

EQM Research Seminar

“The Role of Prior Beliefs in Decisions under Experienced Uncertainty”

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ABSTRACT

This paper points out the role of prior beliefs in understanding decisions under ambiguity with sampling experience. As a working hypothesis, the subjective beliefs are modelled with a Bayesian rule of updating, combining prior beliefs with sampling observations. The Bayesian updating provides a rational explanation for the commonly found overestimation of rare outcomes, and an empirically appealing way to deal with always – or never – observed outcomes. Then, the preferences are modelled with cumulative prospect theory, where the probability weighting captures deviations from subjective expected utility theory. A reanalysis of the existing data sets from the literature of decisions from experience confirms the role of prior beliefs. A two-stage model with risky weighting function coupled with the updating of symmetric priors outperforms the single-stage model, which ignores the role of prior beliefs, as well the source method. While the well-known ambiguity aversion is not observed in the data sets, regressive probability estimations (due to updating of symmetric priors) provides a better account of the data than ambiguity-generated likelihood insensitivity captured by source functions.

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