

Written Exam at the Department of Economics winter 2020-21 R

Behavioral Finance

Final Exam

12 February 2021

(2-hour open book exam)

Answers only in English.

The paper must be uploaded as one PDF document. The PDF document must be named with exam number only (e.g. '127.pdf') and uploaded to Digital Exam.

This exam question consists of 2 pages in total

This exam has been changed from a written Peter Bangsvej exam to a take-home exam with helping aids. Please read the following text carefully in order to avoid exam cheating.

Be careful not to cheat at exams!

You cheat at an exam, if you during the exam:

- Copy other people's texts without making use of quotation marks and source referencing, so that it may appear to be your own text. This also applies to text from old grading instructions.
- Make your exam answers available for other students to use during the exam
- Communicate with or otherwise receive help from other people
- Use the ideas or thoughts of others without making use of source referencing, so it may appear to be your own idea or your thoughts
- Use parts of a paper/exam answer that you have submitted before and received a passed grade for without making use of source referencing (self plagiarism)

You can read more about the rules on exam cheating on the study information pages in KUnet and in the common part of the curriculum section 4.12.

Exam cheating is always sanctioned with a warning and dispeiling from the exam. In most cases, the student is also expelled from the university for one semester.

Intertemporal decision making

- a) Please give an example of a financial decision that involves a temporal dimension (i.e. a tradeoff of benefits and costs that occur at different points in time). Explain in detail how standard economic theory has addressed this time dimension. Describe how time preferences are usually measured experimentally and the evidence we discussed in the course regarding short and long term discounting.
- b) Take this evidence on short vs long term discounting as a starting point to formally explain the model of quasi-hyperbolic discounting discussed during the course. Give an example of how quasi-hyperbolic discounting affects financial decisions involving a temporal dimension.

The Disposition Effect

- a) Explain the disposition effect and formally explain how prospect theory can rationalize it.
- b) Odean (1998) [*Odean (1998), Are Investors Reluctant to Realize Their Losses?, Journal of Finance, 53(5), 1775-1798*] also presents an alternative behavioral explanation. What is this alternative explanation? Furthermore, Odean empirically tests the disposition effect. Please explain Odean's methodological approach and results. In doing so, please explain why his analysis is not able to distinguish between the two behavioral hypotheses (i.e. prospect theory and the alternative).

Heuristics and Financial Decision Making

- a) What are the different judgement biases we discussed during this course. Please give examples that show how using these heuristics might impact people's financial decision making.
- b) Barberis et al. (1998) present a model of investor sentiment featuring judgement biases that lead to under / overreaction [Nicholas Barberis, Andrei Shleifer & Robert Vishny (1998), A model of investor sentiment, *Journal of Financial Economics*, 49, 307-343]. Please explain their model in detail and relate it to the judgment biases you mentioned in your answer to subquestion a).