

What is prospect theory?

Prospect theory is a behavioural economics theory that describes how people make decisions under uncertainty. It was developed by psychologists Daniel Kahneman and Amos Tversky in 1979 and has since become a fundamental concept in the field.

Key points of prospect theory include:

1. **Loss Aversion:** People tend to be more sensitive to losses than to equivalent gains. In other words, the pain of losing \$100 is generally felt more strongly than the pleasure of gaining \$100.
2. **Diminishing Sensitivity:** As the size of potential gains or losses increases, individuals become less emotionally responsive to changes. The psychological impact of an additional gain or loss diminishes as the overall magnitude grows.
3. **Reference Point:** Decision-making is influenced by a reference point, which can be a previous state, an expected outcome, or a perceived norm. Gains and losses are assessed relative to this reference point.
4. **Asymmetric Values Function:** The value function, representing how individuals perceive gains and losses, is typically steeper for losses than for gains. This reflects the greater emotional impact of losses.
5. **Framing Effects:** The way a decision or scenario is framed can influence decision-making. People may react differently to the same situation if it is presented as a potential gain or a potential loss.

Prospect theory challenges the traditional economic assumption of rational decision-making and utility maximisation. It suggests that people's decisions are influenced by cognitive biases and emotional responses, leading to deviations from classical economic models. The theory has implications for various fields, including finance, marketing, and public policy.

What is the Effectuation Principle of Affordable Loss?

The Effectuation Principle of Affordable Loss is a concept within effectuation theory, a framework developed by entrepreneur and scholar Saras Sarasvathy. Effectuation is a decision-making approach often associated with entrepreneurial thinking. The principle of Affordable Loss is one of the key principles of effectuation.

The Effectuation Principle of Affordable Loss involves making decisions based on what you are willing and able to lose rather than solely focusing on expected returns or outcomes. Here's a breakdown:

1. **Risk-Taking Perspective:** Instead of starting with a predefined goal and assessing the risks to achieve that goal, the entrepreneur begins with what they are willing to invest or lose in a venture. This approach is in contrast to a more traditional, goal-driven, and risk-averse mindset.
2. **Affordable Loss:** Entrepreneurs consider what they can afford to lose in terms of resources, time, and effort. This affordable loss becomes the basis for decision-making. The emphasis is on making decisions that won't jeopardize the entrepreneur's core assets or well-being.
3. **Iterative Decision-Making:** The entrepreneur takes small steps, learns from each step, and adapts their approach based on the feedback received. The process is iterative and allows for flexibility and adjustment as the venture unfolds.
4. **Learning Orientation:** The focus is not solely on avoiding failure but on learning from the experience, regardless of the outcome. Entrepreneurs view the process as an opportunity to gather information, build relationships, and refine their understanding of the market.

5. Entrepreneurial Mindset: The Principle of Affordable Loss aligns with an entrepreneurial mindset that embraces uncertainty and views setbacks as part of the learning process. It encourages a more proactive and experimental approach to decision-making.

Effectuation theory is often contrasted with causation, where entrepreneurs set specific goals and then determine the means to achieve those goals. In contrast, effectuation emphasizes the dynamic and emergent nature of the entrepreneurial process, with decision-making based on the resources at hand and a willingness to adapt to changing circumstances.