APPLICATION MODULE 2: Social Psychology and Personal Finance

MULTIPLE CHOICE

1. When psychologists began applying insights from psychology to develop models about economic behavior, they were developing the field of
   a. financial psychology.
   b. behavioral economics.
   c. economic psychology.
   d. social-psychological economics.

   ANS: B DIF: Easy REF: Behavioral Economics and Financial Markets
   OBJ: AM2.1A MSC: Remembering

2. The price of stock in Computer Literacy, Inc., increased by 33 percent in one day when it changed its name to fatbrain.com. This illustrates the
   a. importance of branding.
   b. presence of irrationality in stock trading.
   c. absence of any basis for fairly valuing stocks.
   d. fact that humans are incapable of making rational decisions about investments.

   ANS: B DIF: Easy REF: Behavioral Economics and Financial Markets
   OBJ: AM2.1A MSC: Applying

3. Jerome’s investment performance has not been very good. He studies behavioral economics to get a better understanding of his poor performance and finds that, like many other people, he was more likely to buy stocks (contributing to market performance)
   a. on sunny days.
   b. when his favorite sports team lost.
   c. on weekdays.
   d. when his family visited.

   ANS: A DIF: Moderate REF: Behavioral Economics and Financial Markets
   OBJ: AM2.1A MSC: Applying

4. Behavioral economists have revealed what about people’s financial decision making?
   a. People hardly ever consider the long-term consequence of their financial decisions.
   b. People do not always act rationally when making decisions about money.
   c. People are always selfish and rational when it comes to their financial decisions.
   d. People do not want to be tied to their money.

   ANS: B DIF: Easy REF: Behavioral Economics and Financial Markets
   OBJ: AM2.1A MSC: Understanding

5. Individuals tend to have a negative reaction to losing an amount of money—a reaction that is stronger in magnitude than the positive reaction associated with gaining the same amount of money. This is referred to as
   a. risk tolerance.
   b. market irrationality.
   c. loss aversion.
   d. risk avoidance.

   ANS: C DIF: Moderate REF: Loss Aversion
   OBJ: AM2.2A MSC: Remembering

6. David has $10,000 worth of stocks in his trading account. He needs to cash in $1,000 worth of stock to make a purchase. He could sell shares in one stock (Jupiter, Inc.) that cost him $2,000 initially but is now only worth $1,000, or he could sell shares in another stock (Mercury Co.) that he bought for $500 but is now worth $1,000. Even though the amount of money withdrawn would be the same, which stock is he more likely to cash out?

a. Jupiter, Inc.
b. Mercury Co.
c. He is more likely to select a stock that was originally purchased at $1,000.
d. The original stock price will have no influence on his decision.

ANS: B DIF: Difficult REF: Loss Aversion
OBJ: AM2.2A MSC: Applying

7. Risk aversion is the
a. general human tendency to stay away from activities that are dangerous, even if they may be fun.
b. reluctance to choose an uncertain option that, on average, pays better than the certain payoff of a second option.
c. reluctance to enter into any transaction in which the outcome is not known with certainty.
d. tendency to seek out activities that are mildly dangerous but thrilling.

ANS: B DIF: Moderate REF: Loss Aversion
OBJ: AM2.2A MSC: Remembering

8. Maria insists that she go see a movie for which she purchased nonrefundable tickets, even though she is exhausted and has no desire to see the movie. This best illustrates
a. risk avoidance.
b. the sunk cost fallacy.
c. loss aversion.
d. the influence of fatigue on decision-making abilities.

ANS: B DIF: Moderate REF: Loss Aversion
OBJ: AM2.2A MSC: Applying

9. Rhonda and June are both planning a trip to Las Vegas. Rhonda saved up for six months to pay for the trip, whereas June was given plane tickets and hotel lodging as a bonus from her employer. In both cases, the purchase of the trip is nonrefundable. Two days before the trip, Rhonda and June both develop bronchitis and have a strong desire to cancel the trip. Given this situation, which of the following is true?
a. Rhonda is more likely to cancel the trip, whereas June is more likely to go through with the trip because she will feel obligated to honor the gift she received.
b. Rhonda is more likely to cancel the trip, because purchasing the trip on her own gives her a greater sense of control.
c. Rhonda is less likely to cancel the trip, because she will be reluctant to waste her money, even though she will not likely enjoy the vacation due to her sickness.
d. Rhonda is less likely to cancel the trip, because she will have developed a tendency toward risk seeking after purchasing her tickets.

