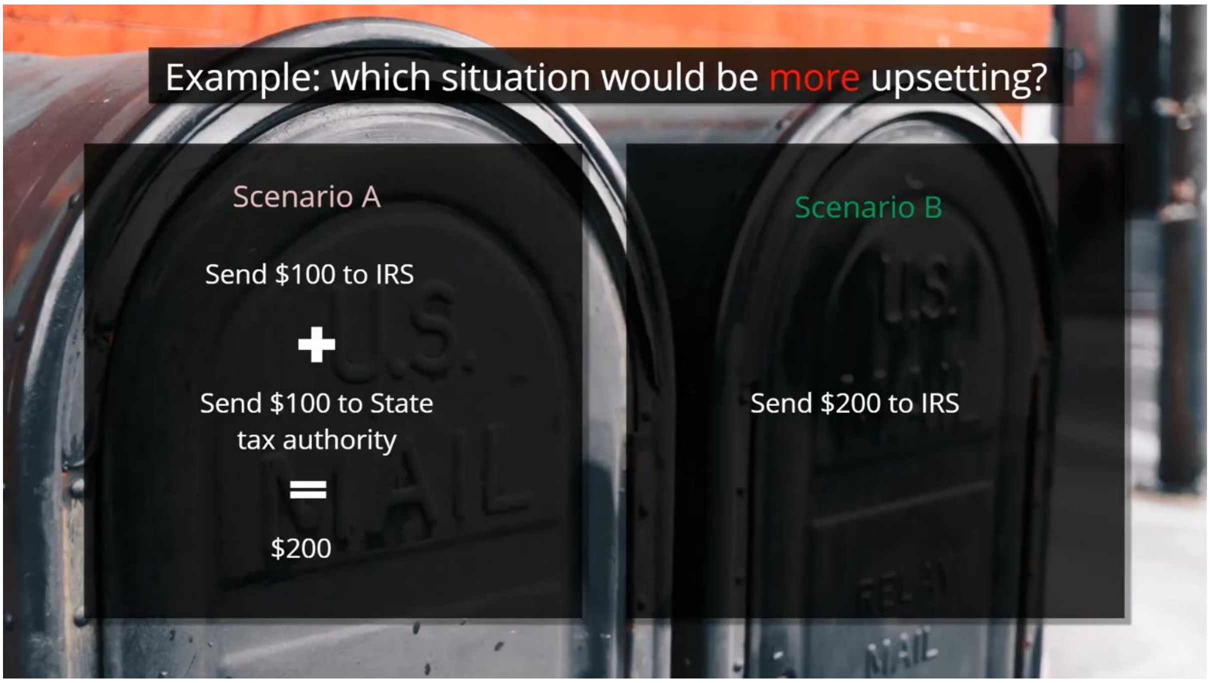
M2L15. Prospect Principle Revisited

Slide #1

In this topic, we will expand on the prospect principle.

