Capstone Reference Material
Listing of Behavioral Biases and Brief Definitions

Behavioral Biases

Belief Perseverance Biases

Conservativeness – Overweighting of initial beliefs (base rate is over emphasized)
- **Confirmation –** Tendency to look for and overvalue trends that confirm beliefs and ignore or undervalue contradictory trends

Representativeness – Belief perseverance based on classification of new information into past experiences
- **Base rate neglect** – Underweighting the information already have (the "base rate") and overweighting new information

- **Sample size neglect** (sometimes called "law of small numbers") **–** When judging data, fail to take small number of sample into consideration

Emotional Biases

Prospect Theory (also called **Loss Aversion) –** Investors strongly prefer avoiding losses (asymmetrical utility function which is convex for losses and concave for gains)

Overconfidence – People tend to overestimate the precision of their beliefs or abilities.
- **House money effect –** Take riskier bets after wins because playing with "house money"

Regret aversion – Reluctance to take action out of fear of making a poor decision

Hot hand phenomenon – Belief that winning trend will continue

Gambler's fallacy – Belief that an event (or continuation of a trend) is less likely to happen because that event (or trend) has already happened

Information Processing Biases

Anchoring – Relies too heavily on initial number ("anchor") which is then adjusted up or down

Framing – How question is asked causes different decisions even though information is the same

Mental accounting – One sum of funds or investments is treated differently than others

Market Puzzles

Equity Premium Puzzle – Why equity premium so large relative to risk free rate can be the result of loss aversion plus frequent evaluations

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- **Myopic loss aversion** and mental accounting

Post-Earnings Announcement Drift – Stocks with positive (negative) earnings surprises tend drift in the following weeks toward stronger (weaker) returns

Long-Term Reversals – OverLoss longer horizon (3-5 years) losers rebound and winners fade back to average returns

Momentum – Better returns by buying short-term (6 months – 1 year) high performers and selling low performers without extra risk

Small firm effect (size effect) – Small market cap have historically high returns relative to market

Value effect – Low market to book value stocks have high returns relative to systematic risk

Mutual fund performance – Investors buy actively-managed mutual funds even though they persistently underperform passive funds after fees

Individual Investor Biases

Disposition effect – Tendency to hold onto losing investments (loss aversion)

Naïve diversification – Use simple strategies like dividing wealth equally across investment options

Keeping up with the Joneses – Relative utility function set vs. peers (relative performance rather than absolute performance)

Home bias – Preference for local stocks

Good stocks are stocks of good companies

Attention – Buy decisions driven by more attention than sell decisions
- Attention grabbing or "all that glitters" stocks