

STUDY SESSION 3

BEHAVIORAL FINANCE

Behavioral finance is introduced in the first study session on portfolio management because an understanding of the psychological factors that affect investment decision making is relevant for the management of both private wealth and institutional assets. Behavioral finance provides practical insight to investors' perceptions and preferences regarding financial risk, making it a valuable aid to understanding client goals and concerns. The analysis of investment decision making from a behavioral finance perspective may also provide an explanation for certain market inefficiencies and suggest investment strategies to exploit them.

READING ASSIGNMENTS

- Reading 7** **Heuristic-Driven Bias: The First Theme**
Beyond Greed and Fear: Understanding Behavioral Finance and the Psychology of Investing, by Hersh Shefrin
- Reading 8** **Frame Dependence: The Second Theme**
Beyond Greed and Fear: Understanding Behavioral Finance and the Psychology of Investing, by Hersh Shefrin
- Reading 9** **Inefficient Markets: The Third Theme**
Beyond Greed and Fear: Understanding Behavioral Finance and the Psychology of Investing, by Hersh Shefrin
- Reading 10** **Portfolios, Pyramids, Emotions, and Biases**
Beyond Greed and Fear: Understanding Behavioral Finance and the Psychology of Investing, by Hersh Shefrin
- Reading 11** **Investment Decision Making in Defined Contribution Pension Plans**
Pensions
- Reading 12** **Global Equity Strategy: The Folly of Forecasting: Ignore All Economists, Strategists, and Analysts**
Global Equity Strategy, by James Montier
- Reading 13** **Alpha Hunters and Beta Grazers**
Financial Analysts Journal

Note:

Some of the behavioral concepts presented in this study session are developed across multiple readings. Candidates should consider the readings as a whole in mastering the Learning Outcome Statements.

LEARNING OUTCOMES

Reading 7: Heuristic-Driven Bias: The First Theme

The candidate should be able to evaluate the impact of heuristic-driven biases on investment decision making, including representativeness, overconfidence, anchoring-and-adjustment, and aversion to ambiguity.

Reading 8: Frame Dependence: The Second Theme

The candidate should be able to:

- a. explain how loss aversion can result in investors' willingness to hold on to deteriorating investment positions;
- b. evaluate the impact that the emotional frames of self-control, regret minimization, and money illusion have on investor behavior.

Reading 9: Inefficient Markets: The Third Theme

The candidate should be able to:

- a. evaluate the impact that representativeness, conservatism (anchoring-and-adjustment), and frame dependence may have on security pricing and discuss the implications for market efficiency;
- b. discuss the implications of investor overconfidence when trading.

Reading 10: Portfolios, Pyramids, Emotions, and Biases

The candidate should be able to:

- a. discuss the influence of hope and fear on investors' desire for security and investment potential;
- b. explain how portfolios can be structured as layered pyramids and how such structures address needs associated with security, potential, and aspiration;
- c. evaluate the impact of excessive optimism and overconfidence on investors' decisions regarding portfolio construction.

Reading 11: Investment Decision Making in Defined Contribution Pension Plans

The candidate should be able to:

- a. explain how limited participant knowledge and bounds to rationality, self-control, and self-interest may lead defined-contribution (DC) plan participants to construct inefficient investment portfolios;
- b. evaluate the impact of status quo bias, myopic loss aversion, 1/n diversification, and the endorsement effect on DC plan participants' investment decisions and the risk profile of their investment plans;
- c. discuss the factors that may contribute to DC plan participants holding "excess" amounts of their own company's stock in their plan.

Reading 12: Global Equity Strategy: The Folly of Forecasting: Ignore All Economists, Strategists, and Analysts

The candidate should be able to:

- a. explain how the illusions of knowledge and control lead expert forecasters to be overconfident in their forecasting skills;
- b. explain the ego defense mechanisms that forecasters rely on as justification for inaccurate forecasts;
- c. explain why forecasts may continue to be used when previous forecasts have been inaccurate.

Reading 13: Alpha Hunters and Beta Grazers

The candidate should be able to:

- a. contrast chronic market inefficiencies with acute inefficiencies and describe the behavioral factors (such as convoy behavior, Bayesian rigidity, price-target revisionism, and the ebullience cycle) that may give rise to chronic market inefficiencies;
- b. explain the portfolio rebalancing behavior of holders, rebalancers, valuers, and shifters and evaluate the impact these rebalancing behaviors have on market efficiency.