Learning Module 5: The Behavioral Biases of Individuals

Q.3993 Which of the following is the *most likely* reason for the difficulty in correcting emotional biases? Emotional biases:

A. Mostly stem from impulses and intuitions.

B. Are impossible to recognize and adjust to emotional bias.

C. Cause a deviation in decisions from what is presumed by traditional finance theory.

The correct answer is **A.**

It is normally difficult to correct emotional biases through education, better information, and advice since it results from impulses and intuitions.
B is incorrect. It is possible to recognize and adjust to emotional bias, which may be undesirable to the individual. One can only adapt to emotional bias as it is difficult to correct.

C is incorrect. Both emotional biases and cognitive errors are most likely to cause a deviation in decisions from what is presumed by traditional finance theory.

CFA Level I, Portfolio Management, Learning Module 5: The Behavioral Biases of Individuals. LOS (c): Describe how behavioral biases of investors can lead to market characteristics that may not be explained by traditional finance.

Q.3994 Which of the following is *most likely* a type of emotional bias?

A. Hindsight bias.

B. Conservatism bias.

C. Loss aversion bias.

The correct answer is **C.**

Emotional bias consists of loss aversion, overconfidence, self-control, status quo, endowment, and regret aversion biases.
A and B are incorrect. Both hindsight and conservatism bias are examples of belief perseverance bias.

CFA Level I, Portfolio Management, Learning Module 5: The Behavioral Biases of Individuals. LOS (b): Discuss commonly recognized behavioral biases and their implications for financial decision making.

Q.3995 Belief perseverance bias *least likely* include:

A. Representativeness bias.

B. Mental accounting bias.

C. Illusions of control bias.

The correct answer is **B.**

Mental accounting bias is a processing error and not a belief perseverance bias. It refers to mentally distributing money into accounts that impact decisions even though money is fungible.
A and C are incorrect. Both representativeness and illusions of control biases form part of the belief perseverance bias.

CFA Level I, Portfolio Management, Learning Module 5: The Behavioral Biases of Individuals. LOS (b): Discuss commonly recognized behavioral biases and their implications for financial decision-making.

Q.3996 Which of the following is *most likely* a consequence of conservatism bias? A financial market participant (FMP) may:

A. Be slow to update forecasts even in the presence of new information.

B. Trade more than is practical since portfolio turnover correlates negatively with investment returns.

C. Adopt a point of view or a forecast based almost entirely on small sample size or individual, unique data.

The correct answer is **A.**

One of the notable effects of conservatism bias is that the financial market participant (FMP) may be slow to update forecasts even in the presence of new information.
B is incorrect. It relates to the effects of illusion control and not conservatism bias.

C is incorrect. It relates to the consequence of representative bias and not conservatism bias.

CFA Level I, Portfolio Management, Learning Module 5: The Behavioral Biases of Individuals. LOS (b): Discuss commonly recognized behavioral biases and their implications for financial decision-making.

Q.3998 Christine Blake, an investment analyst at XYZ Ltd, presents and narrates the firm's investment results after the COVID 19 pandemic to their clients. During her presentation, Blake states that *"the performance during the pandemic was quite evident as depicted the yield curve and other leading indicators approximately six months prior."*
The statement by Blake *most likely* indicates what type of bias?

A. Hindsight bias.

B. Confirmation bias.

C. Illusion of control.

The correct answer is **A.**

Hindsight bias is the certainty that a prior event is expected and can be reasonably expected to occur. The COVID 19 impact on the investment returns could appear obvious but, in reality, cannot be accurately predicted. Thus Blake's comments depict hindsight bias.
B is incorrect. Confirmation bias occurs when there is an inclination to look for and notice what approves prior beliefs and disregard what opposes them. Blake's statement is not indicative of a confirmation bias.

C is incorrect. The illusion of control occurs when an individual believes they can influence the outcomes of events when in reality they cannot. This is not the case concerning Blakes's statement.

