

FINM3407 - Behavioural Finance**Tutorial 7 Emotional Foundations and Individual Investors**

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 topics: Application to Managerial Overconfidence and Stata related questions.

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

Ackert/Deaves Chapters 7 and Chapter 10

- **Part One: Emotional Foundations**

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

a. IQ and EQ

b. Mood and emotion

c. Human brain and the brain of other animals

d. Phineas Gage and Elliot

2*. You are considering managing your own money rather than trusting in an investment advisor. Some argue that emotional intelligence may be just as important as investment knowledge. Do you agree? Discuss.

3. Imagine you just won a lottery with a \$10 million prize. What primary emotions might you feel? (Note that the seven primary emotions generally include anger, contempt, disgust, fear, happiness, sadness, and surprise.) Describe their features, including the six used to define an emotion. Be sure to include observables.

4*. Your colleague argues that emotion and reasoning are completely separate influences on decision-making. Do you agree? Discuss.

5. Put yourself in the place of an equity mutual fund manager. Think of all the stocks you might select for inclusion in the portfolio. How would emotions enhance your decision-making process?

- **Part Two: Individual Investors and the Force of Emotion**

1*. Differentiate the following terms/concepts:

- a. Regret and disappointment
- b. House money and break-even effects
- c. Affect (noun) and affect (verb)
- d. Bad mood and depression

2. In housing markets, there is a positive correlation between prices and trading volume. When there is a housing boom, many houses sell at, or even above, the prices asked by sellers. In times of bust, homes sit on the market for a long time with asking prices that exceed the prices that can reasonably be expected. How can this be explained?

3*. Some investment banks engage in proprietary trading, which means that the firm's traders actively trade financial securities using the bank's money, in order to generate a profit. To offset a slowdown in one division, traders in a profitable division might more actively engage in proprietary trading. Do you think this practice is wise?

4*. This morning I woke up in a sour mood because my favorite team lost its game yesterday. Then I had to wait an extra-long time in line for coffee. It started to rain, and I forgot my umbrella in the car. When I arrived at my office (finally) I found that a stock I held in my portfolio was falling in value, so I sold. Is this evidence that mood moves markets?

5*. What does research based on the game show Deal or No Deal tell us about path-dependence and integration vs. segregation of gambles?

- **CFA Questions ***

Luca Gerber recently became the chief investment officer for the Ludwigs Family Charity, a mid-size private foundation in Switzerland. Prior to assuming this role, Gerber was a well-known health care industry analyst. The Ludwigs' family fortune is primarily the result of entrepreneurship. Gerhard Ludwigs founded ABC Innovations (ABC), a biotech company dedicated to small cell lung cancer research. The foundation's portfolio is fifteen percent invested in ABC. Gerber initially feels that fifteen percent investment in ABC is high. However, upon review, he decides it is appropriate based on Ludwigs' involvement and their past success with similar ventures. Gerber makes a mental note to himself to closely monitor the investment in ABC because he is not familiar with small-cap startup companies. The remaining 85 percent of the foundation's portfolio is invested in equity of high quality large-cap pharmaceutical companies. Gerber deems this allocation appropriate and is excited that he is able to continue to use his superior knowledge of the health care industry. For the past two years, ABC has been dedicated to Project M, an effort directed at developing a drug for the treatment of relapses in small cell lung cancer. Project M has delayed its Phase Two trials twice. Published results from Phase One trials have raised some concerns regarding the drug. In its last two quarterly investors' conference calls, ABC's CEO was very cautious in discussing expectations for Project M. ABC's stock price decreased by over 20 percent during the past six months. Gerber believes that the research setbacks are temporary because of ABC's past success with projects. He expects that ABC will begin Phase Two within a year, and also believes that once Project M goes into Phase Two, ABC's stock price should reach a new 52-week high of CHF 80. Soon after deciding to hold the stock, Gerber reads an article by ABC's chief scientist in which certain scientific results from Project M are detailed. As a conclusion, the article states: "Although we still have some major obstacles to overcome, the Project M team has seen positive signs that a treatment for small cell lung cancer is achievable." While Gerber has difficulty interpreting the scientific results, he feels reassured after reading the concluding statement. Today, ABC announces the news that it will no longer pursue Project M, citing early signs of failure of the project. As a result of the announcement, the stock price drops by 50 percent. Gerber is stunned. He reviews the company's history and notes that ABC has been up front about its struggles to solve the Project M issues. Gerber now realizes that he has been ignoring all the signs and feels a tremendous regret for not having sold the foundation's investment in ABC earlier.

- 1. Discuss how Gerber displayed overconfidence bias and cite one example to support this statement. Distinguish between the availability bias and the overconfidence bias.**
- 2. Discuss how Gerber displayed conservatism bias. Cite three examples from the reading**