Slide #2

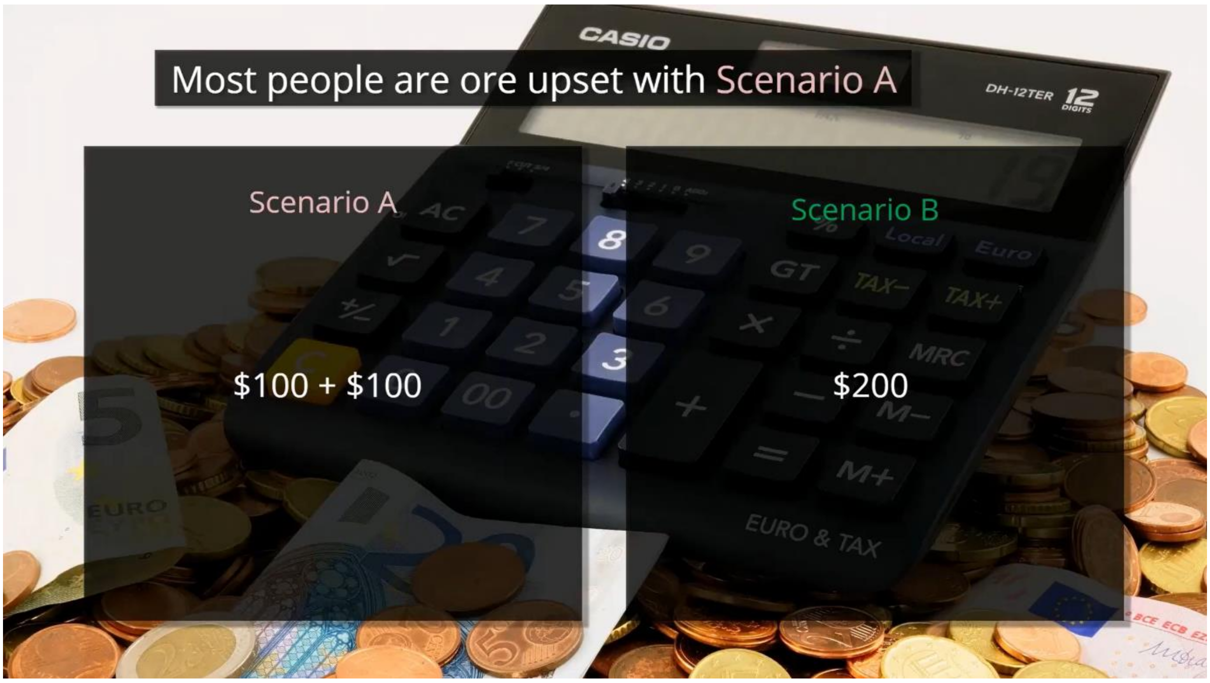


Which of the following two situations would be more upsetting to you?

Scenario A, you receive a letter from the IRS saying that they made a mistake in your tax return and you need to send them a $100 check. On the same day you receive a similar letter from your state tax authority saying that they also made a mistake and you need to send them a $100 check. Basically, you need to send a $100 check to the IRS. and another $100 check to the state tax authority.

Scenario B, you only receive a letter from the IRS saying that they made a mistake in your tax return and you need to send them a $200 check. You receive no letter from the state tax authority.

