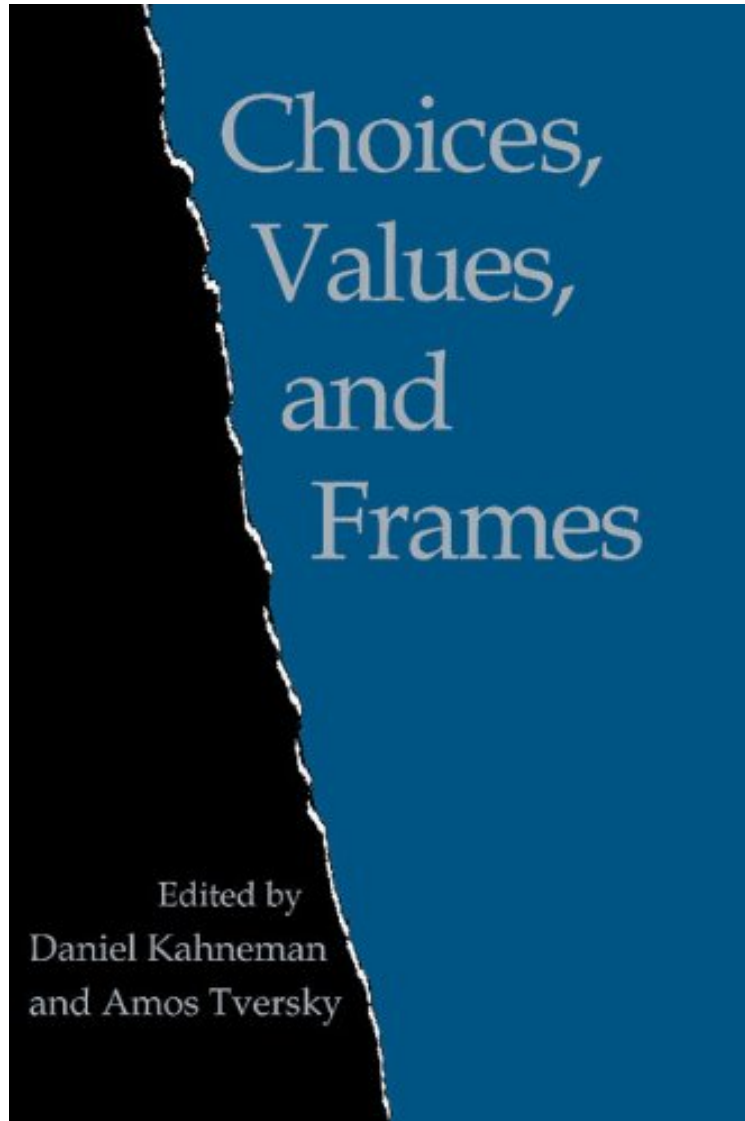


## Choices, Values, and Frames

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**From Cambridge University Press : Choices, Values, and Frames** before purchasing it in order to gage whether or not it would be worth my time, and all praised Choices, Values, and Frames:

73 of 73 people found the following review helpful. SIGNIFICANT ADVANCES IN ECONOMICS THAT LED TO NOBEL PRIZE By Denis Benchimol Minev Kahneman and Tversky's compilation of articles in this book is an outstanding exposition of recent advances in cognitive psychology, especially advances associated with prospect theory. The work presented in this volume is largely responsible for the authors being awarded the Nobel Prize (Tversky died before receiving it). The text is somewhat dense at parts, being aimed at economists and psychologists with some mathematical familiarity. However, the portions of the book that require much mathematics can safely be

bypassed without losing much of the substance of the text. This text is the most credible presentation of an alternative theory to the rational actor theory usually assumed in economics. For example, some of the articles help explain the magnitude of the equity return premium, or help show how people make choices differently in similar situations based simply on the way the situation is presented. I would highly recommend this book to anyone interested in decision making theory, especially as it relates to consumer behavior. It is a brilliant volume that includes the most important articles by the leading mind in the field.

5 of 5 people found the following review helpful. Risk decisions finally explained. By Beaumont Vance. I wonder, what can one say about work that has already won the Nobel Prize that can possibly add to the estimation of a work? Being far too insignificant to lend any great weight to the already abundant praise for this work, I can only perhaps illuminate an application of the material that seems to have been overlooked. Regarding the field of risk management (not the Wall Street kind, but just regular risk decision making in business) this book is of inestimable value. I have often noticed certain biases towards risk aversion or risk taking when business decisions are being made. Much seemed to be due to the context. This work shows exactly why and how decision bias arises. This is the foundation for the creation of a useful risk decision analytical framework. The paper of interest to me relates to why people will choose to take or avoid risks that, according to utility theory, are the wrong decisions. For example, why people buy insurance even when it is a better financial choice to be uninsured. These works explain why and under what circumstances one's biases override logic. Why this is not a common text on the desk of every risk manager, I will never know. In this one volume, there is enough information to design an utterly new field of risk management and to solve most every problem one can face. This has become the one reference material that I consider indispensable. Throw out the CPCU and ARM texts that you never use and can't bear to read ever again. Chuck them and place this volume in their place and you will be far, far better off.

