



Prospect Theory: How People Make Decisions



Written by **Cole Abbott** • Updated: September 26, 2024 • 11 Minute Read

Welcome to Founder's Framework, offering full access to objective, informational, and researched articles on core business frameworks — aggregated into a single, organized space.

This article provides a detailed overview and expert insights on the prospect theory (also known as loss aversion) to help leaders select the appropriate framework to support business growth and sustainability.

At a Glance

Framework: Prospect Theory (aka Loss Aversion)

Creator: Daniel Kahneman and Amos Tversky

Stage of Development: All Stages

Core Competency: [Structure](#)

Business area: [People](#), [Productivity](#)

Change Required: No direct change management requirements.

Key pain points addressed:

- Missed opportunities based on overly conservative strategies
 - Suboptimal decision-making
 - Restricted insight into consumer behavior
 - Suboptimal investment strategies
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What Is Prospect Theory?

Prospect theory, also known as **loss aversion**, belongs to the behavioral economic subgroup and describes how people make decisions under conditions of risk and uncertainty. This theory was formulated in 1979 and further developed in 1992, leading to it becoming more psychologically accurate in terms of how decisions are made under **cumulative (rather than separable) decision weights** and across various outcomes.

Who Created Prospect Theory?

“Prospect theory assumes that losses and gains are valued differently, and thus individuals make decisions based on perceived gains instead of perceived losses...if two choices are put before an individual, both equal, with one presented in terms of potential gains and the other in terms of potential losses, the former option will be chosen.” ([Investopedia](#))

Prospect theory was developed by psychologists **Daniel Kahneman** and **Amos Tversky** in 1979. Their groundbreaking research on decision-making under the pressure of risk and uncertainty laid the foundation for understanding how people evaluate potential losses and gains. Since its inception, this theory has had a significant impact on behavioral economics and finance.

KEY TERM

Loss Aversion

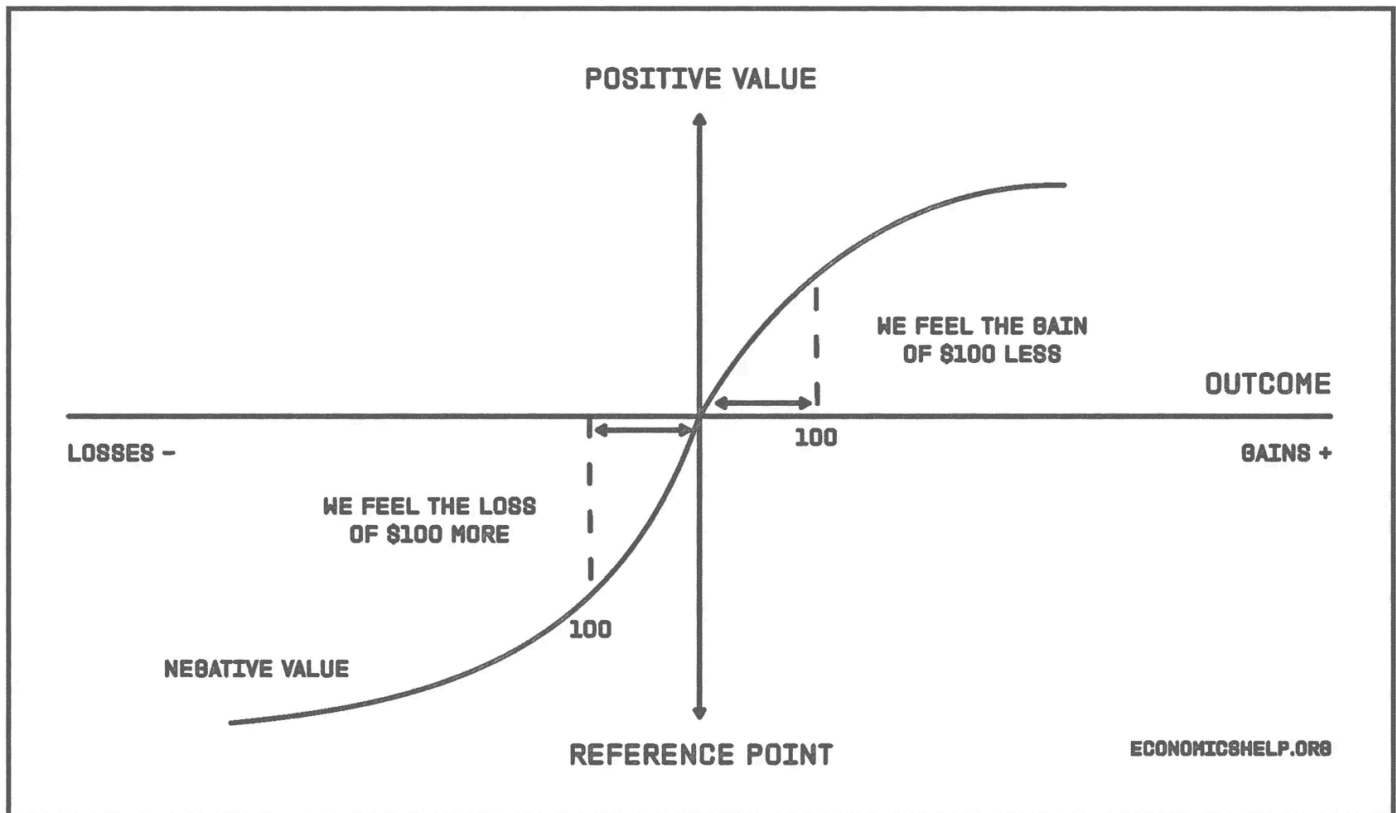
Businesses often face decisions where the potential for loss is more influential than equivalent gains. Prospect theory highlights that losses loom larger than gains, which can impact business decisions, such as pricing strategies, investment choices, and risk management.

