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Prospect Theory

Comprehension Questions

Indicate whether the statement is true or false, and justify your answer. Be sure to cite evidence from the chapter and state any additional assumptions you may need.

1. Individuals who always make decisions consistent with completeness, transitivity, and independence are exhibiting bounded rationality.

FALSE. Under bounded rationality, people are hindered by cognitive limitations and as a result they do not always make decisions consistent with completeness, transitivity, and independence.

2. Loss aversion is the economics of jealousy: people value what they do not have more than what they do have.

FALSE. The endowment effect claims that people value an item more if they have it than if they do not.

3. During prospect theory's editing stage, the operation of segregation always occurs before the operation of simplification.

FALSE. The order of operations varies by question as well as the actor.

4. Expected utility theory offers one possible valuation function that satisfies the properties of completeness, transitivity, and independence of preferences under uncertainty.

TRUE. The expected utility function is a value function where $v(x) = u(x)$.

5. The certainty effect and subcertainty are opposite phenomena.

FALSE. Both the certainty effect and subcertainty arise from people's observed tendency to overvalue certain outcomes (and implicitly, underweight outcomes that are just shy of certainty).

6. A typical value function is concave due to risk aversion.

FALSE. A typical value function has both concave and convex parts.

7. Whether a prospect is coded as a gain or as a loss can depend on how that prospect is framed.

TRUE. Empirical evidence says that the framing of a question can dramatically alter how changes in wealth are coded.

8. The endowment effect leads to a stronger status quo bias, because trades are more likely to occur.

FALSE. The endowment effect means trades are less likely to occur.

9. All perceived probabilities are weighted lower than actual probabilities.

FALSE. Extremely low perceived probability is weighted higher than extremely low actual probability.

10. Risk-averse individuals have a concave value function for prospective gains and a convex value function for prospective losses.

FALSE. Risk-averse individuals have concave value functions for prospective gains and losses. Loss-averse individuals have concave value functions for prospective gains and convex value functions for prospective losses because they are risk-averse when it comes to gains and risk-seeking with losses.