Prospect Theory And Its Applications

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Abstract

Economics involves the use of the scarce available resources to ensure that every need is satisfied. It might not be easy to achieve such a task if one does not plan all the things that he or she needs. People have to plan well so that they know whether they can satisfy themselves using the scarce available resources. The prospect theory talks about the manner in which people make choices based on probabilities rather than looking at the outcomes of a given task. The theory can be applied in many different ways.

Introduction

Behavioral Economics

Economics mainly deals with how people make decisions on the combinations of resources they should use. Behavioral economics mainly deals with the ability of a given decision made by a person to result in profit or losses. The branch of economics mainly deals with the decisions that are made in the market. The ability of people to make market choices depends on whether one can identify the things that make prices and outcomes change in the market. Different variables in the market determine the outcomes. In behavioral economics, one is only able to make the right decision by studying the trends in the market. Different areas behave differently, and it is important that one analyzes them before one knows the best step to take.

Prospect Theory Model

The prospect theory states that for a decision to be made about choices, one has to consider probabilities in case the outcomes are not known. In most cases, people always consider the probabilities of making losses or gains before they make a decision. For example, in a situation where people feel that there is a high chance of making losses, they may decide to avoid it because they will lose all their investments. The theory has been used in many areas of the economy (Green, P10). The approach has been used for a long time after Daniel Kahneman introduced it. He thought it wise to come up with a model that can enable people to make the right choices in different situations.

The theory makes use of psychology to make decisions in any field. The first thing that one should always consider is the probability of making profits or losses in any given situation. In most cases, people engage in business without knowing the decisions they should make if they are to make a good amount of income. Most businesses that have failed have not taken into account the application of the theory. The model has two sections: the first section, in which one lists all the possible outcomes before making a choice. One might have different options, but making the right decision is the problem. In such a situation, the best step to take is to list them down and look at those that have a high ability to gain as those that have lower risks. On the other hand, those that have high risks involved have lower gains; hence, the decision to take the first one is right. The second stage is called the evaluation stage, where one calculates the utility of any given option before choosing the one with the highest utility.

Literature Reviews

1. Kahle, Lynn R. (2013). Belief Systems, Religion, and Behavioral Economics: Marketing in Multicultural Environments. Business Expert Press.

The book looks at the different things that control the choices that one might make in the market. By taking a broad view, the book looks at different sectors that can be affected by fluctuations. Making a decision about investment can be a difficult task if one does not know the things that he or she should always take into consideration. The author looks at different environments where the idea of behavioral economics can be applied. For example, the book looks at the options that can be used in marketing and how businesses can use this knowledge to be able to market their products (Lynn, P56). By using this technology, marketing can be a very easy task. The research in this book is important because it enables us to come up with the right information about behavioral economics.

2. Green, Leonard (1995). Economic Choice Theory: An Experimental Analysis of Animal Behavior. Cambridge University Press

The book is also another resource that can be used in the process of understanding the idea of behavioral economics. By studying the case studies provided in the book, one can clearly see the relationship between the choices that they make and the possible outcomes. Controlling the decisions that one makes can be important in different situations, as they are outlined in the book. The book also gives a clear view of the things that people must always look at before they make a choice of the best option. The book is relevant to this research as it talks in detail about behavioral economics and the steps that one should take if they are to get the best outcomes.

3. Grafstein R (1995). Rationality as Conditional Expected Utility Maximization. Political Psychology.

Calculating utility is one of the most important stages that one must encounter in the prospect theory model. The author of the book has outlined the steps that one should take so that one knows the best decisions to make. Deciding on business requires one to identify the factors that affect the operations of any activity. The risks involved should be looked at thoroughly before they decide on whether they need to choose the option or not. The book provides clear reasons why people would choose to use a given option over the other ones.

4. Camerer Colin (1997). “Progress in behavioral game theory.” Journal of Economic Perspectives. Caltech.

This is another book that has content relevant to this topic. The book looks at economics as a psychological game that involves looking at the different behavioral aspects of different commodities or transactions before they make a given decision. Decisions in many fields are always made after looking at a set of conditions that affect the given transaction. The book will provide a good basis on which one can make decisions. The book also provides the current trends that people use to ensure they are able to understand the idea of prospect theory in a better way.

