Written Re-Exam for the course

Behavioral Economics and Finance

Master's Course

Date: 18 February 2013

(2-hour, closed book exam)

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

Good luck.

(1) The Disposition Effect:

(a) Explain what the disposition effect is and why prospect theory predicts the disposition effect.

(b) Explain how Weber and Camerer (JEBO, 1998) test for the disposition effect experimentally in their paper entitled `The disposition effect in securities trading: an experimental analysis´. Explain their experimental set-up and results.

(2) Representativeness:

(a) Explain the representativeness heuristic and how the representativeness heuristic can lead to the gambler's and hot hand fallacy. Furthermore, define the gambler's and hot hand fallacy.

(b) Consider the following situation featuring a Bayesian decision maker and a decision maker that evaluates situations according to the model by Rabin (2002) (called Rabin Type):

An observer believes that there is an equal chance a fund manager can be any of three types, bad, average, or good, who outperforms other mutual funds 1/3, 1/2, or 2/3 of the time, respectively

What does he infer concerning the type of the fund manager from two good years in a row, if he is a Bayesian and what does he infer, if he is a Rabin Type with N=6?

Does this example feature the gambler's or hot-hand fallacy? Explain why?

(3) Social Preferences: There is by now a large amount of evidence showing that people are not only motivated by their material self-interest. People also seem to care about others' outcomes, expectations and intentions. Against the background of this empirical finding models of "distributional concerns", "guilt aversion" and "reciprocity" have been developed.

(a) Explain the model of inequality aversion presented by Fehr and Schmidt (QJE, 1999) with the help of the Dictator Game discussed in class.

(b) Explain why linear inequality aversion a la Fehr and Schmidt (QJE, 1999) leads to too extreme predictions in the context of the Dictator Game. The authors suggest a simple change in their model to `fix´ this. What is their proposition to solve the problem of the extreme prediction?