CFA Level I, Portfolio Management, Learning Module 5: The Behavioral Biases of Individuals. LOS (b): Discuss commonly recognized behavioral biases and their implications for financial decision-making.

Q.3999 Which of the following statements is *most accurate*?

A. A cognitive dissonance is a form of behavioral bias.

B. To prevent hindsight bias, the financial market participant (FMP) should prudently record its investment choices.

C. The effect of confirmation bias cannot be reduced by aggressively looking for data that contest prevailing beliefs.

The correct answer is **B.**

To mitigate hindsight bias, the financial market participant (FMP) should prudently record its investment choices and detail the time in which such decisions were made. This will ensure ease of cross-referencing of prior decisions rather than trusting on recollection.
A is incorrect. Cognitive dissonance, also known as belief perseverance bias, is a category of cognitive error that results from the distress of the mind that arises when new data conflicts with prior beliefs. Cognitive error is a form of behavioral bias and not cognitive dissonance.

C is incorrect. To reduce the effect of confirmation bias, investors should aggressively seek new information that challenges present beliefs.

CFA Level I, Portfolio Management, Learning Module 5: The Behavioral Biases of Individuals. LOS (b): Discuss commonly recognized behavioral biases and their implications for financial decision-making.

Q.4000 Base rate neglect and sample size neglect are *most likely* types of which of the following behavioral biases?

A. Framing bias.

B. Confirmation bias.

C. Representativeness bias.

The correct answer is **C.**

Representativeness bias is a belief perseverance bias that categorizes new data based on prior experience and groupings. The two types of representativeness bias that apply to FMPs are base rate neglect and sample size neglect.
A is incorrect. Framing bias is a type of processing error and occurs when an individual responds to an inquiry differently in reference to the context in which it is asked or outlined. Both base rate neglect and sample size neglect are not classified under framing bias.

B is incorrect. Confirmation bias is a belief perseverance bias that seeks and notices what approves past beliefs and disregards anything that opposes them. It reflects a tendency to validate what we wish to believe and is unrelated to the base rate and sample size neglect.

CFA Level I, Portfolio Management, Learning Module 5: The Behavioral Biases of Individuals. LOS (b): Discuss commonly recognized behavioral biases and their implications for financial decision-making.

Q.4001 Which of the following is *least likely* a type of emotional bias?

A. Endowment bias.

B. Regret-aversion bias.

C. Illusion of control bias.

The correct answer is **C.**

Illusion of control bias is a cognitive error categorized as a form of belief perseverance bias that refers to the certainty that people can control or affect the conclusion when it is not possible in reality.

A is incorrect. Endowment bias is a form of emotional bias where people tend to appreciate an asset more when they have possession and conflicts with the standard economic theory.

B is incorrect. Regret-aversion bias is a category of emotional bias and occurs when individuals evade making conclusions for fear that it will be incorrect. Regret-aversion bias results either in actions that individuals take or those that they could have opted to take.

CFA Level I, Portfolio Management, Learning Module 5: The Behavioral Biases of Individuals. LOS (b): Discuss commonly recognized behavioral biases and their implications for financial decision making

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Q.4002 ABC Investments Ltd is an investment firm that handles a portfolio of investments for its clients and prides itself in recruiting CFA charterholders. On a recent open day, CEO Kyle Walker stated, *"On average most CFA charterholders work at investment firms."*
The statement by the CEO *most appropriately* indicates which behavioral bias?

A. Framing bias.

B. Availability bias.

C. Representativeness bias.

The correct answer is **B.**

The CEO is basing his observation on a limited range of experience, which is a form of availability bias, by recruiting CFA charterholders at Kyle and Myles Investment Ltd compared to the entire cluster of CFA charterholders recruited in other sectors.
A is incorrect. Framing bias is an information-processing bias that occurs when an individual responds to an inquiry differently based on the context in which it was asked. It is practically possible to explain a justification to an inquiry in more than one option. Framing bias is not applicable in the case of the CEO statement since he was not responding to an inquiry, for example, why the firm only prefers recruiting CFA Charterholders.

