Practice Session: Behavioural finance

a) Briefly discuss what is meant by behavioural finance.

Answer

The field of behavioural finance looks at how a variety of mental biases and decision-making errors affect financial decisions. It relates to the psychology that underlies and drives financial decision-making behaviour

b) You are working in the research department of an investment bank. You have analysed intensively a particular stock. This stock has underperformed for the last three years. In a report for the front office you state that you are 90% sure that this asset will underperform in the coming year as well. Is it possible that your advice is biased? Please explain your answer based on concepts learnt in behavioural finance.

Answer: Yes, you need to consider:

- Overconfidence bias: people tend to over-estimate their own knowledge, abilities and skills.
- Anchoring and Adjustment Biases: this as is common human tendency to rely too heavily, or anchor on one piece of information when making decisions.
  - The analyst may set as an anchor the fact that this asset has underperformed in the past. Thus, he may be biased towards suggesting that in the coming year the asset will underperformed as well.
  - As this stock has already underperformed for the last three years it is more difficult for the analyst to adjust his estimate of the returns to the current data.

c) Before you submit your report, you learn of a rumour that the company might soon announce higher than expected earnings for the last year. However, you decide that this is unfounded and do not incorporate it in your report. Is it possible that you are now biased? If yes, how this bias is called in behavioural finance?

Answer: Yes, as the analyst tends to dismiss evidence that does not justify his point of view. This is called confirmation bias.

2.

(a) Do you think you will pass the exam for MTH6113? With what probability? Is it possible that your answers are biased? Please explain your answers based on concepts learnt in behavioural finance.

Answer

Here, one should consider when analysing a possible answer:

- Overconfidence bias: people tend to over-estimate their own knowledge, abilities and skills.

- Biases affect probability estimates as people tend to underestimate the probability that negative events may occur (for example not passing the exam).

(b) After discovering that he scored 60% in the exam even though he was extremely confident of scoring at least 70% before he sat the exam, Peter confessed to his friend that he didn't really think he could get 70%. Is it possible that Peter's confession is biased? How do we call this bias in terms of behavioural finance?

Answer

Peter's confession may suffer from hindsight bias: events that have happened (in this case scoring below 70%) are thought of as having been predictable prior to the event.