

## ★ Alternate Theories of Decision Making

### ● Prospect Theory

- The axioms of expected utility theory are systematically violated at several problems
- Prospect Theory is an alternative model that's informed by the patterns of choices observed in the decision problems

#### \* Key Features

- 1) reference dependence
- 2) loss aversion
- 3) diminishing sensitivity
- 4) probability weighting

### • Certainty Effect

- Under Expected Utility, the values of outcomes are weighted by their probabilities
- Decision maker tends to overweigh outcomes that are considered certain, relative to those that are merely probable
- Variations of Allais's Paradox

### • Reflection Effect

- The pattern of preferences over prospects that involve only gains (positive outcomes) are reversed when considering comparable prospects with the same stakes, except that they involve losses (negative outcomes)

### • Implications

#### • Isolation Effect

- Expected Utility Theory neglects the effect of different paths to final states
- Decision Makers only compare the contingent prospects