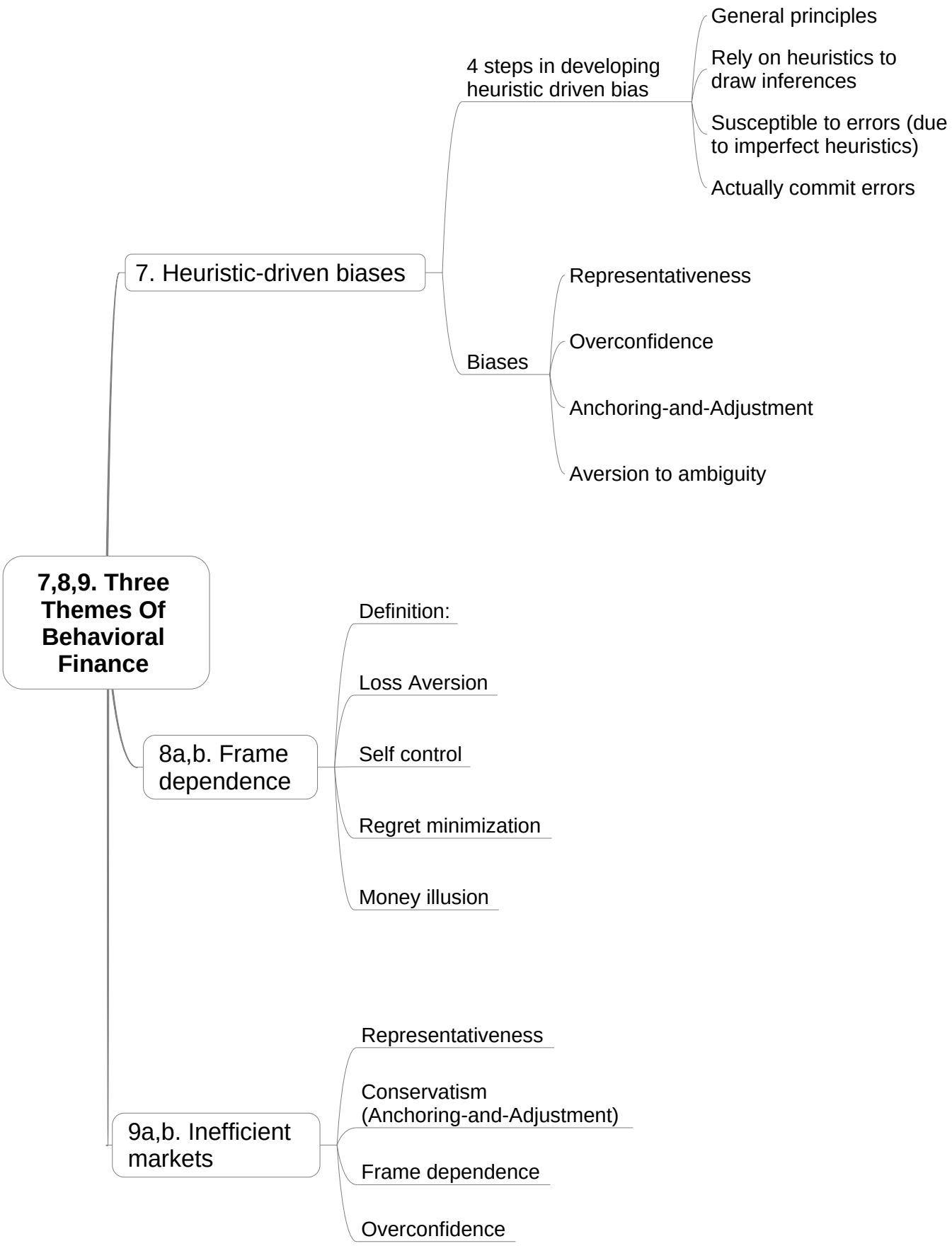
