1. Which of the following statements is <u>not</u> correct?

   a. Traditional finance assumes investors are risk averse and make unbiased, utility maximizing decisions.

      This is not the correct answer, since the statement is accurate.

   b. Behavioral finance tries to explain the observed investor behavior, which is not fully explained by traditional finance.

      This is not the correct answer, since the statement is accurate.

   c. Traditional finance assumes that investors can correctly update their expectations when they receive new information.

      This is not the correct answer, since the statement is accurate.

   d. Behavioral finance explains how investors should behave based on mathematical models and theories.

      Yes, this is the incorrect statement. Behavioral finance tries to explain the observed investor behavior, which is not fully explained by traditional finance that relies on mathematical models and theories.

   <u>Answer:</u>

   The correct answer is d.

2. The behavioral life-cycle models assume that investors classify their wealth as current income, currently owned assets, or present value of future income. Which of the following would explain this behavior?

   a. Risk aversion

      No, this is not the correct answer.

   b. Framing

      Yes, this is the correct answer. Framing can explain the tendency of people to segregate their wealth.

   c. Overconfidence

      No, this is not the correct answer.

   d. Under-diversification

      No, this is not the correct answer.

   <u>Answer:</u>

   The correct answer is b.

3. Which of the following is most likely an example of an emotional bias?

   a. You base decisions on only a subset of available information

No, this is not the correct answer because this is an information processing error.

b. You react impulsively to a negative earnings announcement by selling stock

Yes, this is the correct answer. The decision is solely based on loss aversion.

c. You remain invested in a profitable technology stock even though new information indicates that PE is too high.

No, this is not the correct answer because this is an information processing error.

d. You have difficulty interpreting new information

No, this is not the correct answer because this is an information processing error.

Answer:

The correct answer is b.

4. Which of the following is most likely an example of a cognitive bias?

a. You take on more and more risk because you mentally attribute your recent investing success to your strategies

Yes, this is the correct answer. This is an example of cognitive bias.

b. You experience a large loss on an investment because you had hoped to recover your losses from a negative position but the position worsened

No, this is not the correct answer.

c. You end up under-diversified because you do not take a holistic approach to portfolio construction.

No, this is not the correct answer.

d. You tend to naively extrapolate past returns into the future.

No, this is not the correct answer.

Answer:

The correct answer is a.

5. Which of these statements is not correct?

a. The disposition effect can be explained by a desire to optimize taxes.

Yes, this is the incorrect statement. The disposition effect actually is opposing to the desire to optimize taxes.

b. Investors usually exhibit overconfidence, leading to excessive trading and underestimating the risk involved.

This is not the correct answer, since the statement is accurate.

c. Confirmation bias and self-attribution bias, which is when investors take personal credit for the success of their trades, both contribute to overconfidence.

This is not the correct answer, since the statement is accurate.

d. When investors are overconfident, portfolios become concentrated, and they reject contradictory information.

   This is not the correct answer, since the statement is accurate.

Answer:

The correct answer is a.

6. Abe Tyler and John Petersen are portfolio managers for the largest mutual fund of Corsera Financial Advisors, which provides a wide range of mutual funds for both individual and institutional investors. Abe Tyler has been a portfolio manager for more than ten years. He has experienced both bull and bear markets. Tyler has hired Petersen, who serves as his assistant a few years back, and while Petersen has a MBA degree from a prestigious b-school and has proved to be a quick learner, he has only been with Corsera Financial Advisors for three years. Petersen looks up to Tyler and hopes he will learn as much as he can from him.

   At the end of the day, the two usually spend time together discussing strategy as well as the latest quarterly earnings announcements for several firms in their portfolios. Despite analysts' optimistic projections, the most recent earnings have been disappointing. Petersen states to his boss that he is not convinced that the prospects for these firms are as grim as the most recent announcements suggest.

   A couple of days later, Petersen and Tyler together provide a presentation to Corsera Financial Advisors' clients. They have invited a prominent economist, Jack Sullivan, at the local university who often provides economic commentary for national financial media outlets. Sullivan predicts an oncoming recession, stating the country is likely to enter a recession in the coming year. He recommends that the clients move their assets into investment grade bonds and noncyclical stocks. Sullivan feels very certain of his forecasts. He adds that he has successfully predicted every downturn in the past 15 years, with the exception one. He explains that had the Congress had not unexpected changed course to increase spending, he would have been right on that one, too.

   Later in the day, Tyler takes the lead and discusses with the clients the various strategies at Corsera Financial Advisors. He explains that the neglected firm/value strategy seeks firms trading reasonable valuations with no analyst coverage. Tyler points out to academic research that indicates that these firms to outperform over a three-year horizon. Tyler states that his portfolio in particular has adopted this strategy.

   Later that evening, Tyler and Petersen meet with Sullivan for dinner to discuss the day's events. Commenting on investment strategies, Sullivan talks about his own focus on growth stocks with past six-quarter earnings growth and how he monitors his portfolio on a quarterly basis. Sullivan also states that when the short-term moving average rises above the long-term moving average, he takes this to be an opportune time to trade.

Which of the following best describes Petersen's behavior characteristics?

a. Anchoring

   Yes, this is the correct answer. Petersen is relying on the initial analysts' optimistic projections and overlooks what the most recent announcements suggest for the prospects of those firms.

b. Framing

   No, this is not the correct answer.

c. Loss aversion

   No, this is not the correct answer.

d. Disposition effect

   No, this is not the correct answer.

Answer:

The correct answer is a.

7. Abe Tyler and John Petersen are portfolio managers for the largest mutual fund of Corsera Financial Advisors, which provides a wide range of mutual funds for both individual and institutional investors. Abe Tyler has been a portfolio manager for more than ten years. He has experienced both bull and bear markets. Tyler has hired Petersen, who serves as his assistant a few years back, and while Petersen has a MBA degree from a prestigious b-school and has proved to be a quick learner, he has only been with Corsera Financial Advisors for three years. Petersen looks up to Tyler and hopes he will learn as much as he can from him.

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Which of the following describes Sullivan's behavior characteristics?

a. Framing

No, this is not the correct answer.

b. Anchoring

No, this is not the correct answer.

c. Overconfidence

Yes, this is the correct answer. He tends to overestimate the precision of his forecasts.

d. Loss aversion

No, this is not the correct answer.

Answer:

The correct answer is c.

8. Abe Tyler and John Petersen are portfolio managers for the largest mutual fund of Corsera Financial Advisors, which provides a wide range of mutual funds for both individual and institutional investors. Abe Tyler has been a portfolio manager for more than ten years. He has experienced both bull and bear markets. Tyler has hired Petersen, who serves as his assistant a few years back, and while Petersen has a MBA degree from a prestigious b-school and has proved to be a quick learner, he has only been with Corsera Financial Advisors for three years. Petersen looks up to Tyler and hopes he will learn as much as he can from him.

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Which of the following can be an explanation for Sullivan's defense of his past inaccurate forecast?

a. Hindsight bias

No, this is not the correct answer.

b. Confirmation bias

No, this is not the correct answer.

c. Self-attribution

Yes, this is the correct answer. Sullivan attributes his accurate forecasts to his capabilities, but blames the inaccurate one on bad luck.

d. Representativeness

No, this is not the correct answer.

Answer:

The correct answer is c.