FINM3407 - Behavioural Finance

Tutorial 4 Overconfidence and Investors Questions/Answers

Note: This topic has more questions than can be covered in a 2-hour session. The questions to be covered by your tutor are indicated by an asterisk (*); the rest questions should be viewed as extra practice problems.

In this tutorial, we are going to cover the following relevant topics: Overconfidence and The Impact of Overconfidence on Financial Decision-making

There are a few references reading for these two relevant topics:

AckertDeaves Chapters 6 & Chapter 9

- **PART ONE: Overconfidence**

1*. **Differentiate the following terms/concepts:**

a. Miscalibration and excessive optimism

b. Better-than-average effect and illusion of control

c. Self-attribution bias and confirmation bias

d. Pros and cons of overconfidence

2*. Is miscalibration greater for easy questions or hard questions? Is it greater when we look at 50% confidence ranges or 98% confidence ranges?

3. Provide an example where someone can be both excessively optimistic and miscalibrated at the same time.

4*. Overconfidence does not quickly dissipate via learning because of the existence of contributing biases. Explain.

5*. In 2007 the New England Patriots (an American football team) had a banner year winning all 16 regular season games. In these 16 games their points were: 38, 38, 38, 34, 34, 48, 49, 52, 24, 56, 31, 27, 34, 20, 28, and 38. Despite this obvious success, their fans were still a bit overconfident going into the playoffs. The consensus among fans was that they would average 50 points per game in the playoffs. Plus their fans were 95% sure that they would be within five points of this number (45 to 55). Illustrate the dimensions of their overconfidence. (For the purpose of this question, assume the Patriots participated in four playoff games.)

- **Part TWO: Impact of Overconfidence on Financial Decision-making**

1*. Differentiate the following terms/concepts:

a. Indirect and direct tests of relationship between overconfidence and trading activity

b. Sensation seeking and overconfidence

c. Under diversification and excessive trading

d. Statics and dynamics of overconfidence

2*. Consider two investors (A and B) with the following demand curves for a stock:

A: $p = 100 - q$

B: $p = 150 – 2q$

a. At a price of $50, how much will A and B purchase?

b. If the price falls to $30, who will increase their holdings more? Explain.

c. On this basis, which investor seems to be more overconfident?

3*. Discuss what the evidence (using naturally-occurring data, survey data, and experimental data) suggests about the relationship among overconfidence, trading activity, and portfolio performance.

4*. What evidence is there that people do not diversify enough? Why is it that this occurs? What is the simplest way to “buy” a high level of diversification in an equity portfolio?

5*. Research indicates that stock market forecasters are also overconfident. Do they learn from their mistakes? Discuss.