Importance Of The Study Of Prospect Theory

The study of prospect theory is of great importance in many fields. The first important aspect of the study is that one learns how to make decisions in different cases. There are cases when one might not understand the decisions that are made by the business. As a business student, it is always important that one ensures that one keeps track of the things that take place in the industry. In most cases, students find it hard to understand why a business would decide to use a given method of production over the other ones. The student might believe that there are better ways of doing business than the one chosen by the given business. The prospect theory always guides the ability of a company to make the best choices. The theory provides a framework within which good decisions can be made.

As a student, one is also able to apply the knowledge in daily activities. The student will know that the best way to tackle a given issue is by considering the possible outcomes before making any given decision. The knowledge of prospect theory will also be important to a student when they want to do business. Business students are always encouraged to practice business so that they know how to deal with the problems that business people encounter in their daily lives. It is possible to know the various problems that one can meet when doing business. It is also possible to come up with ways that can be used to ensure the business runs well and does not make any losses. Losses are always the result of poor decisions made by a business.

How Prospect Theory Can Influence Decision-Making

Just like any other file, it is always important to take some factors into consideration before making a choice. The type of choice that one makes will determine whether the type of business they do will be a success or not. The prospect theory is a very important tool that can be used in decision-making. Decision-making is a process that involves choosing the best option out of the many available options. For example, in a case where one wants to do sales, he or she will have to come up with the best marketing plan for the product. The best tool that can be used in such a situation is the prospect theory. The business will have to list all the possible methods they can use in marketing. Once they list them, they can compare the costs versus the income they can get by using all of them. A good marketing strategy is one that will minimize the overall cost of marketing the products and still be able to produce the best income.

Application Of The Prospect Theory To Different Fields

The prospect theory can be applied in different fields like investment, risk management as well as economics. The application will mainly depend on the area.

Application of the theory to economics

The field that many people know to be directly related to prospect theory is the field of economics. Economics involves the use of scarce available resources to satisfy human wants. The definition mainly looks at economics from a consumer perspective. The consumer will have to compare different alternatives in the market versus the amount he or she has before making a purchase. Most goods have substitutes, which will require that the consumer lists all of them to see which one will bring better satisfaction and reduce the amount of money used in the purchase. It will operate like the case of opportunity cost, where one has to choose the best good to utilize, putting into consideration the money he or she wants to spend. The theory can also be applied to producers. They also have various methods of production, marketing, and distribution. They have to compare the methods before they decide on the one that will bring more profits to the company at a lower cost (Colin, P34).

Application of the theory to investment

Investments involve the use of finances to create more wealth. Many investments have failed because the owners did not make the best investment decisions. Such decisions can only be made by looking at possible investment decisions available, the risks involved, and the possible income that one can get from such an investment. The best way to apply this theory is by looking at the investment that will bring back more income than the other and still has low-risk levels. When one has a given amount of capital, they find it difficult to make investment decisions by simply looking at the investments. Once they look at the risks involved as well as the amount of money that they will get in return, it will be easy to make investment decisions.

Application of the prospect theory to risk management

Risk management is also another filed in which the method can best be applied. Since the approach is always aimed at making losses, it can best be used to avoid the circumstances that cause losses in any business. A company will look at the level of risks it has to incur when it uses different methods of production before it decides on the best one to use. A business that experiences more risks has a high chance of making losses since there is a high chance of the risks occurring. To avoid such risks, it is important that the business ensures it looks for the best option to avoid such losses caused by the risks.

Conclusion

Behavioral economics can be applied in many cases. Along with the prospect theory, it can help business people avoid making a lot of losses that they have always made. Many people end up not getting the best ways to carry out business because they do not know the factors they have to take into consideration. The best way to avoid a lot of risks in the industry is by ensuring that they carry out an analysis of the options. It is the method that innovative businesses have used to avoid risks in the industry. It is not always advisable to stick to the old ways of doing things as it only exposes the business to more risks. The best way to avoid risks is to always look for options to analyze before making a decision (Ruth, P12). Using prospect theory as a decision-making tool is the only way that one can ensure profitability in any business.

Works Cited

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