FINM3407 - Behavioural Finance

Tutorial 10 Behavioural Investing

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: Behavioural Investing

Reference for Behavioural Investing.

AckertDeaves Chapters 19

- **Part One: Behavioural Investing**

1. Differentiate the following terms/concepts:

a. Style peer groups and style investing

Style-investing is the consideration of style in portfolio formation. A style-peer group is a group of investors following the same style, where style is usually defined in terms of firm size and growth vs. value.

b. Style tilting and style rotation

If a manager tilts towards small-cap value because historically small-cap value has outperformed other market segments, she is practicing style-tilting. Style-rotation is the act of moving from style to style in an attempt to time aggregate style preference shifts.

c. Financial soundness and financial statements

Financial statements provide a sense of the firm's financial state: its assets, liabilities and net worth along with income and cashflows. Financial soundness on the other hand exists if the firm has such characteristics as a strong balance sheet and positive and growing earnings and cashflows.

d. Univariate and multivariate approaches

A univariate approach to behavioral investing conditions on a single variable (e.g., past returns), while a multivariate approach conditions on more than one (and often many).

2. Describe how momentum can be refined by conditioning on the entire term structure of interest rates in the manner of the Grinblatt and Moskowitz regression model.

This is dealt with in detail in the chapter. Desirable is a predictive model that utilizes the term structure of past returns; that differentiates between winners and losers; and that considers whether past positive/negative returns have been consistently so.

3. Describe how value investing can be refined by paying close attention to a company's financial statements.

As described in the chapter, the model by Piotroski attempts to separate the wheat from the chaff among value stocks by concentrating on those with financial soundness. Specifically, nine fundamental signals were used to measure three areas of a firm's financial condition: (1) profitability, (2) financial leverage/liquidity, and (3) operating efficiency.

4. What does the early evidence on the ability of behavioral investing to enhance performance tell us?

In a recent study of this issue, the performance of 16 self-proclaimed or media-identified behavioral mutual funds was evaluated. These funds claimed to base their investment strategies in whole or in part on the principles of behavioral finance. When the Fama-French three-factor model is supplemented with an additional factor for momentum, the behavioral funds were not able to earn excess returns. Mostly they seemed to have capitalized on the value advantage.

5. What is an example of an anomaly that once reported in research studies has attenuated? Is this positive or negative from the standpoint of market efficiency?

The small-firm effect is an example. This is actually negative from the standpoint of an efficient view of the world since the Fama-French three-factor model argues that firm size is a risk factor. If it's a risk factor, why should it disappear?

- **Part Two: Revision**

Please refer to FINM3407 – Behavioural Finance – Practice Questions