ANS: C DIF: Difficult REF: Loss Aversion
OBJ: AM2.2A MSC: Applying

10. Jacquie has just lost $100 on a bet with a friend. The friend offers her a double-or-nothing deal, which would result in either her winning back her $100 and having no loss or losing a total of $200. The alternative would simply be to accept her already certain loss of $100. According to the principle of diminishing marginal utility, Jacquie will be more likely to
a. bet again in the hopes of wiping out her earlier $100 loss.
b. bet again so that she can save face in front of her friend.
c. decline to bet and simply accept her $100 loss.
d. decline to bet again but make plans for how she will get back at her friend.

ANS: A DIF: Difficult REF: Loss Aversion
OBJ: AM2.2A MSC: Applying

11. According to the textbook, research has found that people experience greater neural activation when considering ________ than when considering ________.
a. saving; spending
b. spending; saving
c. losses; gains
d. gains; losses

ANS: C DIF: Easy REF: Loss Aversion
OBJ: AM2.2A MSC: Understanding

12. Deborah went to the casino with $1,000 and has managed to win an additional $500. At this point, she has $1,500 in her possession; however, she separates this money into $1,000 that she stores in her purse, and the remaining $500, with which she continues to gamble. Deborah's behavior illustrates the phenomenon of
a. mental accounting.
b. superstitious behavior.
c. the gambler's fallacy.
d. the sunk cost fallacy.

ANS: A DIF: Easy REF: Mental Accounting
OBJ: AM2.3A MSC: Applying

13. According to what you know about mental accounting, if you were a government official who wanted to stimulate the economy by increasing spending, which of the following should you do?
a. send all adults a $500 tax rebate
b. send all adults a $500 bonus
c. send $500 to only those who paid high taxes the previous year
d. send $500 to only those who paid no taxes the previous year

ANS: B DIF: Difficult REF: Mental Accounting
OBJ: AM2.3A MSC: Applying

14. ________ is the tendency to treat money differently depending on how it is acquired and the psychological category to which it is attached.
a. Money categorization
b. Risk categorization
c. Sunk cost accounting
d. Mental accounting

ANS: D DIF: Easy REF: Mental Accounting
OBJ: AM2.3A MSC: Remembering

15. Decision paralysis is best illustrated by
a. Martha's inability to decide on a college because she has a low sense of control.
b. Jose's difficulty in deciding whether to break up with his girlfriend because he does not want to hurt her feelings.
c. Carla's difficulty in selecting a road bike to purchase out of the seventy-five different bikes for sale.
d. Charles's inability to decide whether to practice yoga or meditation, because they both have great health benefits.

ANS: C DIF: Easy REF: Decision Paralysis
OBJ: AM2.4A MSC: Analyzing

16. Melinda and Julie want to get off to a great start with their new business selling baby toys. Melinda proposes that they offer at least thirty-five different types of stuffed animals to give their consumers a wide range of choices; however, Julie counters that they should start with only five different stuffed animals. If their primary goal is to encourage consumers to buy stuffed animals, whose approach is correct?
    a. Julie's, because too many choices leads to decision paralysis
    b. Julie's, because a core of a few items builds greater brand loyalty
    c. Melinda's, because the more choices available, the greater the likelihood of matching the unique needs of each consumer
    d. Melinda's, because the abundance of choices will lead to impulse buying

    ANS: A DIF: Moderate REF: Decision Paralysis
    OBJ: AM2.4A MSC: Applying

17. As a benevolent CEO, Min wants her employees to reap great financial benefits from working at her company. After consulting with a specialist in investor behavior, Min makes the wise choice of
    a. offering her employees a diverse but small number of options for their 401(k)s.
    b. offering retirement funding in the form of poker chips that they can play at a local casino.
    c. offering her employees every possible fund from which to choose for their 401(k)s.
    d. deciding on her employees' behalves which funds they should invest in for their 401(k)s.