11 of 13 people found the following review helpful. A relatively new but useful paradigm for risk management. By Dr. Lee D. Carlson. Most, if not all who have done financial modeling have made some use of prospect theory in order to assess and measure risk in financial instruments, although this use has yet to be widespread throughout the risk management community. The reason for this is very simple: prospect theory gives another view of risk that is different from the traditional one offered by classical economics, and one that is closer to what is exemplified in real economic data. Its theoretical foundations are less clear however, as compared to what is found in the now canonical approaches to risk based on Merton, Black, Scholes, etc. In prospect theory it is assumed that individuals make financial decisions relative to a reference point, and loss aversion plays a predominant role. In housing markets for example, some homeowners are reluctant to sell their properties if the prices fall below the market value. Empirical data shows that when house prices decline, houses sit for exceedingly long periods of time with their asking prices exceeding greatly the expected selling prices. These houses are usually withdrawn from the market without being sold. Classical economic theory would suggest that they would be sold with the asking price being very close to the market price, since the sellers are assumed to be rational and weigh expected gains in the same way as they expected losses. In prospect theory however, the value function for an individual is concave in gains but convex in losses, and is much more sensitive to losses than to gains of an equivalent size. Prospect theory is thoroughly and beautifully discussed in this book and this is due to some degree by the presence of articles written by Daniel Kahneman and Amos Tversky, its originators. As outlined by these two researchers, prospect theory asserts that individuals tend to be sensitive to changes in values rather than absolute values and have diminishing marginal sensitivity to changes. This is reflected in the shape of their utility functions: qualitatively speaking they are steepest in regions where the marginal sensitivity to change is greatest and then they flatten out in directions where the changes in wealth increase. As a consequence, individuals prefer a small gain that is certain to a larger gain that is uncertain. Conversely, they prefer the possibility of a larger gain than the certainty of a small loss. To motivate the content of the book, Kahneman writes an excellent preface, giving an overview of what to expect in the book and thus allowing readers to assign their own weights to which particular articles they find of interest. Some readers may want to read the entire book, but it seems likely that only selected articles will be chosen for careful study, based of course on the background of the reader. However, the first article in the book, which was published by Kahneman and Tversky in 1983, should probably be read by everyone interested in prospect theory and its foundations. The second article is a more quantitative formulation of what was said in the first, and contains an in-depth critique of expected utility theory. The content of this article should be helpful to those readers who work in a risk management environment and need to construct realistic models of choice under risk. If the development of these models is guided by prospect theory, the analyst will arrive at a final product that could with fairness be classified as "microeconomic." The challenge in using prospect theory is to conglomerate the individual choices so that a risk manager can speak intelligently of the risk of a portfolio that is based on these individual choices. Some insight that could guide this development can be found in Part Five of the book, which covers applications of prospect theory. One particular article that stands out in this regard is the one by S. Benartzi and R. H. Thaler on the equity premium puzzle. This article attempts to understand, in the context of prospect theory, why fixed income securities have underperformed relative to stocks for the last nine decades, from about a 7% annual real return on stocks to a 1% return on treasury bills. The author's simulations indicate that the loss aversion aspect of prospect theory gives a better explanation to the equity premium puzzle than the traditional approaches based on expected

maximum utility. Still another interesting article in Part Five is the one on the 'money illusion' written by E. Shafir, P. Diamond, and A. Tversky, and which first appeared in publication in 1997. The term 'money illusion' is used to refer to the tendency of some individuals to think in terms of nominal values instead of real monetary ones. It is thus at odds to the picture offered by classical economics with its assumption of perfect rationality. The authors point to studies in cognitive psychology that indicate that some individuals form alternative representations of identical situations, and that these lead therefore to different responses. Examples of this are given, leading the authors to assert that the money illusion can be interpreted as a bias in assessing the real value of an economic transaction. This bias is induced by a nominal evaluation and its magnitude is determined by the real salience between the nominal and real representations, and the sophistication of the decision maker. The reviewer has used these types of considerations in modeling home equity markets.

This book presents the definitive exposition of 'prospect theory', a compelling alternative to the classical utility theory of choice. Building on the 1982 volume, *Judgement Under Uncertainty*, this book brings together seminal papers on prospect theory from economists, decision theorists, and psychologists, including the work of the late Amos Tversky, whose contributions are collected here for the first time. While remaining within a rational choice framework, prospect theory delivers more accurate, empirically verified predictions in key test cases, as well as helping to explain many complex, real-world puzzles. In this volume, it is brought to bear on phenomena as diverse as the principles of legal compensation, the equity premium puzzle in financial markets, and the number of hours that New York cab drivers choose to drive on rainy days. Theoretically elegant and empirically robust, this volume shows how prospect theory has matured into a new science of decision making.

"Daniel Kahneman and the late Amos Tversky have started a new perspective on the traditional economic categories of choice, decision, and value. A series of experimental and empirical studies by them and others have rejected traditional economic assumptions of rationality. Even more importantly, these scholars have developed alternative generalizations with significant predictive power and have found empirical verification for them. This outstanding collection of studies will make these new results widely accessible." Kenneth J. Arrow, Joan Kenney Professor of Economics, Emeritus and Professor of Operations Research, Emeritus, Stanford University  
From the Publisher Daniel Kahneman is co-winner of the 2002 Nobel Memorial Prize in Economic Sciences. The award was bestowed in recognition of the influential research conducted by Kahneman and his long-time collaborator, the late Amos Tversky, on the psychology of human judgment and decision-making. According to a recent article published in the journal *Psychological Science*, the research program initiated by Kahneman and Tversky is considered psychology's "leading intellectual export to the wider academic world." Current scholarship and research in medicine, law, public policy, international relations, and economics has been profoundly shaped by their insights into human rationality.  
About the Author Kahneman is the Eugene Higgins Professor of Psychology and Professor of Public Affairs at the Woodrow Wilson School of Public and International Affairs at Princeton University. He has been a faculty member at Hebrew University, Israel, the University of British Columbia, Canada, and the University of California, Berkeley.