C is incorrect. Representation bias refers to the act of categorizing new information based on prior practices. The CEO's claim that the sample size, i.e., the number of CFA Charterholders employed at the investment firm, cannot be proven since data representing the population of CFA Charterholders employed in other sectors is unavailable.

CFA Level I, Portfolio Management, Learning Module 5: The Behavioral Biases of Individuals. LOS (b): Discuss commonly recognized behavioral biases and their implications for financial decision-making.

Q.4003 Which of the following strategies is *most appropriate* in mitigating self-control bias by financial market participants (FMPs)?

A. Drafting an investment plan and introducing personal budgets.

B. Scrutinizing investments and credibly considering the likelihood of future gains and losses.

C. Developing a suitable investment policy strategy through conducting in-depth research and scrutinizing prior investment decisions.

The correct answer is **A.**

Self-control bias occurs when individuals opt for short-term gratification as opposed to pursuing long-term goals.

Lack of self-control leads to individuals prioritizing current consumption instead of saving money for future investments, resulting in insufficient savings leading to investment decisions in risky portfolios in anticipation of higher returns.

Lack of self-control may also result in unnecessary borrowing to fund existing consumption.

To overcome self-control bias, the financial market participants (FMP) should design, document an investment plan and introduce a personal budget that can be reviewed regularly.

B is incorrect. It relates to preventing loss-aversion bias.

C is incorrect. It relates to mitigating availability bias.
CFA Level I, Portfolio Management, Learning Module 5: The Behavioral Biases of Individuals. LOS (b): Discuss commonly recognized behavioral biases and their implications for financial decision-making.

Q.4004 Disposition effect is *most accurately* defined as:

A. When an individual values an asset more when they possess it than when they don't.

B. When individuals take credit for good performance but blame others for poor performance.

C. Holding of investments that have recorded losses for a long period, and promptly disposing of investments that have recorded profits.

The correct answer is **C.**

The disposition effect is a concept embedded under loss-aversion bias.

It refers to the holding of investments that have recorded losses for a long period while promptly selling off investments that have recorded gains.

A is incorrect. It refers to endowment bias, whereby a person attaches value to an asset when they own it rather than when they don't.

B is incorrect. Self-attribution bias is when an individual takes too much credit for success but apportions blame others for failure.
CFA Level I, Portfolio Management, Learning Module 5: The Behavioral Biases of Individuals. LOS (b): Discuss commonly recognized behavioral biases and their implications for financial decision-making.

Q.4005 Which of the following strategies would *best describe* the mitigation process for regret-aversion bias? Financial market participants (FMPs) should:

A. ensure that an investment plan and personal budget are reviewed constantly.

B. properly diversify respective portfolios by accepting the appropriate risk and returns.

C. appropriately measure the risk-reducing and return enhancing changes and appropriate asset allocation returns.

The correct answer is **B.**

To mitigate regret aversion bias, the financial market participants should properly diversify by accepting the appropriate risk and returns of the respective portfolios.

A is incorrect. It indicates the measure to mitigate self-control bias.

C is incorrect. It relates to preventive measures for status quo bias.
CFA Level I, Portfolio Management, Learning Module 5: The Behavioral Biases of Individuals. LOS (b): Discuss commonly recognized behavioral biases and their implications for financial decision-making.

Q.4006 The sources of availability bias applied by financial market participants (FMPs) *least likely* consists of:

A. Reliability of the information.

B. Categorization of the information.

C. Wide range of experience on the part of FMPs.

The correct answer is **C.**

FMPs apply a narrow range and not a wide range of experience as an availability bias.

The FMPs apply a narrow range of knowledge and not a wide range when considering an estimate.

A and B are incorrect. Both reliability and categorization are sources of availability bias.

CFA Level I, Portfolio Management, Learning Module 5: The Behavioral Biases of Individuals. LOS (b): Discuss commonly recognized behavioral biases and their implications for financial decision-making.

