Written Exam at the Department of Economics winter 2019-20

Behavioural Finance

Final Exam

18-12-2019

(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 2 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 – Overconfidence

a) Explain the different notions of overconfidence that we discussed in class. Which notion of overconfidence is used in Malmendier & Tate (2005), CEO Overconfidence and Corporate Investment, JFE, 60(6), 2661-2700? Explain.

   Points that need to be included: The answer should include a definition of Miscalibration, Positive illusion, Better-than-average effect, Illusion of control and Unrealistic optimism (see also slide 5 and following as well as the relevant parts in the mandatory readings). Furthermore, the answer should explain which type (i.e. notion) of overconfidence is considered in Malmendier & Tate (2005).

b) Explain the different kinds of consequences that overconfidence might have on the financial decisions of traders and managers. Please discuss in particular the results of Barber & Odean, 2001, Boys will be Boys: Gender, Overconfidence, and Common Stock Investment, QJE, 116(1), 261-292

   Points that need to be included: The answer should explain that overconfidence leads to security misvaluations and excessive trading volumes. Furthermore, it should be explained that overconfidence has shown to have an effect on corporate decisions:

   i) Merger and acquisition activities of corporations and

   ii) Internal corporate financing structures

   Point ii) in particular refers to the discussion we had around Malmendier & Tate (2005)'s analysis.

   Moreover, the answer should discuss the analysis and results presented in the article "Barber & Odean, 2001, Boys will be Boys: Gender, Overconfidence, and Common Stock Investment, QJE, 116(1), 261-292"

Question 2 – Decision under risk and uncertainty

In our financial decisions, we are often faced with risk and uncertainty.

a) Please explain prospect theory. In your explanation, please highlight clearly its difference to expected utility theory.

   Points that need to be included: The answers should include the relevant points that can be found in the lecture material "03_Prospect Theory_I_2019" and "04_Prospect Theory_II_2019" as well as the mandatory reading to this block. The differences between

Expected Utility Theory as well as Prospect Theory should be highlighted. Furthermore, the answer should include a concise discussion of the different assumptions made about the probability weighting function as well as the value function.

b) How can prospect theory explain the disposition effect? Furthermore, explain the empirical evidence presented in Weber & Camerer (1998), The disposition effect in securities trading: an experimental analysis, Journal of Economic Behavior & Organization, Vol. 33, 167-184
Points that need to be included: The answer should explain how prospect theory can explain the disposition effect. The two elements that are central here are the reference point effect and the reflection effect. The answer should show 'how' these two elements of prospect theory can explain the disposition effect. Furthermore, the answer should discuss the analysis and results of Weber & Camerer (1998)

Question 3 – Under and Overreaction to news

a) Please explain the model presented in Nicholas Barberis, Andrei Shleifer & Robert Vishny (1998), A model of investor sentiment, Journal of Financial Economics, 49, 307-343. Define under and overreaction to news announcements.
Points that need to be included: The answer two this question should explain the model in which an investor incorrectly assumes that the earning's generating process of a firm is either given by a mean reverting model or a trending model (the true model is a random walk). The answer should explain the functioning of this behavioral model and the consequences of this 'misperception'. Points regarding this can, for example, be found in the lecture "12_Conservatism_2019" (e.g. slides 26-37) as well as in the mandatory reading. Furthermore, the answer should define what overreaction and underreaction to news announcements means.

b) Explain the conservatism bias and the representativeness heuristic. How can these two biases explain the over- and under-reaction featured in the model by Barberis et al. (1998)?
Points that need to be included: The answer to this question should include a definition of conservatism (see lecture 12_Conservatism_2019) and the representativeness heuristic (see

lecture 09_Representativeness_2019) as well as the relevant parts in "12_Conservatism_2019" (see e.g. slide 11) as well as the relevant parts in the mandatory readings to this block.