Kahneman and Tversky proposed that losses have a greater emotional impact on an individual than an equivalent amount of gain. So, given two choices – both offering the same result – an individual will select the option offering perceived gains.

Key Concepts of Prospect Theory

- **Loss aversion:** This concept asserts that losses are felt more strongly than equivalent gains. This explains why individuals are often more motivated to avoid losses than to acquire gains of equal value.
- **Framing effects:** This refers to how choices are “framed” and the impact that framing can have on decision-making. It highlights that decisions are not always based on pure logic or utility.
- **Certainty effects:** This refers to when individuals prioritize certain outcomes over probable ones. This explains behaviors such as buying insurance for unlikely events.
- **Reference point dependence:** People evaluate outcomes relative to a reference point (typically the status quo) rather than in absolute terms. This explains behaviors such as purchasing common, popular items rather than those that are more niche.
- **Nonlinear probability weighting:** People tend to place more weight on small probabilities and undervalue large probabilities. This explains behaviors such as avoiding air travel after learning of a plane crash.
- **Subjective value assessment:** Prospect theory recognizes that people assess value subjectively rather than purely based on objective expected utility. This allows for a more

nuanced understanding of how people make decisions.



Original Source: [Economics Theory](#)

Key Pain Points Addressed

Prospect theory addresses key pain points related to stress and human performance:

- ✓ **Missed opportunities based on overly conservative strategies:** This can occur based on loss aversion bias. Prospect theory recognizes the impact that attitudes and emotions have on decision-making. This leads to biased framing, weighting, and evaluation that prompt risk-averse behavior when individuals are presented with possible gains and risk-seeking behavior when they are presented with potential losses.

To mitigate loss aversion, the theory supports decision framing that is influenced by how a product or program prevents losses or solves existing issues rather than focusing only on possible new benefit gains.

