

Question 1 : 3 parts

Topic: Portfolio Management – Behavioral Finance

Minutes: 25

THIS QUESTION HAS THREE PARTS (A, B, C) FOR A TOTAL OF 25 MINUTES.

Secure Capital Investments (SCI) is a financial advisory firm headed by Lucy Appleby, the firm's chief portfolio manager and head of the advisory department. Appleby has been introducing a number of new concepts and techniques toward an improved management of clients' capital. One such change has been the application of behavioral finance in the development of clients' investment policy statements, and in implementing portfolio investment strategies. During a conversation with a member of the portfolio management team, Appleby mentioned the following client behaviors reflecting deviations from perfect rationality:

Client A: "I regularly follow the recommendations of the most successful analysts in the field to ensure that the right decisions are made. Popular investments are likely to return positive returns since everyone must be investing in them for a reason."

Client B: "These last few years, my portfolio experienced a number of ups and downs. Most of my gains resulted from my accurate prediction for the telecommunications sector. However, last year my portfolio's value dropped by 15%, primarily due to the unanticipated turn of economic events in Canada and Europe."

A. Identify one bias inherent in each of the above statements. Give **one reason each** for their existence.

(6 minutes)

Appleby is currently managing the investment portfolio for Chris Moss, a civil engineer working as a consultant for a number of construction companies in the U.S. He is 50 years old, is not married, and has no children. Moss earns a salary of \$175,000 annually and has living expenses well within his annual income (net of tax). However, Moss spends a considerable amount on travelling and entertainment, and so, frequently spends more than his net income. Due to a comprehensive retirement savings and investment plan at his firm, Moss has managed to accumulate a portfolio worth \$2,500,000, invested mostly in international and domestic equities.

Over the past few years the equity allocation of his portfolio had an 18% annual return, primarily due to some successful bets made by him on oil stocks.

Appleby noticed that Moss's equity allocation is concentrated in the stocks of a few oil companies. In addition, Moss frequently traded in and out of investments based on his predictions since he believes they have helped him earn high returns in the past. Appleby also observed an investment in the stock of Lions Enterprises (LEN) that had been performing poorly for the past two years.

When he recommended liquidating the investment, Moss stated that he would hold it for another year until the stock price reaches his purchase price. When Appleby asked him about his retirement goals, Moss mentioned that he would not like to compromise his current spending for future consumption. He believed in 'living in the present'.

- B. i. Identify** three biases that Moss is *most likely* subject to. **Justify** your response for each bias.
- ii. Determine** whether to 'moderate' or 'adapt to' or 'moderate and adapt to' Moss's biases. **Justify** your response.

(9 minutes + 5 minutes)

Roger Wong is a financial advisor at SCI. Wong has been assigned the responsibility to work with Jasmine Arcus, a 35-year-old successful entrepreneur who owns a fashion boutique in Chicago, USA. Arcus has an investment portfolio worth \$5,000,000 that is invested 55% in stocks, and 45% in bonds. She manages to make an annual profit from her boutique that comfortably covers her living expenses and also contributes to her savings. Arcus is convinced about the future prospects of the U.S. automobile sector and has invested 25% of her equity allocation in automobile stocks.

When Wong suggested diversifying part of the holding due to a deterioration of the industry's fundamentals, Arcus disagreed, and stated that his predictive model validated the industry's positive outlook. Arcus also mentioned that most of the companies within the auto industry had high P/E multiples which confirmed that her investment in the industry is of good value.

When Wong asked her how she gathered the information about the P/E multiples, Arcus mentioned that she read in most of the best-selling financial journals about how high P/E multiples for companies within the industry prove that their stocks have growth potential and can yield high returns for investors.

C. Determine whether to adapt to, moderate, or adapt to *and* moderate Arcus's biases. **Justify** your response.

(5 minutes)