

Written Exam at the Department of Economics winter 2016-17

Behavioral Finance

Final Exam

14-12-2016

(3-hour closed book exam)

This exam question consists of 2 pages in total (including cover page)

NB: If you fall ill during the actual examination at Peter Bangsvej, you must contact an invigilator in order to be registered as having fallen ill. 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!

Question 1

(1.a) Explain concisely miscalibration, why miscalibration represents a form of overconfidence and how it is measured. Also discuss the possible difficulties / confounds of the way in miscalibration is measured. Describe an example highlighting how miscalibration influences financial/investment decisions.

Question 2

(1.b) Briefly define the representativeness heuristic and give a short example highlighting how the representativeness heuristic influences judgements and financial decisions.

(1.c) During one of the lectures and in the context of the assignment we talked about the gambler's and the hot-hand fallacy. We also went through examples based on the model by Rabin (2002), Inferences by Believers in the Law of Small Numbers, Quarterly Journal of Economics, 117(3), 775-816.

Given this, please consider the following situation and answer the subsequent question:

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 $1/5$, $2/5$, or $3/5$ of the time, respectively. What does he infer concerning the type of the fund manager from two bad years in a row, if he is a Bayesian and what does he infer, if he is a Rabin Type with $N=4$?

Question 3

(2.a) Please explain formally how economic theory has traditionally modelled decisions that have consequences (costs/benefits) at different points in time? In explaining the traditional model, please highlight the most fundamental consequence of this approach?

(2.b) Why have economists started to criticize this traditional approach? Please formally explain the β - δ -model which has been suggested as a new, descriptively more accurate way to capture intertemporal decision making.

Question 4

(3.b) Explain the equity premium puzzle. Furthermore, explain how myopic loss aversion can account for it.