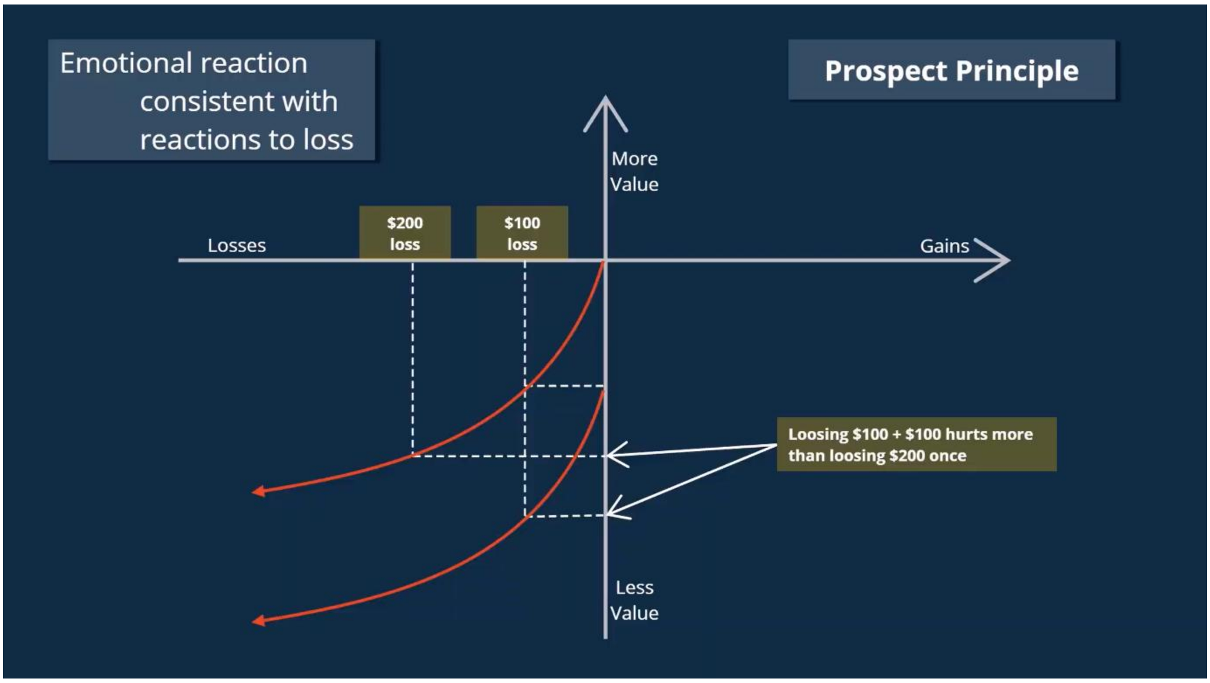
Slide #3



Most people are more upset by situation A.

The two losses of $100 are more painful than one large loss of $200, despite the fact that the two outcomes are equal from a financial perspective.

Slide #4

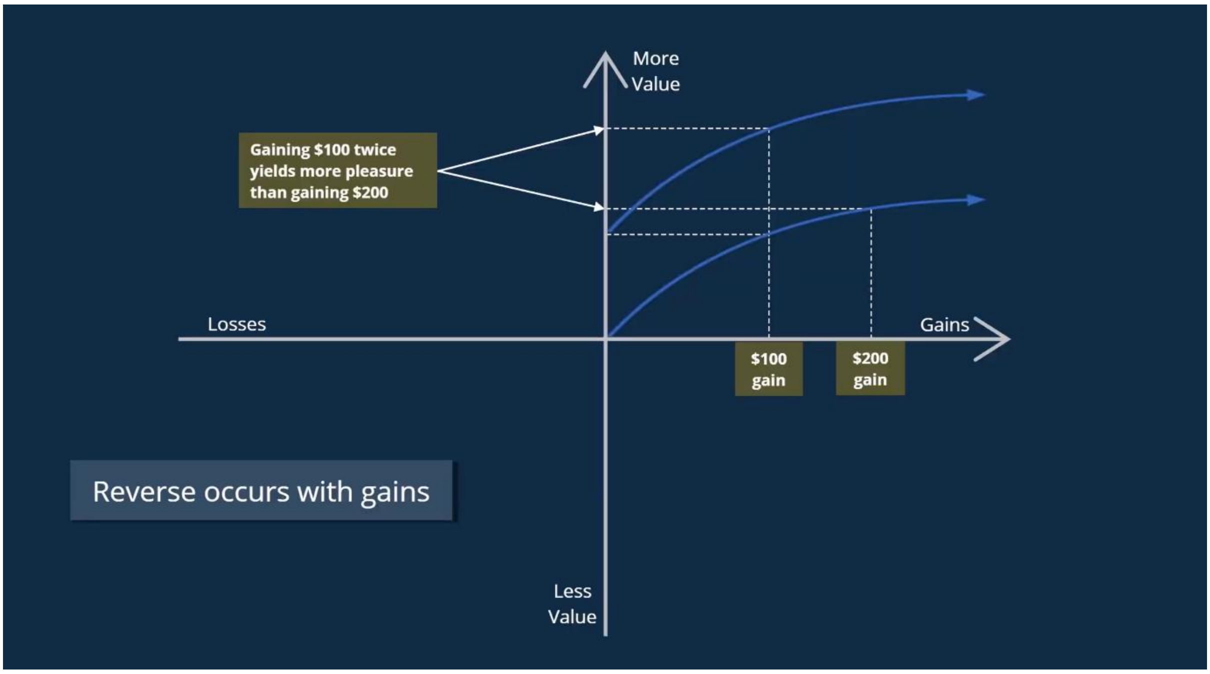


This emotional reaction is consistent with the nature of our reactions to loss, as shown in the prospect principle chart.

