CHAPTER 52

THE BEHAVIORAL BIASES OF INDIVIDUALS

1. (C) **associates new information with an easily recalled past event.**

Explanation

Investors who exhibit availability bias estimate future probabilities by how easily they recall a past event. An easily recalled event is more quickly associated with (fit to) new information. The problem is worsened by the fact that individuals' memories can be incomplete or biased. Investors who exhibit confirmation bias tend to notice only information that agrees with their perceptions or beliefs. They look for confirming evidence while discounting or even ignoring evidence that contradicts their beliefs or their perceptions. Investors who exhibit framing bias view information differently depending on the way it is presented and received.

(Study Session 18, Module 52.1, LOS 52.b)

Related Material

SchweserNotes - Book 5

2. (C) **Status quo and endowment biases.**

Explanation

Status quo and endowment biases are emotional biases whereas the other biases fall under the category of cognitive errors.

(Study Session 18, Module 52.1, LOS 52.b)

Related Material

SchweserNotes - Book 5

3. (C) **Conservatism, representativeness, and hindsight biases.**

Explanation

Mental accounting, framing, anchoring and adjustment, and availability biases are information processing biases whereas conservatism, representativeness, confirmation, illusion of control, and hindsight biases are belief persistence biases.

(Study Session 18, Module 52.1, LOS 52.b)

Related Material

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4. (C) **overconfidence.**

Explanation

Overconfidence bias may lead to overtrading, underestimation of risk, and lack of diversification. Anchoring may cause investors to believe recent highs are rational prices, even as they decline significantly. Fear of regret (of missing positive

returns) may keep even skeptical investors in the market when analysis suggests assets are significantly overvalued.
(Study Session 18, Module 52.2, LOS 52.c)
Related Material
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5. (B) **Conservatism, hindsight, and framing biases.**
Explanation
Conservatism, hindsight, and framing biases are examples of cognitive errors. Loss aversion, self-control, regret-aversion, and overconfidence are all emotional biases.
(Study Session 18, Module 52.1, LOS 52.b)
Related Material
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6. (B) **has a tendency to place information into categories.**
Explanation
This describes the cognitive error of "representativeness bias" where investors classify information into the most appropriate subjective category based on "if-then" heuristics. The other two answer choices describe "loss aversion" and "regret aversion."
(Study Session 18, Module 52.1, LOS 52.a)
Related Material
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7. (B) **Anchoring and adjustment.**
Explanation
Anchoring and adjustment is a cognitive error related to information processing, whereas loss aversion and status quo bias are emotional biases.
(Study Session 18, Module 52.1, LOS 52.b)
Related Material
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8. (B) **hindsight bias can fuel overconfidence.**
Explanation
With hindsight bias, investors may give themselves credit for recent market advances, fueling overconfidence bias. Behavioral finance has not supplied an overall explanation for the existence of market bubbles. Anchoring may cause investors to believe recent market highs are rational and keep them in the market even as market prices or company fundamentals have started to decline.
(Study Session 18, Module 52.2, LOS 52.c)
Related Material
SchweserNotes - Book 5