Prospect Theory & Framing

EE 434 Behavioral Finance, SEM1/2022

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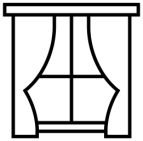
Framing



A decision frame

- A decision-maker's view of a problem and the possible outcomes
- A frame is affected by:
  - the presentation,
  - the person's perception of the question, and
  - personal characteristics.

Framing

- Framing is the presentation of a problem in informationally equivalent ways that highlight different information cues.

Violation of EUT

- If a person's decision changes simply because of a change in frame, expected utility theory is violated because it assumes that people should have consistent choices, regardless of presentation or how a problem is framed.

A decision frame: example

- Thought experiment B (in handout: “Foundation of Finance part 2: EUT?”
  - Respondents were asked to imagine different starting wealth positions
- Frame also matters even the outcomes are nonmonetary.

Adapted from Tversky&Kahneman(1981) unusual Asian Disease

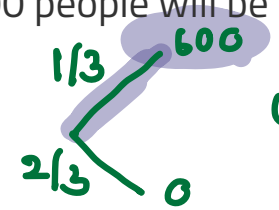
Airborne Disease: Survival frame

Imagine that the United States is preparing for the outbreak of an unusual airborne disease, which is expected to kill 600 people.

Two alternative programs to combat the disease have been proposed. Assume that the exact scientific estimates of the consequences of the programs are as follows:

If Program A is adopted, 200 people will be saved. (200, 1)

If Program B is adopted, there is a ⅓ probability that 600 people will be saved, and a ⅔ probability that no people will be saved.



(600, 1/3 ; 0, 2/3)

Which of the two programs would you favor?
What are the referent points in this case?

Adapted from Tversky&Kahneman(1981) unusual Asian Disease

Airborne Disease: Mortality frame

Imagine that the United States is preparing for the outbreak of an unusual airborne disease, which is expected to kill 600 people.

Two alternative programs to combat the disease have been proposed. Assume that the exact scientific estimates of the consequences of the programs are as follows:

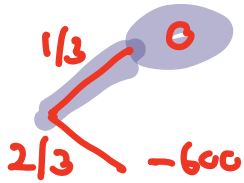
But A & C are the same

B & D are the same in terms of final wealth

If Program C is adopted, 400 people will die.

(−400, 1)

If Program D is adopted, there is a ⅓ probability that nobody will die, and a ⅔ probability that 600 people will die.



⇒ (−600, ⅔ ; 0, ⅓)

Which of the two programs would you favor?
What are the referent points in this case?

DANKE!

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