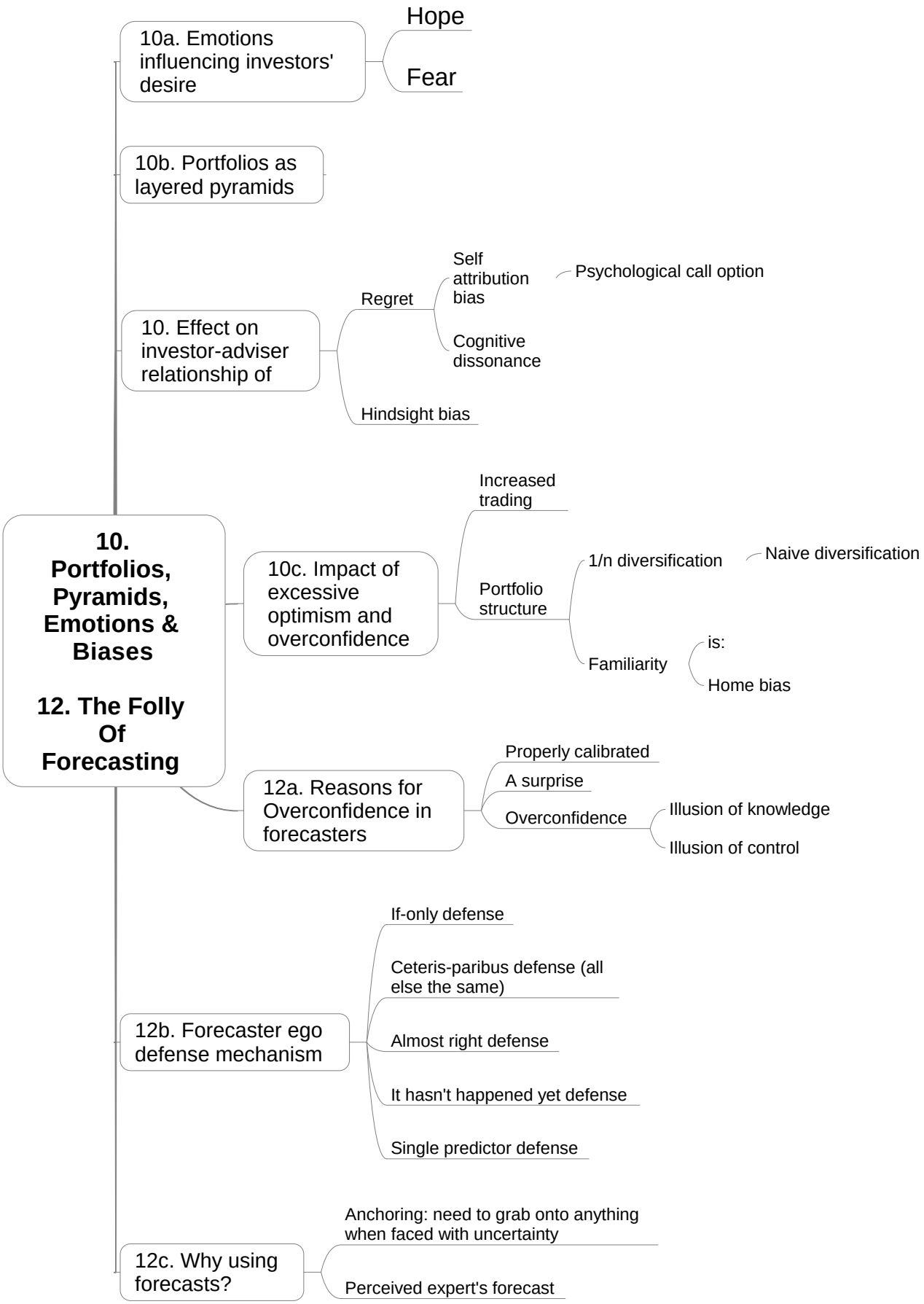
CFA LEVEL 3