    ANS: A DIF: Moderate REF: Decision Paralysis
    OBJ: AM2.4A MSC: Applying

18. The inability to make a decision in the presence of too many options is known as
    a. decision paralysis.
    b. opinion dread.
    c. option aversion.
    d. choice reluctance.

    ANS: A DIF: Easy REF: Decision Paralysis
    OBJ: AM2.4A MSC: Remembering

19. One key strategy to having sufficient savings later in life is to start saving early. Why is this recommended?
    a. Saving money earlier in life gets you into the habit of saving, so you are likely to continue.
    b. You can take advantage of compound interest to grow your savings faster.
    c. You are less likely to fall prey to the sunk cost error.
    d. If you gain more money early, you will be more resistant to loss aversion if something happens to the stock market.

    ANS: B DIF: Moderate REF: Getting Started on Your Own Financial Planning
    OBJ: AM2.5A MSC: Understanding

20. Ella just started her first job and wants to be thoughtful about planning for retirement. She visits a financial planner for the first time. What advice is this planner likely to give Ella?
    a. buy shares in mutual funds that invest in a broad range of companies
    b. start by buying real estate because it is a safe investment
    c. wait to begin investing until you are more settled in work life
    d. stick to one kind of asset so you can maximize your payoffs

    ANS: A DIF: Easy REF: Getting Started on Your Own Financial Planning
    OBJ: AM2.5A MSC: Applying

SHORT ANSWER

1. Challenge the long-held assumption that people make rational financial decisions. Provide two pieces of evidence in support of your position.

   ANS:
   Research from the field of behavioral economics has revealed that people are not entirely rational in their financial decision making. Extraneous variables indeed relate to people's economic behavior. Several examples are acceptable, including shopping when one needs a pick-me-up and investing more on sunny days.

   DIF: Difficult REF: Behavioral Economics and Financial Markets
   OBJ: AM2.1A MSC: Evaluating

2. Define *sunk cost fallacy* and describe one research finding that demonstrates this phenomenon.

   ANS:
   The sunk cost fallacy is a reluctance to "waste" money that leads people to continue with an endeavor, whether it serves their future interests or not, because they have already invested money, time, or effort in it. Several findings are acceptable. For example, people that paid $15 for a theater ticket were more likely to show up for the performance than those who got a $2 discount on the ticket, and those in the latter group were more likely to show up than those who got a $7 discount on the ticket.

   DIF: Difficult REF: Loss Aversion OBJ: AM2.2A
   MSC: Understanding

3. Explain what is meant by *mental accounting* and describe the disadvantages of mental accounting for financial decision making.

   ANS:
   Mental accounting is the tendency to treat money differently depending on how it is acquired and the mental category to which it is attached. When people do not integrate their assets into a common mental pool, they may be more frivolous with their spending or investing. For example, money earned gambling is likely to be seen as belonging to the casino, and, therefore, to be treated more recklessly than money classified as one's own. Likewise, when the government provides a tax rebate people are more likely to treat it as their own money and place it in a more serious mental account. In contrast, when the government provides a bonus, people are likely to place it in a more frivolous mental account and, therefore, spend it sooner.

   DIF: Moderate REF: Mental Accounting OBJ: AM2.3A
   MSC: Evaluating

4. Imagine that a friend is thinking of opening up a shop and asks you how many different products she should sell. Explain the concept of decision paralysis and design a product plan for your friend's new store.

   ANS:
   Decision paralysis occurs when we have so many options from which to choose that we have difficulty making a choice. Given this phenomenon, several product plans are acceptable as long as they involve having a small array of high-quality products from which customers can choose.

   DIF: Moderate REF: Decision Paralysis OBJ: AM2.4A
   MSC: Creating

5. Describe three things a young person should consider when planning his or her financial future.

ANS:
The chapter provides five principles for young people to consider in planning for their financial futures. These include 1) starting early, 2) diversifying one's portfolio of investments, 3) investing in mutual funds, 4) setting up payroll deduction plans, and 5) paying off credit card debt as soon as possible.

DIF: Difficult REF: Getting Started on Your Own Financial Planning
OBJ: AM2.5A MSC: Understanding