# MODULE 6 UNIT 3

## Assignment

Learning outcomes:

LO1: Explain the effects of behavioural finance on market dynamics and investments.

LO2: Articulate the impact of different flaws in thinking on effective financial decision-making.

LO3: Analyse investment strategies to mitigate risks caused by irrational behaviour.

LO4: Evaluate risk management and automation tools to prevent flaws in thinking.

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| **Plagiarism declaration** |
| **1. I know that plagiarism is wrong. Plagiarism is to use another’s work and pretend that it is one’s own.**  **2. This assignment is my own work.**  **3. I have not allowed, and will not allow, anyone to copy my work with the intention of passing it off as their own work.**  **4. I acknowledge that copying someone else’s assignment (or part of it) is wrong and declare that my assignments are my own work.** |

### Name:

#### 1. Instructions and guidelines (Read carefully)

##### Instructions

1. Insert your name and surname in the space provided above, as well as in the **file name.** Save the file as: **First Name Last Name M6U3 Assignment** – **e.g. Lilly Smith M6U3 Assignment.** **NB:** *Please ensure that you use the name that appears in your participant profile on the Online Campus.*
2. Write all your answers in this document. There is an instruction that says, “Start writing here” under each question. Please type your answer there.
3. Submit your assignment as a **Microsoft Word document only**. No other file types will be accepted.
4. Do not delete the plagiarism declaration or the assignment instructions and guidelines. They must remain in your assignment when you submit.

**PLEASE NOTE:** **Plagiarism cases will be investigated in line with the Terms and Conditions for Participants**

IMPORTANT NOTICE: Please ensure that you have checked your course calendar for the due date for this assignment.

##### Guidelines

1. There are 6 pages and 2 questions in this assignment.
2. Make sure that you have carefully read and fully understood the questions before answering them. Answer the questions fully but concisely and as directly as possible. Follow all specific instructions for individual questions (e.g. “list”, “in point form”).
3. Answer all questions in your own words. Do not copy any text from the notes, readings, or other sources. **The assignment must be your own work only.**

#### 2. Grade allocation

Each question receives a grade allocation. However, you will only receive a final competency score and will not be given individual grades for each question. The grade allocation is there to show you the weighting of each question.

Question 1 33%

Question 2 67%

**TOTAL 100%**

#### 3. Questions

Module 6 introduced you to the flaws in thinking that can result in unfavourable outcomes for investors. These are categorised into framing effects, intuitive judgements and biases. These flaws can affect the way investors receive and interpret information to make investment decisions.

In this assignment, you will use the case of the dotcom bubble to describe the phases of a bubble and the potential flaws in thinking that could have led investors astray. Read the passage on the dotcom bubble to answer the questions that follow.

Dotcom bubble:

The famous dotcom bubble resulted from excessive speculation of technology and internet-based companies from 1995 to 2000. These companies drew the attention of investors and attracted an influx of capital investments due to their innovative practices. These practices revolutionised online shopping, communication and news sources (TheStreet, 2022).

The popularity of these companies increased drastically, causing the price value of the industry to expand. However, the intrinsic value of the companies could not support the profitability expected by investors.

As a result, the share prices skyrocketed due to increased demand, which resulted in massively overpriced trades (Mills, 2001). Furthermore, low interest rates around this time made debt financing easier to acquire, only fuelling the unprecedented growth. In addition, investors were more attracted to equity investments due to the low yields on fixed income instruments (TheStreet, 2022).

One major problem with the investment strategies most investors were employing was that they ignored many of the metrics they would normally use. Instead, they flooded the market with demand for fear of missing out on the opportunity and forfeited appropriate analysis (Mills, 2001).

The rapid growth eventually caused investors to believe that the companies were overvalued. As a result, they began to disinvest in an attempt to realise the profits they had gained. However, mass sell-offs caused the prices of companies without a concrete value proposition to drop. The industry subsequently imploded and entered a bear market. This was likely due to the underlying value of the industry not being able to support the inflated valuations of the companies (TheStreet, 2022).

##### Question 1

Using the case of the dotcom bubble as an example, describe the phases of a bubble using the table that follows.

