Economics 252 – Financial Markets

Spring 2011

Lecture 10: Behavioral Finance and the Role of Psychology

February 21, 2011

Multiple Choice Questions

Question 11.1

Adam Smith in *The Theory of Moral Sentiments* from 1776 emphasizes that people's actions are not completely driven by selfishness, but by another important motive. What is this motive?

(a) The Antisocial Personality Disorder.
(b) A desire for praiseworthiness.
(c) Social contagion.
(d) Cognitive dissonance.

Question 11.2

Which of the following components are not part of Daniel Kahneman's and Amos Tversky's Prospect Theory?
(More than one answer may apply.)

(a) A value function that evaluates the outcome of the different prospects.
(b) A value function that is concave in gains and convex in losses, with a kink at the reference point that separates the gains- from the loss-region.
(c) An overconfidence-factor that is directly applied to the value function in the loss-region.
(d) A probability weighting function that overvalues small probabilities and undervalues probabilities close to one.

Question 11.3

Which of the following phenomena are attributable to overconfidence?
(More than one answer may apply.)

(a) The tendency for people to think that they have very smart friends.
(b) The tendency to think that CEOs are geniuses.
(c) The fact that only between 5 and 10% of the students in the class had the correct weight of the earth within their 90% confidence interval.
(d) The tendency to avoid anything that you might regret later.

Question 11.4

Sendhil Mullainathan and his co-authors conducted an experiment, in which they sent actors to financial advisors. They found that the financial advisors did not challenge the assumptions that supposedly made these ”clients” put all their money in one kind of investment. Which psychological phenomenon has been cited to be responsible for this behavior?

(a) The financial advisors did not want to stir up cognitive dissonance feelings in their “clients”.
(b) The financial advisors were overconfident about their own ability as financial advisors.
(c) The financial advisors were influenced by Kahneman’s and Tversky’s probability weighting function, which lead them to overweight very small probabilities.
(d) The financial advisors suffered from Antisocial Personality Disorder.

Question 11.5

What is the main point of Anna Bernasek’s *Economics of Intergrity*?

(a) She outlines that a sense of personal integrity has dominated what people do in the business world much more than we thought recently.
(b) She points out that that the manager of a company shouldn't be underestimating the importance of shared value creation with society.
(c) She states that most of the things that happen in life are just chance.
(d) She claims that there's a tendency for people to think that CEOs are geniuses.

Correct Answers

11.1: (b)
11.2: (c)
11.3: (a), (b), and (c)
11.4: (a)
11.5: (a)