STUDY SESSION 3

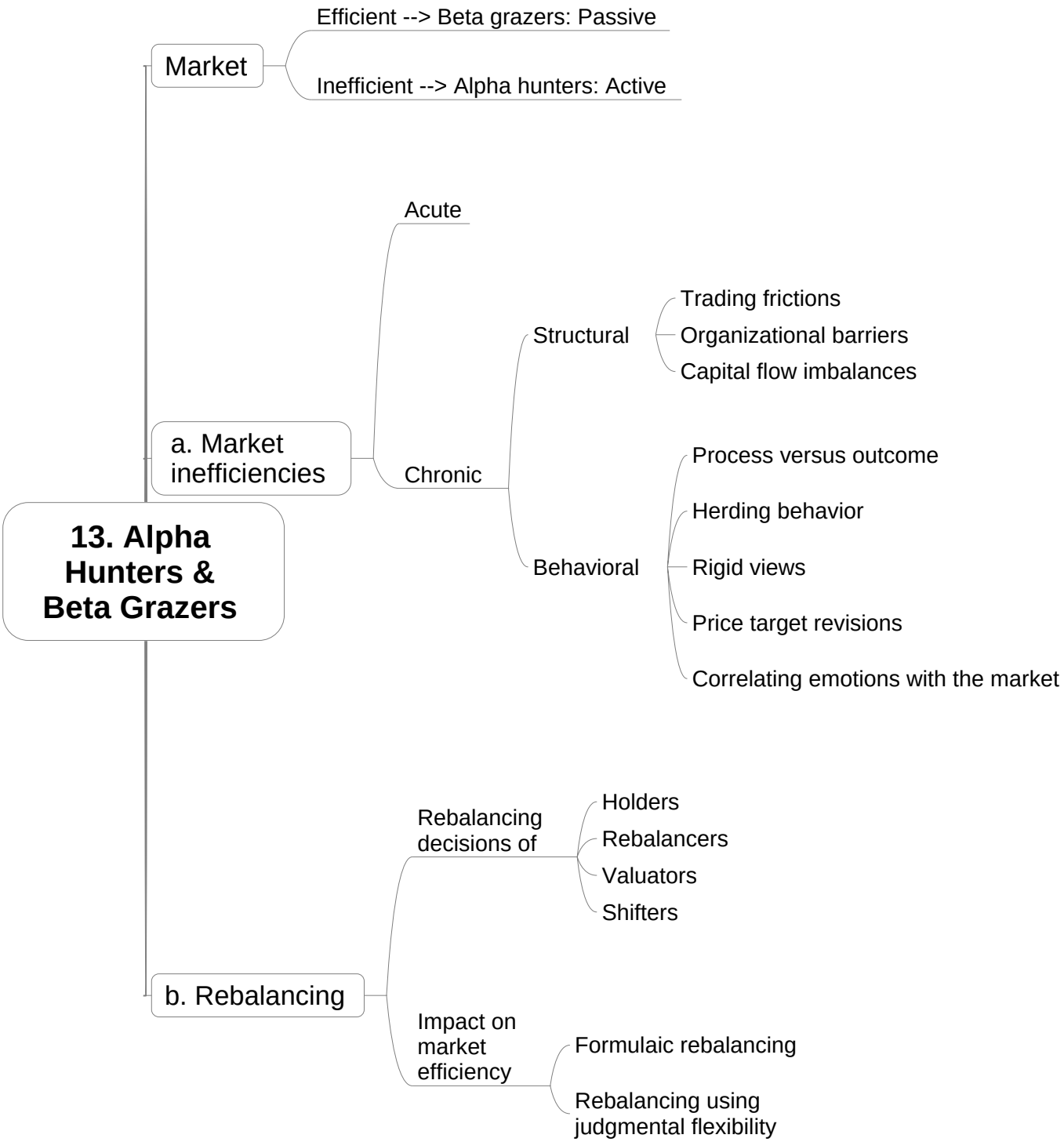
BEHAVIORAL FINANCE


7,8,9. Three Themes Of Behavioral Finance
7. Heuristic-driven biases
4 steps in developing heuristic driven bias
General principles
Rely on heuristics to draw inferences
Susceptible to errors (due to imperfect heuristics)
Actually commit errors
Biases
Representativeness
Overconfidence
Anchoring-and-Adjustment
Aversion to ambiguity
8a,b. Frame dependence
Definition:
Loss Aversion
Self control
Regret minimization
Money illusion
9a,b. Inefficient markets
Representativeness
Conservatism (Anchoring-and-Adjustment)
Frame dependence
Overconfidence


10. Portfolios, Pyramids, Emotions & Biases
12. The Folly Of Forecasting
10a. Emotions influencing investors' desire
Hope
Fear
10b. Portfolios as layered pyramids
10. Effect on investor-adviser relationship of
Regret
Self attribution bias
Psychological call option
Cognitive dissonance
Hindsight bias
10c. Impact of excessive optimism and overconfidence
Increased trading
Portfolio structure
1/n diversification
Naive diversification
Familiarity
is:
Home bias
12a. Reasons for Overconfidence in forecasters
Properly calibrated
A surprise
Overconfidence
Illusion of knowledge
Illusion of control
12b. Forecaster ego defense mechanism
If-only defense
Ceteris-paribus defense (all else the same)
Almost right defense
It hasn't happened yet defense
Single predictor defense
12c. Why using forecasts?
Anchoring: need to grab onto anything when faced with uncertainty
Perceived expert's forecast

11. Investment Decision Making In Defined Contribution Pension Plans

- Warm-up
  - Defined Benefit (DB) pension plans
  - Defined Contribution (DC)
- a. Inefficient DC investment portfolios --> due to
  - Limited knowledge
  - Bounded rationality
  - Bounded self-control
  - Bounded self-interest
- b. Impacts on DC plan investment decision of
  - Status quo bias
  - Myopic loss aversion
  - 1/n diversification
  - Endorsement effect
- c. Holding excess amounts of own company's stocks in the plan --> due to
  - Stock ownership plans
  - Familiarity


13. Alpha Hunters & Beta Grazers
Market
Efficient --> Beta grazers: Passive
Inefficient --> Alpha hunters: Active
a. Market inefficiencies
Acute
Chronic
Structural
Trading frictions
Organizational barriers
Capital flow imbalances
Behavioral
Process versus outcome
Herding behavior
Rigid views
Price target revisions
Correlating emotions with the market
b. Rebalancing
Rebalancing decisions of
Holders
Rebalancers
Valuators
Shifters
Impact on market efficiency
Formulaic rebalancing
Rebalancing using judgmental flexibility