Topics:  
Hedge Funds and the Quest for Alpha
Hedge Fund Strategy Overview
New Product Overview

Reading:  
Efficiently Inefficient, Chapters 1 & 2
“The ABCs of Hedge Funds: Alphas, Betas, and Costs” (2011)
“Do Hedge Funds Deliver Alpha? A Bayesian and Bootstrap Analysis” (2005)

Class # 3  October xx

Answers to Problem Set #1 Due

Topic:  
The Time Driver
ADRs and Risk Arbitrage
Closed End Funds

Reading:  
Efficiently Inefficient, Chapter 16
“Characteristics of Risk and Return in Risk Arbitrage” (2001)
“Yes, Discounts on Closed End Funds are a Sentiment Index” (1993)

Class # 4  October xx

Quiz

Topics:  
The Liquidity Driver
Fixed Income Arbitrage
CDS Index Membership

Reading:  
Efficiently Inefficient, Chapter 3
“Long Term Returns Boosted by Illiquidity” (2014)
Citi CDS Primer (2010)

Class # 5  October xx
Answers to Problem Set #2 Due, Paper Topic Submitted

Topic: The Technical Pressure and Cross-Holder Risk Drivers
(Flash) Crashes
Bond Basis

Reading:  *Efficiently Inefficient*, Chapter 9 (focus = p 155-157)
“The Basis Monster That Ate Wall Street” (2009)

Class # 6  October xx
Quiz

Topic: The Human Emotion Driver
A Crash Course in Behavioral Economics
Value Investing

Reading:  *Efficiently Inefficient*, Chapters 6 & 7
*Behavioral Corporate Finance: An Updated Survey* (2013)
Richard Thaler Awarded Nobel Prize (2017)

Class # 7  October xx
Answers to Problem Set #3 Due

Topics: The Complexity and Investor Segmentation Drivers
Convertible Securities
Warrants

Reading:  *Efficiently Inefficient*, Chapter 15
Case Study: Convertible Bonds of Countrywide Financial Corporation (2007)

Class # 8  November xx
Quiz

Topics: Be Careful – What Looks Like Inefficiency Might Not Always Be So
Counterparty Risk
Borrow Constraints
Tax/Regulatory Frictions

Reading:  “Limited Arbitrage and Equity Investments” (2002)
Class # 9 November xx
Answers to Problem Set #4 Due

Topics: Activism and Making Your Own Luck
CDS Shenanigans
Tying It All Together: A Framework

“Bill Ackman’s Allergan Insider-Trading Suit Doesn’t Look Bad” (2018)
“Blackstone May Do Its Cleverest CDS Trade Again” (2017)

Final Exam December xx