FINM3407 - Behavioural Finance

Tutorial 5 Application to Managerial Overconfidence

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:

AckertDeaves Chapters 16

- **Part One: Application to Managerial Overconfidence**

1*. Differentiate the following terms/concepts:

a. Payback and NPV:

b. Holding in-the-money options too long and engaging in frequent acquisitions:

c. Random treatment and self-selection treatment in Camerer and Lovallo experiment:

d. Risk aversion and overconfidence in debt issuance:

2*. Investment activity is driven by both rational value-maximization and behavioral influences on the part of managers. Discuss.

3*. In the Camerer and Lovallo experiment, let N=10 and c=2. Specify the number of entrants that maximizes industry profit. What will this industry profit be? Specify the number of entrants that minimizes industry profits. What will this industry profit be? What number of entrants leads to zero industry profits?

4*. In the Camerer and Lovallo experiment, overconfidence leads to excessive entry into markets. Do you believe that if a prospective entrepreneur read this research, she would be more or less likely to undertake a start-up? Explain.

5*. You are a divisional manager. Currently you are a member of a committee which is considering two product investments proposed by two other divisional managers, Joe and John. While walking over to the presentations, Joe seems rather arrogant. He mentions that he golfs with the CEO, is a key player in the firm, and that you could really learn a lot from him. In thinking over the projects after the presentations, you find you are really leaning toward John's proposal even though the projects are quite similar in terms of estimated cashflows and risks. How can you explain this?

CFA Questions*

The following information related to CFA Question 1 - 7

Tiffany Jordan is a hedge fund manager with a history of outstanding performance. For the past 10 years, Jordan's fund has used an equity market neutral strategy (long/ short strategy that strives to eliminate market risk; i.e., beta should be zero) which has proved to be effective as a result of Jordan's hard work. An equity market neutral strategy normally generates large daily trading volume and shifts in individual security positions. Jordan's reputation has grown over the years as her fund has consistently beaten its benchmark. Employee turnover on Jordan's team has been high; she has a tendency to be quick to blame, and rarely gives credit to team members for success. During the past twelve months, her fund has been significantly underperforming against its benchmark.

One of Jordan's junior analysts, Jeremy Tang, is concerned about the underperformance and notes the following:

- Observation 1: Certain positions are significantly under water, have much higher risk profiles, and have been held for much longer than normal.
- Observation 2: The trading volume of the fund has decreased by more than 40 percent during the past year.
- Observation 3: The portfolio is more concentrated in a few sectors than in the past.

Tang is worried that the portfolio may be in violation of the fund's Investment Policy Statement (IPS). Tang brings this to Jordan's attention during a regular weekly team meeting. Jordan dismisses Tang's analysis and tells the team not to worry because she knows what she is doing. Jordan indicates that since she believes the pricing misalignment will correct itself, the portfolio will not be able to take advantage of the reversion to the mean if she sells certain losing positions. She reassures the team that this strategy has performed well in the past and that the markets will revert, and the fund's returns will return to normal levels.

Tang tactfully suggests that the team review the fund's IPS together, and Jordan interrupts him and reminds the team that she has memorized the IPS by heart. Tang contemplates his next step. He is concerned that Jordan is displaying behavioral biases which are affecting the fund's performance.

CFA Question 1:
By taking credit for successes but assigning blame for failures, Jordan is most likely demonstrating:

A. loss-aversion bias.

B. self-attribution bias.

C. illusion of knowledge bias.

CFA Question 2:
Which of Tang's observations is least likely to be the consequence of Jordan demonstrating loss-aversion bias?

A. Observation 1.

B. Observation 2.

C. Observation 3.

CFA Question 3:

Which of Jordan's actions least supports that she may be affected by the illusion of control bias?

A. Her dismissal of Tang's analysis.

B. Her routine of holding weekly team meetings.

C. Her comment on market turnaround and current holdings.

CFA Question 4:

How does Jordan most likely demonstrate loss-aversion bias?

A. Telling the team not to worry.
B. Reducing the portfolio turnover this year.
C. Deciding to hold the losing positions until they turn around.

CFA Question 5:

Which of the following emotional biases has Jordan most likely exhibited?

A. Endowment.
B. Regret aversion.
C. Overconfidence.

CFA Question 6:

Which one of the following biases did Jordan not demonstrate?

A Self-attribution.

B Representativeness.

C Illusion of knowledge.

CFA Question 7:

Which of Tang's findings is not a typical consequence of self-control bias?

A Failure to explore other portfolio opportunities.

B Asset allocation imbalance problems in the portfolio.

C A higher risk profile in the portfolio due to pursuit of higher returns.