“It is thought that the pain of losing is psychologically about twice as powerful as the pleasure of gaining. People are more willing to take risks to avoid a loss than to make a gain.” ([BehavioralEconomics.com](#))

✔ **Suboptimal decision-making:** How choices are presented or “framed” (aka framing effects bias) can significantly impact decision-making, even when the underlying options are identical. Simply translated: Decisions are not always based on pure logic or realistic value.

✔ **Restricted insight into customer behavior:** Closely related to loss aversion and framing, prospect theory recognizes that individuals assess value subjectively rather than on objective expected value. This allows for a more nuanced understanding of how people (that is, customers) make decisions.

Businesses can overcome subjective assessment by implementing data-driven decision-making and policies and encouraging feedback across diverse roles and functions to better understand consumer behaviors.

✔ **Suboptimal investment decisions:** Loss aversion, framing, and subjective value assessment can lead to suboptimal investment choices based on bias.

Companies can combat this by presenting information in multiple formats, mitigating negative-heavy framing effects. For example, they could emphasize potential gains and losses simultaneously. Organizations should also put effort into educating key decision-makers on prospect theory and the benefits of unbiased framing and objective assessment.

Overall, the application of prospect theory helps companies align strategies (for example, pricing, marketing, and business development), financial policies, and communications with decision-making behaviors.

When You Should Apply Prospect Theory

Prospect theory is applicable across all stages of organizational development. It's particularly useful when:



Making strategic decisions involving risk and uncertainty



Designing marketing and pricing strategies



Developing investment and financial policies



Creating employee incentive programs and negotiating deals and contracts

Pros and Cons of Prospect Theory

As you evaluate this framework, consider the top pros and cons:

Pros

- ✓ Provides a more accurate model of human decision-making concerning uncertainty and risk
- ✓ Helps explain seemingly irrational economic behaviors
- ✓ Provides deeper insight into consumer buying behavior
- ✓ Useful in understanding and mitigating cognitive biases in decision-making
- ✓ Applicable across various industries and business contexts

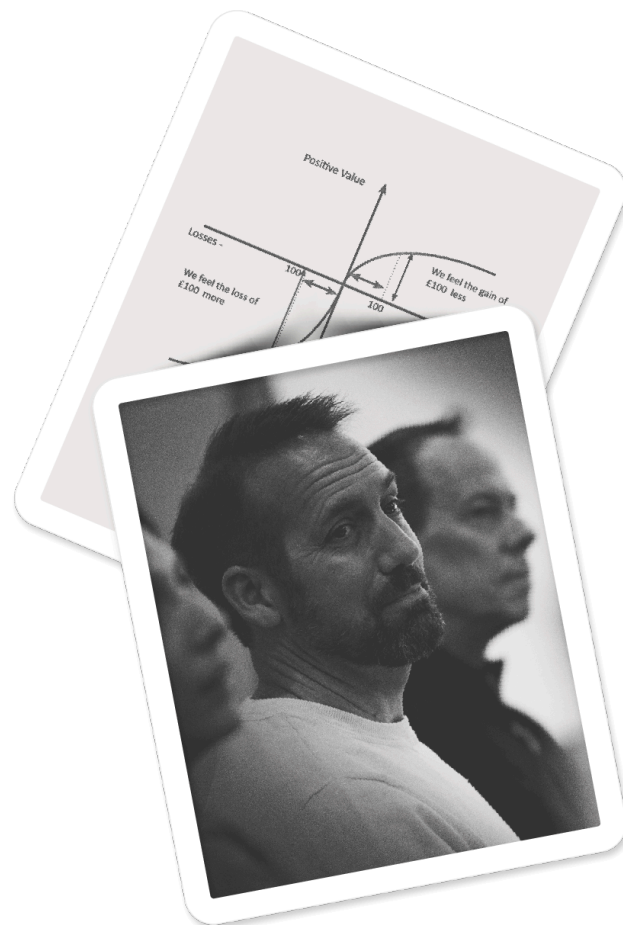
Cons

- ✗ Can be complex to apply in practice
- ✗ May not account for all factors influencing decision-making
- ✗ Can be challenging to accurately measure reference points
- ✗ May lead to overly cautious decision-making if not properly understood

TLDR: Prospect Theory in Summary

Prospect theory offers organizations a framework for understanding how individuals make decisions under conditions of risk and uncertainty. By recognizing that individuals are loss-averse and that their choices are influenced by framing and reference points, organizations can create more effective strategies in areas such as marketing, finance, human resources, and beyond.

