
RESEARCH ELSEWHERE

Robert A. Olsen

A Study of Financial Analysts: Practice and Theory

by Stanley B. Block

Financial Analysts Journal, July/August, 1999, pp. 86–95.

Most financial academicians implicitly model professional financial analysts as supremely rational beings, capable of ensuring capital market efficiency. Yet these same modern finance researchers act as if these professionals would either be incapable or unwilling to reveal how they generally approach their task. In this survey-based study, Professor Block confirms that financial professionals are quite able and willing to talk about their approach to security analysis and portfolio management. More importantly, this study confirms previous findings that a significant majority of analysts tend not to approach their work in ways consistent with many academic models. For example, analysts tend not to make use of present value models or consider dividends to be important in valuing stocks. In addition, they do not consider risk as the most important factor influencing relative security returns over time or believe that market timing is likely to lead to superior performance.

A Cognitive-Emotional Account of the Shape of the Probability Weighting Function

by Eduard Brandstatter, Anton Kuhberger and Friedrich Schneider

Journal of Behavioral Decision Making, Vol. 15, 2002, pp. 79–100.

Much recent research has shown that decision makers tend to overweight small probabilities and under-

weight moderate and large probabilities. In this unique conceptual and experimentally based paper, the authors suggest that emotion, rather than diminishing sensitivity (as proposed by others), plays a key role in this weighting phenomenon. In particular, it is demonstrated that over weighting arises from anticipated elation when winning is very unlikely. Similarly, under weighting arises from the anticipated disappointment when winning was more likely to begin with. In general, over weighting of small probabilities is the consequence of the additional utility derived from elation, while under weighting is the consequence of the additional disutility derived from disappointment. The authors discuss how their emotion-based theory is consistent with other related research.

Risk Sensitive Decision Making Examined Within an Evolutionary Framework

by Catrin Rode and XT Wang.

American Behavioral Scientist, Vol. 43, No. 6, 2000, pp. 926–939.

The ambiguity effect (ambiguity aversion) occurs when decision makers choose an option for which probability information is explicitly stated over one for which it is either imprecise or lacking, even though both have the same expected utility. The framing effect occurs when decision makers switch choices when options are alternatively framed as gains or losses. More specifically, risk aversion is usually found in a gain frame and risk seeking is found in a loss frame. Other researchers have suggested a number of unrelated explanations for these effects. Following the principle of Occam's razor, Rode and Wang argue that both of these effects might have a common evolutionary explanation in what has come to be known in behavioral ecology as "risk sensitive foraging theory". Risk sensitive foraging theory predicts that an animal will always forage on the patch with the lower variance of nutrient content, unless the animal's minimum need is greater than the expected patch payoff. If ambiguity is interpreted as greater variance (which seems to be the case) then the more ambiguous outcomes will be avoided, *ceteris paribus*. Similarly, if wording changes (switches from

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gains to losses), reframe the decision as one where the expected payoff falls below the minimum needed(for survival etc.), then risk-seeking behavior would be predicted by foraging theory.

European Price Momentum and Analyst Behavior

by Ronald van Dijk and Fred Huibers

Financial Analysts Journal, March/April 2002, pp. 96–105.

Previous studies have shown that U. S. stocks exhibit price momentum that appears to be caused by analyst under reaction to new earnings information. This empirical study using market data for stocks from fifteen European countries, covering the period 1987 to 1999, finds similar results. In particular, after controlling for risk, size, and market to book value effects, the authors found earnings surprises, expected earnings growth and earnings revisions to be systematically related to stock price changes. Earnings revisions exhibited strong positive autocorrelation over a 12-month period and price change momentum appeared to be significant for about 7 months after earning surprises. Strong positive price momentum stocks exhibited the most earnings under estimation, while strong negative price momentum stocks exhibited the most earnings over estimation. In summary, the authors conclude that price momentum is primarily due to the slow incorporation of earnings related news.

Risk Assessment Based on Financial Data: Market Response to Airline Accidents

by Robin Dillon, Blake Johnson and M. Elisabeth Pate- Cornell

Risk Analysis, Vol. 19, No. 3, 1999, pp. 473–486.

Using financial market “Event Study” methodology, the authors examine the pattern of excess stock market returns surrounding ten very large and fatal airplane accidents occurring between 1991 and 1996. In

particular, while controlling for market -based risk, predicted market returns were subtracted from actual market returns, after the direct and indirect costs of each accident were subtracted from predicted returns. In six cases, no abnormal returns were found, suggesting that the market appropriately impounded accident costs into market prices. However in four instances, abnormal returns were found. In two instances investors over reacted and in two instances they under reacted ,giving rise to deficient and excessive returns respectively. The over and under reactions occurred when the cause of an accident was anomalous in some respect. This suggests that analogy, or some other template based reasoning process ,may play a significant role in investors’ stock valuation process, as other researchers have noted.

Pragmatic Beliefs and Overconfidence

by Hans K. Hvide

Journal of Economic Behavior and Organization, Vol. 48, 2002, pp. 15–28.

Many studies have found that decision makers are generally overconfident about their own relative abilities. However, generalized overconfidence is not consistent with the rationalist approach to decision-making wherein agents pursue some notion of “truth” in their belief formation. In this conceptual paper, the author sees the main force behind belief formation as pragmatism, wherein accepted beliefs are those that maximize (or at least increase the potential for) the payoff in a given situation. In particular, the author demonstrates that overconfidence can often be a source of advantage due to strategic effects. For example, overconfidence can often provide first mover advantage in a bargaining situation. While the author does not elaborate as to how generalized overconfidence may arise, such that decision makers are unaware of its presence, he does suggest that it may have some evolutionary basis. While the specific mathematical model presented by the author is much too limited, the principal value of this paper lies in its unique approach and discussion of the overconfidence issue

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