Reading 87

THE BEHAVIORAL BIASES OF INDIVIDUALS

1. (B) mental accounting bias

Explanation

An example of mental accounting bias is viewing money from various sources differently when making investment decisions. Framing bias refers to when decisions are affected by the way in which the data are presented. Availability bias refers to putting undue emphasis on information that is readily available, easy to recall, or based narrowly on personal experience or knowledge.

(Module 87.1, LOS 87.b)

2. (B) They are due primarily to faulty reasoning

Explanation

Cognitive errors are due primarily to faulty reasoning or irrationality. Emotional biases are not related to conscious thought and stem from feelings, impulses, or intuition.

(Module 87.1, LOS 87.a)

3. (B) stem from feelings or intuition.

Explanation

Emotional biases stem from feelings or intuition; therefore, they are difficult to overcome and may have to be accommodated. Cognitive errors are due primarily to faulty reasoning.

(Module 87.1, LOS 87.a)

4. (C) 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.

(Module 87.1, LOS 87.b)

5. (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 sceptical investors in the market when analysis suggests assets are significantly overvalued.

(Module 87.2, LOS 87.c)

6. (A) 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.

(Module 87.1, LOS 87.b)

7. (A) Conservatism bias.

Explanation

Conservatism bias refers to failing to change a view as new information becomes available, and may result in investors keeping assets too long because they are slow to update a view or forecast. Confirmation bias refers to when investors seek out information that supports their beliefs, while avoiding conflicting views. Hindsight bias refers to selective memory of past events resulting in individuals believing these events were more predictable than they seemed before they happened.

(Module 87.1, LOS 87.b)

8. (B) mitigated by information.

Explanation

Cognitive errors may be reduced by increased awareness, better training, or more information. Emotional biases are related to intuition or impulses and may be more difficult to overcome compared to cognitive errors.

(Module 87.1, LOS 87.a)

9. (C) loss-aversion bias.

Explanation

Loss-aversion bias arises from feeling more pain from a loss than pleasure from an equal gain. A consequence of this bias is that investors may hold onto positions with the hope of getting even rather than selling the position at a loss. Self-control bias occurs when individuals lack self-discipline and favor short-term satisfaction over long-term goals. Availability bias occurs when putting undue emphasis on information that is readily available, easy to recall, or based narrowly on personal experience or knowledge.

(Module 87.1, LOS 87.b)

10. (A) has a tendency to place information into categories.

Explanation

This describes the cognitive error of "representativeness bias" where investors classifyinformation into the most appropriate subjective category based on "if-then" heuristics.The other two answer choices describe "loss aversion" and "regret aversion."

(Module 87.1, LOS 87.a)

11. (A) 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.

(Module 87.1, LOS 87.b)

12. (B) Endowment bias.

Explanation

An individual who exhibits endowment bias considers an owned asset to be special and worth more than its actual market value. Overconfidence bias occurs when market participants overestimate their own reasoning. Mental accounting bias is viewing money from various sources differently when making investment decisions.

(Module 87.1, LOS 87.b)

13 (B) Status quo and endowment biases

Explanation

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

(Module 87.1, LOS 87.b)

14. (B) Availability bias.

Explanation

Availability bias is putting undue emphasis on information that is readily available, easy to recall, or based narrowly on personal experience or knowledge. Loss aversion arises from feeling more pain from a loss than pleasure from an equal gain. Overconfidence bias occurs when market participants overestimate their own intuitive ability.

(Module 87.1, LOS 87.b)

15. (C) Conservatism, hindsight, and framing biases.

Explanation

Conservatism, hindsight, and framing biases are examples of cognitive errors. Lossaversion, self-control, regret-aversion, and overconfidence are all emotional biases.

(Module 87.1, LOS 87.b)

16. (C) hindsight bias can fuel overconfidence.

Explanation

With hindsight bias, investors may give themselves credit for recent market advances, fuelling overconfidence bias. Behavioural 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.

(Module 87.2, LOS 87.c)