Implementing the theory requires a thoughtful approach to decision framing, risk assessment, and communication. While it presents some challenges in terms of complexity and measurement, the potential benefits in terms of improved decision-making, risk management, and overall organizational performance make it a worthwhile consideration.



As with any behavioral theory, prospect theory should be approached with flexibility and dedicated, long-term assessment. Regular feedback and data analysis will properly guide theory application and better ensure that it will enhance individual and organizational outcomes.

Guided Approach to Prospect Theory

If you believe prospect theory is applicable to your organization, it's time to start preparing for implementation. Consider the following guides as you move forward with theory application:

Ensure stakeholders have a deep understanding of the theory.

Research the framework's core concepts, including loss aversion, framing effects, reference point, and probability weighting.

Assess current decision-making processes.

Evaluate how risk and uncertainty are currently handled in your organization and document the results for deeper analysis among all Ideal Stakeholders.

Identify key decision points.

Determine where prospect theory insights could be most beneficial within your organization. This can be at the individual, team, department, or company-wide levels.

Evaluate existing reframe choices.

Consider how decisions are currently presented within your organization and explore alternative framings. Be sure to test framings for the best long-term results.

Educate all stakeholders.

Provide training on prospect theory and its implications for decision-making across roles and departments.

Implement decision support tools.

Develop tools that incorporate prospect theory insights to aid in decision-making. This can include policies, best practice checklists, and proprietary platforms that support your company's unique structure.

Monitor and course correct.

Continuously evaluate the effectiveness of strategies and adjust as needed.

By following these steps, organizations can leverage the insights of prospect theory to improve decision-making processes and outcomes across business functions and individuals.

Take Ninety

At Ninety, we believe that how decisions are made is a cornerstone of a successful company culture. Founders have both the ability and responsibility to set a clear [vision](#) and establish a culture rooted in [transparency](#) and implicit [agreements](#). We often refer to our [Forever Agreements](#), which serve as guiding principles that enable everyone in the organization to make decisions that align with the company's goals and values. By establishing these agreements, we create a unified approach to decision-making that empowers our teams to act confidently and consistently, ensuring that every choice contributes to the broader vision.

Our approach is built on the idea that an [agreements-based culture](#) simplifies decision-making and enhances alignment across the company. As part of our vision, we establish clear [Focus Filters](#) that not only help us avoid the cognitive biases highlighted by prospect theory but also reinforce a culture where decisions are intentional and purpose-driven. By embedding these principles into the fabric of our organization, we ensure every decision is made with clarity, supporting a culture that drives long-term success and sustainability.

Next Steps

For those ready to take action, consider these actionable steps:

- ① Are you simplifying decision-making at your company? Discover what [Focus Filters are and how they help](#).
- ② Don't know what Stage of Development your company is in? Complete the [Stages of Development Assessment](#) to find out.
- ③ Is your company growing at an optimal rate? Find out the signals to look for in our [Grow or Die series](#).
- ④ What does it mean to master the Structure Competency in your company? [Discover the areas to focus on](#).
- ⑤ Are you being intentional about how your business operates? Find out [where your company's approach ranks](#).

Tagged with: **Productivity**, **People**, **Stage 3: Scale**, **Organizational Structure**, **Stage 2: Sustain**, **Stage 1: Survive**, **Stage 4: Succeed**, **Stage 5: Steward**