Q.4007 Which of the following behavioral biases is *least likely* associated with momentum effect in a financial market?

A. Regret bias.

B. Availability bias.

C. Overconfidence bias.

The correct answer is **C.**

Overconfidence bias is associated with bubbles whereby investors are more active, and trading volume rises, reducing expected returns.

A and B are incorrect. Both regret and availability biases are associated with momentum effect.
CFA Level I, Portfolio Management, Learning Module 5: The Behavioral Biases of Individuals. LOS (c): Describe how behavioral biases of investors can lead to market characteristics that may not be explained by traditional finance.

Q.4008 Home bias anomaly is *most likely* to occur when:

A. Investors are proactive, and an increase in trading volume resulting in low returns.

B. A favorable evaluation is extended to some characteristics of stock compared to others.

C. Portfolios display a bias in favor of local securities compared to international portfolios.

The correct answer is **C.**

Home bias anomaly occurs when portfolios display a solid bias in favor of domestic securities compared to global portfolios.

A is incorrect. It depicts overconfidence bias which contributes to a bubble market whereby investors are proactive, and an increase in trading volume resulting in lower profits.

B is incorrect. It defines the halo effect in a stock value whereby favorable evaluation criteria are applied to certain stock characteristics compared to other stocks.
CFA Level I, Portfolio Management, Learning Module 5: The Behavioral Biases of Individuals. LOS (c): Describe how behavioral biases of investors can lead to market characteristics that may not be explained by traditional finance.

Q.4010 Value stocks are *most likely* characterized by which of the following?

A. High price-to-earnings ratio.

B. High book-to-market equity.

C. High price-to-dividends ratio.

The correct answer is **B.**

Value stocks are mainly characterized by low price-to-earnings ratios, high book-to-market equity, and low price-to-dividend ratios.

A is incorrect. Value stocks are characterized by a low price-to-earnings ratio and not a high price-to-earnings ratio.

C is incorrect. Value stocks are characterized by a low price-to-dividends ratio and not a high price-to-dividend ratio.

CFA Level I, Portfolio Management, Learning Module 5: The Behavioral Biases of Individuals. LOS (c): Describe how behavioral biases of investors can lead to market characteristics that may not be explained by traditional finance.

Q.4011 Which of the following is *least likely* a form of cognitive errors?

A. Processing errors.

B. Loss aversion bias.

C. Belief perseverance bias.

The correct answer is **B.**

Loss aversion bias is a form of emotional bias. There are six emotional biases: loss aversion, overconfidence, self-control, status quo, endowment, and regret aversion.

A and C are incorrect. Cognitive errors come in two forms: belief perseverance bias and processing errors.

CFA Level I, Portfolio Management, Learning Module 5: The Behavioral Biases of Individuals. LOS (b): Discuss commonly recognized behavioral biases and their implications for financial decision-making.

Q.4012 Which of the following biases *most likely* results from individuals tend to overweight their prior probability of the event and underweight the new information?

A. Conservatism bias.

B. Confirmation bias.

C. Representative bias.

The correct answer is **A.**

Conservatism bias is a belief perseverance bias in which people give their past beliefs too much weight and the new knowledge too little, resulting in outcomes that are underreacting to the new knowledge.
B is incorrect. Confirmation Bias is the tendency to seek out or recognize information that supports one's existing ideas while ignoring information that contradicts them.

C is incorrect. Representativeness bias is the tendency to categorize new information based on previous experiences and classifications.

CFA Level I, Portfolio Management, Learning Module 5: The Behavioral Biases of Individuals. LOS (b): Discuss commonly recognized behavioral biases and their implications for financial decision-making.

Q.4013 Which of the following is *least likely* a consequence of conservatism bias?

A. Slowness to update forecasts when presented with new information.

B. Considering only positive data and ignoring the negative about an existing investment.

C. Maintaining a previous belief rather than dealing with the stress of updating beliefs given new data.

The correct answer is **B.**

Considering only positive data and ignoring the negative data about an existing investment is a consequence of confirmation bias.

