Written Exam at the Department of Economics winter 2017-18

Behavioural Finance

Final Exam

19-12-3017

(2-hour closed book exam)

Please note that the language used in your exam paper must correspond to the language for which you registered during exam registration.

This exam question consists of 3 pages in total

NB: If you fall ill during an examination at Peter Bangsvej, you must contact an invigilator in order to be registered as having fallen ill. In this connection, you must complete a form. Then you submit a blank exam paper and leave the examination. When you arrive home, you must contact your GP and submit a medical report to the Faculty of Social Sciences no later than seven (7) days from the date of the exam.

Please answer all questions as concise and short as possible!

Good Luck!

Question 1 - Judgements

a) What is a judgement heuristic. Which judgement heuristics did we discuss in this course? Please explain them in detail. Which consequences do they potentially have for financial decision making.

b) Explain the gambler's fallacy and why the representativeness heuristic can lead to it. Give a short example highlighting how the gambler's fallacy might influence financial decision making.

Question 2 – Decision under risk

a) Explain prospect theory. In doing so please highlight the behavioural regularities it is based upon.

b) Please explain the equity premium puzzle and how myopic loss aversion might help to explain it?

c) Please explain the disposition effect. Highlight why it implies irrational behaviour on the side of investors. Which parts of prospect theory can explain the disposition effect?

Question 3 – Behavioural corporate finance

(4) Behavioural corporate finance focuses on explaining financial contracts and real investment behaviour that emerge from the interaction of (i) managers and (ii) investors. It allows for irrationalities and biases on the managers as well as the investors side.

a) Malmendier & Tate (2005), CEO Overconfidence and Corporate Investment, JFE, 60(6), 2661-2700 analyses managers that are biased. Please describe the focus of their study and their results.

b) In contrast to their study, there is another strand of the literature that assumes that managers are rational and investors are irrational. What are the consequences of investor irrationality and how does this change the objective function of managers? Please describe the three

different ‘objectives’ managers might have in this situation which were discussed in the course?