Written Re-Exam for the course

Behavioral Economics and Finance

Master's Course

Date: 17/2/2015

(2-hour, closed book exam)

The exam consists of 3 different questions (with sub-questions).

Good luck.

(1) Overconfidence:

(a) Explain the experimental set-up that Camerer and Lovallo (1999) [i.e *Camerer & Lovallo (1999), Overconfidence and Excess Entry: An Experimental Approach, American Economic Review, 89(1), 306-18*] use to test for overconfidence and explain their results.

(b) Explain how overconfidence might influence the investment decisions of managers as analyzed by Malmendier and Tate (2005) [i.e. *Malmendier & Tate (2005), CEO Overconfidence and Corporate Investment, JFE, 60(6), 2661-2700*]

(2) Representativeness and conservatism:

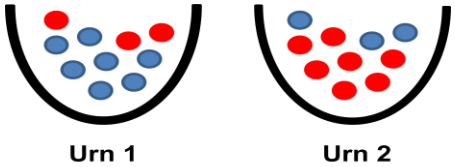
(a) Consider the following example:

- A cab was involved in a hit and run accident at night.
- Two cab companies, the Green and the Blue, operate: 85% of cabs in the city are Green and 15% are Blue
- A witness identified the cab as Blue. The court tested the reliability of the witness under the same circumstances that existed on the night of the accident and concluded that the witness correctly identified each one of the two colors 80% of the time and failed 20% of the time.

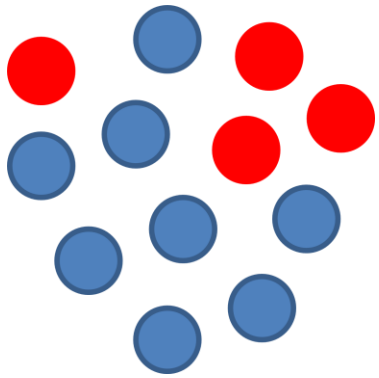
What do people usually answer to the following question related to this Taxicab example and how does this compare to the true answer:
"What is the probability that the cab involved in the accident was Blue rather than Green knowing that this witness identified it as Blue?"
Discuss how this is related to the representativeness heuristic and why using the representativeness heuristic means that people's evaluations are unresponsive to prior probabilities.

(b) Consider the following urn example:

Someone has randomly drawn 12 times from Urn 1 or 2 restoring the ball to the urn after each draw .



The sample that was drawn looks as follows:



What is the likelihood that the sample was drawn from Urn 1 and what do people usually answer to this question? Use this example to explain the conservatism bias and discuss the consequences of this bias for the stock market.

(3) Social Preferences:

(a) Formally define and explain the concept of inequity aversion as defined by Fehr and Schmidt (1999) [i.e. Fehr & Schmidt (1999), A theory of fairness, competition, and cooperation, Quarterly Journal of Economics 114(3), 817–868].

(b) Consider an ultimatum and dictator game. Formally explain how players motivated by inequity aversion as defined by Fehr and Schmidt (1999) behave in this game.