A and C are incorrect. The two consequences of conservatism bias are:

- Slow to update forecasts even when presented with new information.
- Maintaining a previous belief rather than dealing with the stress of updating beliefs given new data.

CFA Level I, Portfolio Management, Learning Module 5: The Behavioral Biases of Individuals. LOS (b): Discuss commonly recognized behavioral biases and their implications for financial decision-making.

Q.4014 Which of the following biases is *most likely* represents a bias in which individuals believe that they can control or influence outcomes when they actually cannot?

A. Hindsight bias.

B. Illusion of control bias.

C. Anchoring and adjustment bias.

The correct answer is **B.**

Illusion of control bias is individuals believe that they can control or influence outcomes when they actually cannot.
A is incorrect. Hindsight bias refers to the tendency to believe that past occurrences were predictable and reasonable to expect.

C is incorrect. Anchoring and adjustment bias refer to the practice of basing subsequent assessments, judgments, and conclusions on an initial piece of data.

CFA Level I, Portfolio Management, Learning Module 5: The Behavioral Biases of Individuals. LOS (b): Discuss commonly recognized behavioral biases and their implications for financial decision-making.

Q.4015 Which of the following is *least likely* a consequence of overconfidence bias?

A. Holding inadequately diversified portfolios.

B. Overestimating predicted gains and underestimating risks.

C. Choosing an investment based on the amount of advertising or press coverage.

The correct answer is **C.**

Choosing an investment based on the amount of advertising or press coverage is a consequence of availability bias.

A and B are incorrect. Consequences of overconfidence bias include:

- Holding inadequately diversified portfolios, leading to high downside risk;
- Overestimating predicted gains and underestimating risks.

CFA Level I, Portfolio Management, Learning Module 5: The Behavioral Biases of Individuals. LOS (b): Discuss commonly recognized behavioral biases and their implications for financial decision-making.

Q.4016 Which of the following is *least likely* a consequence of self-control bias?

A. Saving insufficiently for the future.

B. Borrow excessively to finance current spending.

C. Failing to investigate other investing opportunities.

The correct answer is **C.**

Failing to investigate other investing opportunities is a consequence of status quo bias.

A and B is incorrect. Consequences of self-control bias include:

- Save insufficiently for the future, which may lead to portfolios taking on too much risk in the pursuit of higher returns;
- Borrow excessively to finance current spending.

CFA Level I, Portfolio Management, Learning Module 5: The Behavioral Biases of Individuals. LOS (b): Discuss commonly recognized behavioral biases and their implications for financial decision-making.

Q.4017 Which of the following is *most likely* a consequence of availability bias?

A. A lack of diversification.

B. Borrow excessively to finance current spending.

C. Overestimating predicted gains and underestimating risks.

The correct answer is **A.**

A lack of diversification is a consequence of availability bias. This failure may occur because individuals' decisions are based on a limited set of experiences.

B is incorrect. Borrowing excessively to finance current spending is a consequence of self-control bias.

C is incorrect. Overestimating predicted gains and underestimating risks is a consequence of overconfidence bias.
CFA Level I, Portfolio Management, Learning Module 5: The Behavioral Biases of Individuals. LOS (b): Discuss commonly recognized behavioral biases and their implications for financial decision-making.

Q.4018 Which of the following is *most likely* a method of detecting and overcoming loss aversion bias?

A. A disciplined investment approach.

B. Fearing that profits may diminish, selling investments in a gain position much earlier.

C. Using fundamental analysis to keep investments in a loss position for longer than necessary.

The correct answer is **A.**

A disciplined investment approach is a good way to alleviate the impact of the loss-aversion bias.

B and C are incorrect. Fearing that profits may diminish, selling investments in a gain position much earlier than justified by fundamental analysis and using fundamental analysis to keep investments in a loss position for longer than necessary in the hopes of recouping losses are consequences of loss aversion bias.
CFA Level I, Portfolio Management, Learning Module 5: The Behavioral Biases of Individuals. LOS (b): Discuss commonly recognized behavioral biases and their implications for financial decision-making.

