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CFA Institute

## Level III Essay Exam Primer Course

### Questions related to SS03 Behavioral Finance

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## Question 1

Our client is pursuing a high risk investment strategy based on futures contracts. The expected value of the strategy is negative, but the potential gains are high. Our client has also purchased tornado insurance even though the probability of a tornado in her city is low.

Is the client risk-averse, risk-seeking, or both?

Is the client's utility function consistent with what is assumed in traditional finance?

## Question 2

Our client has an annual salary of \$300,000. Over the last three years his annual bonus has averaged 30,000. He takes expensive vacations, travels first-class and stays at high end hotels. He frequently entertains friends and family. His expenditures come from this salary. The bonus goes to a very modest retirement account.

Identify two biases exhibited by the client. Justify your answer. How will a REM behave differently?

1. Anchoring & Adjustment Bias
2. Mental Accounting Bias
3. Framing Bias
4. Availability Bias
5. Self-Control Bias

### Question 3

Match client behavior to the relevant bias:

Client A bought tech stocks in 1999. He lost a lot of money in 2000-01 when the Internet bubble burst and vowed never to invest in tech stocks again.

Client B does not review his investment portfolio unless explicitly pushed by his investment advisor.

Client C holds on to stocks in the transportation industry despite reports of a slowdown. Transportation index is at 75% of last year's high. C feels the stocks will go back up.

Client D only invests in companies she knows. 70% of her investment portfolio is represented by her company stock.

- Overconfidence
- Self-Control
- Status Quo
- Endowment
- Regret Aversion
- Anchoring
- Illusion of Control

## Question 4

You are working with a wealthy investor and feel that she exhibits the following biases:

- Loss aversion
- Regret aversion

Should you attempt to moderate her biases or adapt her portfolio to accommodate her biases?

Practice, practice, practice