(Max. 100 words per cell)

Start writing here:

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| **Displacement** | The dotcom bubble began with the advent of the internet and innovative technology practices that promised to revolutionize industries such as shopping, communication, and news. This drew the attention of investors who saw potential for immense growth and profitability. |
| **Credit creation** | Low interest rates made borrowing easier, allowing companies to acquire debt financing. This influx of capital further fueled the growth of internet-based companies, as more investors sought equity investments over low-yield fixed income instruments. |
| **Euphoria** | As the popularity of these companies increased, so did their stock prices. Investors, driven by the fear of missing out, ignored traditional metrics and analysis, leading to massively overpriced trades. The market saw an unprecedented surge in demand for tech stocks. |
| **Critical stage** | Doubts began to emerge as investors realized that the companies' intrinsic values could not support their inflated market valuations. This led to a reassessment of the actual worth of these companies, triggering a shift in investor sentiment. |
| **Revulsion** | As investors began to disinvest to realize their profits, the market experienced mass sell-offs. Companies that lacked a solid value proposition saw their stock prices plummet, leading to the implosion of the industry and a subsequent bear market. |

##### Question 2

The investors involved in the dotcom bubble could have been affected by flaws in thinking that caused them to behave irrationally. Explain how **prospect theory, the availability heuristic** and **confirmation bias** could have influenced the investing community’s decisions as the dotcom bubble developed and eventually imploded.

(Max. 150 words per cell)

Start writing here:

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| **Prospect theory** | According to prospect theory, investors tend to fear losses more than they value gains of an equivalent amount. During the dotcom bubble, the initial success of tech companies led investors to overvalue potential gains while underestimating the risks. This fear of missing out on potential profits drove irrational investment behaviors, contributing to the bubble's growth and eventual burst. |
| **Availability** | Investors relied heavily on recent information and success stories of tech companies, which were highly publicized and easily recalled. This bias led them to overestimate the profitability and stability of these companies, reinforcing the belief that investing in tech stocks was a guaranteed path to wealth. The dramatic success stories overshadowed the risks, creating an illusion of continuous growth. |
| **Confirmation bias** | Many investors selectively sought out information that confirmed their pre-existing beliefs about the profitability of tech stocks. They ignored or downplayed any data suggesting overvaluation or potential risks. This bias perpetuated the cycle of investment, as investors reassured themselves and others that the market's upward trajectory was justified, even as warning signs began to appear. |

#### 4. Rubric

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|  | **Requirements not met** | **Poor** | **Satisfactory** | **Good** | **Exceptional** |
| **Question 1:**  *Description of the phases of a bubble* | No submission.  OR  The response fails to address the phases of a bubble. | The response provides a poor or incomplete description of the phases of a bubble, missing key points from the dotcom bubble case. | The response provides an adequate description of the phases of a bubble, highlighting some key points from the dotcom bubble case. | The response provides a clear description of the phases of a bubble, highlighting key points from the dotcom bubble case. | The response provides a thorough description of the phases of a bubble, highlighting key points from the dotcom bubble case. The response demonstrates substantial critical engagement. |
| **Question 2:**  *Explanation of the flaws in thinking* | No submission.  OR  The response fails to explain the flaws in thinking. | The response provides a poor explanation of the flaws in thinking, not sufficiently linking prospect theory, availability heuristic and confirmation bias to the dotcom bubble case. | The response provides an adequate explanation of the flaws in thinking, linking prospect theory, availability heuristic and confirmation bias to the dotcom bubble case. | The response provides a clear explanation of the flaws in thinking, linking prospect theory, availability heuristic and confirmation bias to the dotcom bubble case. | The response provides a thorough explanation of the flaws in thinking, linking prospect theory, availability heuristic and confirmation bias to the dotcom bubble case. The response demonstrates substantial critical engagement. |

#### 5. Bibliography

Jackson, A. L. & Schmidt, J. 2021. Blowing bubbles: what is a stock market bubble? *Forbes*. 20 April. Available: <https://www.forbes.com/advisor/investing/stock-market-bubble/> [2022, October 17].

Mills, D. Q. 2001. Who’s to blame for the bubble. *Harvard Business Review*. May.

TheStreet. 2022. *What was the dot-com bubble and why did it burst?* Available: <https://www.thestreet.com/dictionary/d/dot-com-bubble-and-burst> [2022, October 17].