

1. Which of the following describes investors' behavior in being too slow in updating their beliefs in response to new information?

a. Overconfidence

No, this is not the correct answer.

b. Conservatism

Yes, this is the correct answer. Conservatism bias has to do with the fact that investors respond conservatively to the new information and they are anchored to the old information.

c. Framing

No, this is not the correct answer.

d. Regret avoidance

No, this is not the correct answer.

Answer:

The correct answer is b.

2. Which of the following is the technical name for people's desire to find information that agrees with their existing view?

a. Conservatism

No, this is not the correct answer.

b. Framing

No, this is not the correct answer.

c. Confirmation bias

Yes, this is the correct answer. Confirmation bias is the tendency to interpret new evidence as supporting one's existing beliefs.

d. Over-optimism

No, this is not the correct answer.

Answer:

The correct answer is c.

3. Participants in an experiment were taken to a house for sale, asked to inspect the house for 20 minutes, given a 10-page handout giving information about the house and about other houses in the area. The handout given to subjects were identical except for the asking price. Subjects were then asked their opinions of the appraisal value, appropriate listing, purchase price and the lowest offer price they would personally accept. Agents who were given an asking price of \$119,900 had a mean predicted appraisal value of \$114,201, listing price of \$117,745, a purchase price of \$111,454, and a lowest

acceptable price of \$111,136. Subjects who were given an initial asking price of \$149,900 had a mean appraisal value of \$128,754, listing price of \$130,981, predicted purchase price of \$127,318 and a lowest offer price of \$123,818. What bias does this experiment illustrate?

- a. Overconfidence

No, this is not the correct answer.

- b. Conservatism

No, this is not the correct answer.

- c. Framing

No, this is not the correct answer.

- d. Anchoring

Yes, this is the correct answer. The subjects were anchored to the asking price given to them and the prices that they suggested were related to that initial value.

Answer:

The correct answer is d.

4. Kahneman and Tversky (1973) asked people the following: “In a typical example of text in the English language, is it more likely that a word starts with the letter K or that K is its third letter?” Of the 152 people in the sample, 105 generally thought that words with the letter in the first position were more probable. However, in reality there are approximately twice as many words with K as the third letter as there are words that begin with K. People index on the first letter, and can recall them easier. Which bias does this example illustrate?

- a. Overconfidence

No, this is not the correct answer.

- b. Conservatism

No, this is not the correct answer.

- c. Confirmation bias

No, this is not the correct answer.

- d. Availability bias

Yes, this is the correct answer. This is a case of availability bias, since people would rely on what is more readily available to recall.

Answer:

The correct answer is d.

5. If an investor sees many periods of good earnings then she is inclined to believe that the firm is one with particularly high earnings growth, and hence is likely to continue to deliver future high earnings growth. This is an illustration of which bias?

a. Overconfidence

No, this is not the correct answer.

b. Representativeness

Yes, this is the correct answer. In the case of representativeness bias, the investor is overweighting prior belief and believes that future earnings will continue to be high.

c. Availability bias

No, this is not the correct answer.

d. Loss aversion

No, this is not the correct answer.

Answer:

The correct answer is b.

6. A person may reject an investment when it is posed in terms of risk surrounding potential gains, but may accept the same investment if it is posed in terms of risk surrounding potential losses. What is this an example of?

a. Framing

Yes, this is the correct answer. This is an example of framing where individuals may act risk averse in terms of gains but risk seeking in terms of losses.

b. Regret avoidance

No, this is not the correct answer.

c. Overconfidence

No, this is not the correct answer.

d. Conservatism

No, this is not the correct answer.

Answer:

The correct answer is a.

7. What type of utility function does the behavior in question 6 describe?

a. Mean-variance utility

No, this is not the correct answer.

b. Prospect utility

Yes, this is the correct answer. Under prospect theory, the utility function is defined in terms of losses relative to current wealth. It is convex of losses and concave over gains.

c. Keeping up with the Joneses

No, this is not the correct answer.

d. Habit utility

No, this is not the correct answer.

Answer:

The correct answer is b.

8. What types of errors lead investors to misestimate the true probabilities of possible events or associated rates of return?

a. Regret avoidance

No, this is not correct answer. Mental accounting errors

No, this is not the correct answer.

b. Framing errors

No, this is not the correct answer.

c. Information processing errors

Yes, that is the correct answer. Errors in information processing can lead investors to misestimate the true probabilities of possible events. Overconfidence, conservatism, or representativeness bias are all examples of information processing errors.

Answer:

The correct answer is d.

9. Conservatism explains why investors are too _____ in updating their beliefs in response to news, and hence, they initially _____ to news.

a. quick; overreact

No, this is not the correct answer.

b. quick; underreact

No, this is not the correct answer.

c. slow; underreact

Yes, this is the correct answer. Conservatism explains why investors are too slow to update their beliefs in respond and initially underreact to news.

d. slow; overreact

No, this is not the correct answer.

Answer:

The correct answer is c.

10. Which of these following statements is not correct?

- a. Traditional theory assumes that utility functions are concave and defined in terms of wealth.

No, this is not the correct answer, since the statement is accurate.

- b. Prospect theory assumes that utility functions are S-shaped.

No, this is not the correct answer, since the statement is accurate.

- c. Prospect theory assumes that utility functions are convex over gains and concave over losses.

Yes, this statement is not correct. The statement should be rephrased as “Prospect theory assumes that utility functions are concave over gains and convex over losses”, in order to be correct.

- d. Prospect theory assumes utility functions are defined over gains and losses.

No, this is not the correct answer, since the statement is accurate.

Answer:

The correct answer is c.