Most of us overreact to the loss at the beginning, but our perceived loss levels off as a loss increases.

These two losses of $100 from two separate events makes us feel much worse than one large loss of $200.

Slide #5



The chart explains the prospect principle model.

The x-axis represents the outcome of economic decisions. The financial gains are on the right side and losses are on the left side.

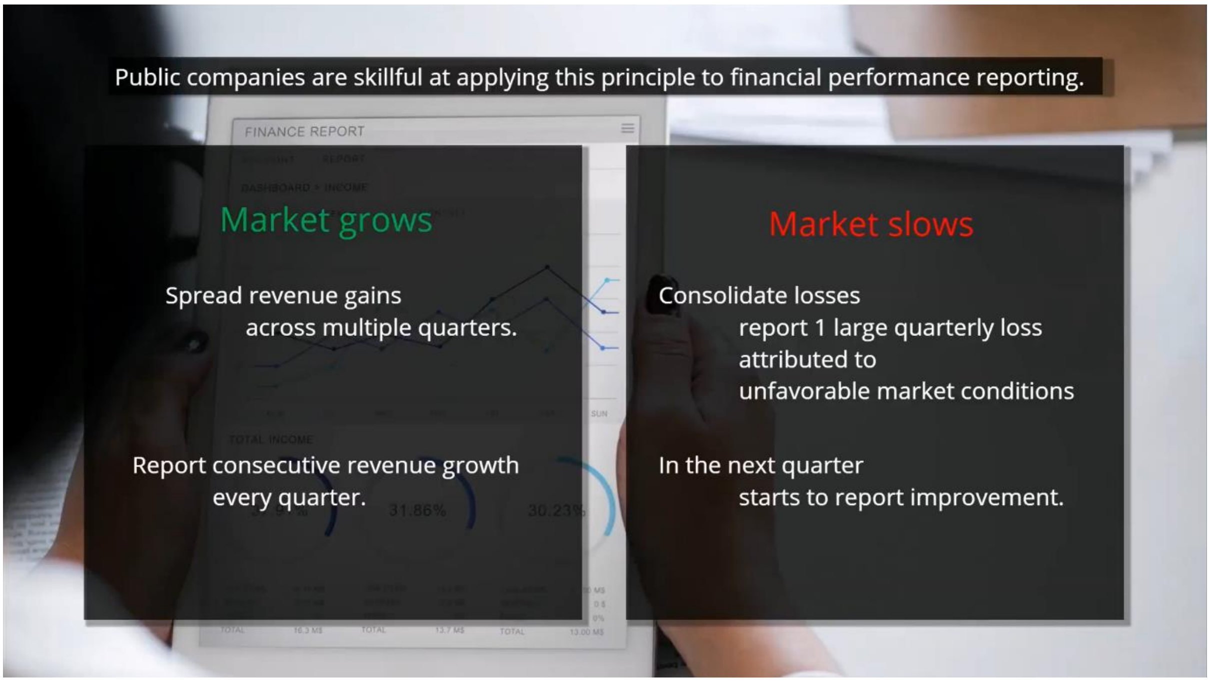
The y-axis represents the subjective perceived value of the outcome to individuals who make the decisions.

From the chart, we can see most people undervalue the financial gains and stop appreciating the value of their outcomes after the value exceeds a certain amount.

Most people follow this behavior pattern when facing risk associated with uncertainty.

We overlook a positive outcome and give more weight to the loss of a negative outcome.

Slide #6



Public companies are skillful at applying this judgment principle to financial performance reporting.

When the market grows, the companies spread their revenue gains across multiple quarters and report consecutive revenue growth every quarter.

But when the market slows, the companies consolidate losses and report one large quarterly loss, which typically is attributed to unfavorable market conditions.

Then, in the next quarter, the companies start to report improvement.