

Trading and Exchanges: Focus on Foreign Exchange

FIN 230

Professor Osler

Fall 2008: Thursdays, 6:30 – 9:30 pm

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Office Hours: M-W 11 am
or drop by informally

Overview

This course teaches students about the trading of financial assets. The focus is primarily on the foreign exchange market – the biggest financial market in the world – but equity, bond, and derivative markets are also discussed at length.

The course begins with the basics: Who trades, when do they trade, what do they trade? What regular patterns are there in trading, spreads, returns, and/or volatility? There are different kinds of markets – dealership markets, limit-order markets, call markets, open-outcry markets, two-tier markets. How do they differ? When might one prefer one over the other? Students learn the types of orders available in each type of market and the factors that drive order choice. Students simulate trading in dealership markets, limit-order markets, and call markets, sometimes trading against each other in class.

The course then turns to the microeconomics of trading: How do dealers set spreads? How does information get into security prices, and how does this process vary according to market structure? What is market liquidity, what determines how much liquidity there is, and who cares? What is “market transparency,” and is it always a good thing? Why are there so many extremely large asset-price moves, even in the absence of news surprises?

Our final topic is whether a large, aggressive community of traders is sufficient to ensure that financial markets are informationally efficient. In considering the evidence pro and con we examine the relationships between forward and spot rates and the profitability of technical analysis, both of which suggest that currency markets, but not equity markets, are inefficient. We interpret this in light of evidence that exchange-rate and bond-price forecasts tend to be biased and inefficient, and discuss various approaches to forecasting these prices.

The course usually includes guest speakers from the local trading community.

Pre-requisites

Students are required to have studied Financial Theory (201 or 301 or equivalent), and basic Statistics. Note also: You will have to use a spread-sheet package such as *Excel*.

Course Work

The course will be lecture based. Lectures clarify concepts with illustrations, while the simulations and the homework assignments focus on applications. The workload should be about 6 hours a week excluding class hours.

All students should keep in touch with the daily happenings in the financial world.

Grading:	Homework:	30%
	Midterm:	30%
	Final exam:	30%
	Trading simulations:	10%

Homework Assignments

Purpose: provide practice in applying concepts learned in class. You can't learn without practice.

Handed out in class and due at the beginning of the class one week later.

Absolutely NO LATE SUBMISSIONS. Answers will be posted on web shortly after class.

Write up your answers **individually**.

Trading Simulations

Over the semester, students will experience trading in simulated markets with various structures. One of these is the FX Trading Game at oanda.com This free FX trading simulator assigns you €100,000 to start and allows you to trade as if you are using oanda.com's trading platform. Spreads on this platform are quite narrow by market standards. Students should submit listings of their trades and profits with every problem set; there should be at least ten (10) trades each time. The goal is to learn how hard this is from experience.

Midterm and Final Exams

Purpose: Help you become sufficiently comfortable with key concepts that you can think with them and converse intelligently about them.

Closed book: You must remember certain key things, e.g., formula for covered interest parity.

Only by learning it that well can you use it to think on your feet in professional situations

The midterm should take roughly two hours.

The final exam covers everything from beginning to end of semester. The exam will be given at a time and place decided by the Registrar, typically 6-9 pm on the same day of the week that the class meets during the semester. You must be there. No exceptions except for verified medical emergency.

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Some Things You Must Do

Attend every single class. There will be a sign-in sheet.

Participate in class discussions.

Hand in your homework assignments on time

Keep track of deadlines

Keep in touch with the financial news and events

Some Things You Must NOT Do

Collaborate on the midterm exams or the final exam.

You may not let anyone else copy your work

You may not copy from anyone else

You may not talk during exams

You may not quote anyone else on homework assignments.

Academic integrity is central to the mission of educational excellence at Brandeis. Each student is expected to turn in work completed independently, except when assignments specifically authorize collaborative effort. It is not acceptable to use the words or ideas of another person, whether it's a world-class economist or your best friend, without acknowledging that source. This means that you must use footnotes and quotation marks to indicate the source of any phrases, sentences, paragraphs, or ideas found in published volumes, on the internet, or created by a another student. Further details of University standards can be found in Section Three of *Rights and Responsibilities*.

Violations of University policies on academic integrity may result in failure in the course or on the assignment, or in suspension or dismissal from the University. The procedure is this: When I suspect a violation, I am required to report it to the University-wide committee. I do this. Then it is out of my hands. If you are in doubt about the instructions for any assignment in this course, it is your responsibility to ask for clarification BEFORE you submit the work.

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Readings: Some required readings are listed below. Additional readings will be assigned during the semester. If a URL is not provided, the document is probably up on Latte.

Most core readings on the foreign exchange market are in Osler, *Survey of Foreign Exchange Microstructure* (2008 Manuscript), distributed electronically.

Most core readings on equity markets are in Lawrence Harris, *Trading and Exchanges*, (Oxford University Press 2003), available from the bookstore.

Most core readings on the bond market are in Mizrach and Neely, *The Microstructure of the U.S. Treasury Market* (2008 manuscript), distributed electronically.

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Disability: If you are a student with a documented disability on record at Brandeis University and want reasonable accommodation in this class, please see me at your earliest opportunity.

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Course Outline

Structure of Financial Markets

Osler, *Survey of Foreign Exchange Microstructure*, Sections I-IV (pp. 3-21).

Mizrach and Neely, *The Microstructure of the U.S. Treasury Market*, Sections 1-9 (pp. 2-18).

Harris, *Trading and Exchanges*, Chapters 2 - 8, 11,

Jen, Morgan Stanley Dollar Outlook, July 27, 2007: Monetary policy drives the effect of news.

Rogue Traders: Daiwa, Rusnak

SocGen Loss_01-08

CLS Bank (Bank of Canada)

Midterm

The Microeconomics of Financial Markets

Osler, *Survey of Foreign Exchange Microstructure*, Sections V –VII (pp. 21-37).

Mizrach and Neely, *The Microstructure of the U.S. Treasury Market*, Sections 10-12 (pp. 18-22).

Harris, *Trading and Exchanges*, Chapters 9, 10, 13-14, 19, 24, 27

Scan: Madhavan, Porter, and Weaver, "Should Securities Markets be Transparent?" *Journal of Financial Markets* 8 (2005): 266-277. ONLY through Section 4.2.

Market Efficiency

Menkhoff and Taylor: "The Obstinate Passion of Foreign Exchange Professionals: Technical Analysis"

Practitioner reading on forward bias.

Harris Chapter 28.

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