Week 2(a)

Previous lectures

Expected value theory - make choices according to expected value

Utility - measure of satisfaction/benefit derived from consuming a good or service.

Marginal Utility Value - satisfaction gained from consuming one additional unit of a product or service

St. petersburg paradox - to represent a classical example were, by taking into account only the expected value as the only decision criterion, the decision maker will be misguided into an irrational decision.

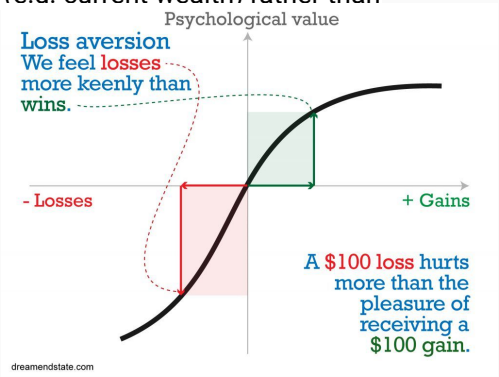
Alias paradox - to show an inconsistency of actual observed choices with the predictions of expected utility theory.

Marginal Utility Function

Marginal utility is the added satisfaction that a consumer gets from having one more unit of a good or service. The concept of marginal utility is used by economists to determine how much of an item consumers are willing to purchase.

Prospect theory

Prospect theory is a behavioral model that shows how people decide between alternatives that involve risk and uncertainty (e.g. % likelihood of gains or losses). It demonstrates that people think in terms of expected utility relative to a reference point (e.g. current wealth) rather than absolute outcomes.



1) People hate losses more than they love their gains!!

Loss Aversion is a cognitive bias that describes why, for individuals, the pain of losing is psychologically twice as powerful as the pleasure of gaining. The loss felt from money, or any other valuable object, can feel worse than gaining that same thing.

Reference point

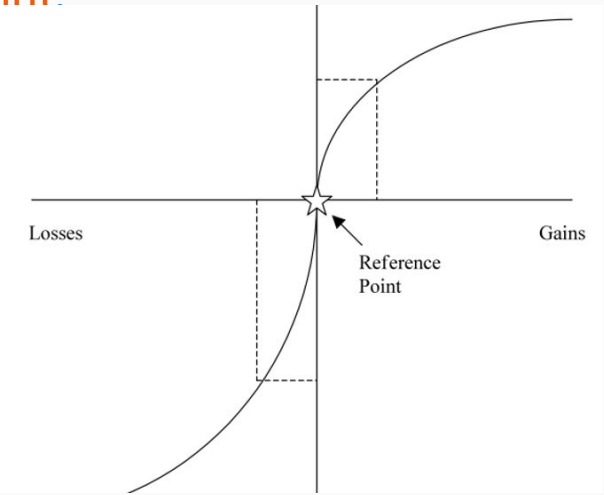
People do not evaluate outcomes of gamble in terms of overall state of wealths they lead, instead as gains relative to a neutral reference point.

Eg. you come out of an exam and you might think that this r

be your worst exam or that you might score lower than

you think, but it's actually lowering your expectation

so as to maximise the change in utility or to avoid loss.



Risk aversion and Risk seeking

We found that people were more risk averse in gain situations when they made decisions for themselves than for a stranger, but were equally risk averse for themselves and their friends. However, people were more risk seeking in loss situations when they made decisions for themselves than for their friends as well as for a stranger, and were more risk seeking for their friends than for a stranger