SS4

Weaver discusses how decisions are shaped by the decision-making process itself. She provides the following example:

> "A new client is interested in becoming an antique car investor and requested I make available $200,000 from his portfolio so he could start his collection. Shortly after the money was made available, the client visited an antique car auction not far from his home. Unfortunately, the auction had a limited number of cars meeting his requirements. He was drawn to one antique car in particular, even though it was missing several of the features he wanted. After some consideration he decided to purchase it anyway. Within an hour, his purchase was placed in storage for safekeeping."

1 What behavior did Weaver's new client most likely demonstrate when he purchased the antique car?

A. Satisficing

B. Utility maximization

C. Using heuristics

Solution: A.

A is correct. Weaver's client most likely demonstrated satisficing when he purchased the antique vehicle. Satisficing combines satisfy and suffice and describes decision, actions, and outcomes that may not be optimal, but are adequate.

2 (From a colleague): "While I try to make decisions analytically, I do believe the markets can be driven by the emotions of others. So I have frequently used buy/sell signals when investing. Also, my 20 years of experience with managers who actively trade on such information makes me think they are worth the fees they charge." The statement is most consistent with:

A. the adaptive markets hypothesis.

B. a behavioral approach to asset pricing.

C. Savage's subjective expected utility theory.

Solution: B

The statement indicates that markets can be influenced by the emotions of others (sentiment). This is consistent with a behavioral approach to asset pricing that includes sentiment such as the behavioral stochastic discount factor-based asset pricing model proposed by Shefrin.

Victoria Arzac recently formed Arzac Wealth Management Services, catering to high- net-worth individuals. Arzac interviews Christine Torok, who has more than 20 years of experience as an equity analyst following the banking industry. Torok considers herself to be one of the most sought after analysts in the market, ranking in the top five analysts in the industry year after year. Her earnings forecasts have tended to be within 1% of actual results. She attributes the accuracy to her firm's highly complex forecast models, including sensitivity analysis and the confirmation of similar information sourced from multiple databases. She is regularly asked to speak at investment conferences and on TV to make comments on financial securities.

3 Given Torok's analysis of the banking industry, she least likely exhibited which of the following behavioral biases?

A. Self-attribution

B. Overconfidence

C. Illusion of control

Solution: A.

A is correct. Self-attribution bias is a bias in which people take personal credit for successes and attribute failures to external factors outside the individual's control. There is no evidence she takes personal credit for her success. Torok actually credits the firm's financial models for the accuracy of the forecasts.

B is incorrect because Torok is likely overconfident given that she considers herself to be one of the top five analysts in the market and being asked to speak at banking conferences and on TV. She also sources additional information similar in nature, so it is unlikely to increase the accuracy of her forecast but instead reinforces her confidence in that forecast.

C is incorrect because Torok may have been subject to the illusion of control due to using highly complex forecast models. Excess of information cannot eliminate the risk in a model or the modeling process.

Ian Wang, CFA, is a financial advisor at Garnier Brothers, a US money management firm. He became a financial advisor several years ago after receiving his CFA charter and currently has three high-net-worth individuals as clients. Wang is conducting his annual review of each client's investment policy statement along with their recently completed risk tolerance questionnaires. He is reflecting on their varying psychographic characteristics:

- Michael Perez is a successful 45-year-old investment banker. Wang describes Perez as a passive investor who is sensible and secure. Perez exhibits low to medium risk tolerance but often overestimates his risk tolerance. His biases include hindsight, framing, and regret aversion. On his questionnaire, Perez indicated a desire for wealth preservation while wanting to invest a significant portion of his assets in his employer's stock.

- Sarah Johnson is an independent-minded 45-year-old real estate developer who has historically utilized significant amounts of financial leverage. Prior to becoming a Garnier client, Johnson managed her own investment portfolio, which was concentrated in just a few stocks. Johnson exhibits a great deal of confidence and high risk tolerance. Johnson's biases include illusion of control and overconfidence. On her questionnaire, Johnson indicated a desire for wealth accumulation and an aversion to investing in non-US equities. In addition, she indicated that her risk tolerance toward a stock investment would increase significantly if she knew that more than one of Garnier's research analysts supported it.
- Neal Patel is a 66-year-old billionaire who accumulated his wealth by starting a successful retail business. Wang describes Patel as cautious and concerned about the future. Patel is concerned about protecting his assets and often seeks advice from those he perceives as being more knowledgeable than himself. Patel exhibits low risk tolerance. Patel's biases include endowment, loss aversion, and status quo. Patel indicated that his risk tolerance would increase significantly if he knew that an investment had the unanimous support of Garnier's Private Wealth Investment Committee.

There was one common observation that Wang noted in all three questionnaires: All three clients indicated that they would perceive a company with a good growth record and good previous share price performance as a good investment.

4 A traditional risk tolerance questionnaire is most likely to be effective as a diagnostic tool for:

A. Patel.

B. Perez.

C. Johnson.

Solution: B

Perez exhibits primarily cognitive rather than emotional biases. Although risk tolerance questionnaires may fail for emotionally biased individuals and work best for institutional investors, they are generally effective for cognitive-based individuals.

5 Which investment portfolio is least likely to deviate from the mean–variance portfolio?

A. Patel.

B. Perez.

C. Johnson.

Solution: B

Perez has primarily cognitive error biases. Accordingly, it is likely that, with education, the impact of these biases can be reduced or even eliminated. Because cognitive biases dominate, Wang should seek to moderate the effect of these biases and adopt a program to reduce or eliminate the bias rather than accept the bias. The result will be a portfolio that is similar to the mean–variance portfolio.