Q.4019 Which of the following is *most likely* an emotional bias in which investors avoid making decisions for fear of making a bad decision?

A. Status quo bias.

B. Endowment bias.

C. Regret-aversion bias.

The correct answer is **C.**

Regret-aversion bias is an emotional bias in which investors avoid making judgments for fear of making a bad decision. It has two dimensions: actions taken by people and actions that people may have taken.

Regret-aversion bias is an emotional bias in which investors avoid making judgments for fear of making a bad decision. It has two dimensions: actions taken by people and actions that people may have taken.

A is incorrect. Status quo bias is an emotional bias where people prefer to do nothing rather than change, even when change is necessary.

B is incorrect. Endowment bias is an emotional bias where people value an asset higher when they own it than when they don't.
CFA Level I, Portfolio Management, Learning Module 5: The Behavioral Biases of Individuals. LOS (b): Discuss commonly recognized behavioral biases and their implications for financial decision-making.

Q.4020 Which of the following is *least likely* a belief perseverance bias?

A. Hindsight bias.

B. Conservatism bias.

C. Loss aversion bias.

The correct answer is **C.**

Loss aversion bias is an emotional bias. There are six emotional biases. These are loss aversion, overconfidence, self-control, status quo, endowment, and regret aversion.

A and B are incorrect. The belief perseverance biases include conservatism, confirmation, representativeness, illusion control, and hindsight. They are caused by the mental discomfort that emerges when new knowledge contradicts previously held concepts, known as cognitive dissonance.
CFA Level I, Portfolio Management, Learning Module 5: The Behavioral Biases of Individuals. LOS (b): Discuss commonly recognized behavioral biases and their implications for financial decision-making.

Q.4021 Which of the following is *most likely* a consequence of conservatism bias?

A. Properly analyzing and considering new information.

B. Slow to update forecasts even when presented with new information.

C. Developing a screening criterion while ignoring information that contradicts the validity of the criteria.

The correct answer is **B.**

Conservatism bias is a belief perseverance bias in which people mistakenly incorporate new contradicting information into their previous beliefs. The consequences of conservatism bias are:

- Slow to update forecasts even when presented with new information.
- Maintaining a previous belief rather than dealing with the stress of updating beliefs given new data.

A is incorrect. Properly analyzing and considering new information is a method of detecting and overcoming conservatism bias.

C is incorrect. Developing a screening criterion while ignoring information that contradicts the validity of the criteria is a consequence of confirmation bias.
CFA Level I, Portfolio Management, Learning Module 5: The Behavioral Biases of Individuals. LOS (b): Discuss commonly recognized behavioral biases and their implications for financial decision-making.

Learning Module 6: Introduction to Risk Management

Q.125 Which risk is *most likely* to disappear when you have a diversified portfolio?

A. Interest rate risk

B. Systematic risk

C. Unsystematic risk

The correct answer is **C.**

Unsystematic risk: The risk that is specific to an industry or firm.
Systematic risk: Also called market risk
Diversifying will not change interest rate risk.
A is incorrect. Interest rate risk is a type of systematic risk that affects all securities in the market. It is the risk that arises from the fluctuation in interest rates which can affect the value of investments in bonds and other fixed-income securities. Since interest rate changes impact the entire market, diversifying a portfolio cannot eliminate this risk. Interest rate risk is inherent to all investments and must be managed, but not through diversification alone.

B is incorrect. Systematic risk, also known as market risk, is the risk inherent to the entire market or market segment. This type of risk is caused by factors that affect the overall economy or securities markets, such as changes in interest rates, inflation, recessions, or political instability. Since systematic risk affects the entire market, it cannot be eliminated through diversification. All stocks and securities are subject to systematic risk, making it impossible to avoid through traditional diversification methods.

CFA Level I, Portfolio Management, Learning Module 6: Introduction to Risk Management. LOS (b): Describe features of a risk management framework.