Rational decisions

Chapter 16

Outline

◊ Rational preferences

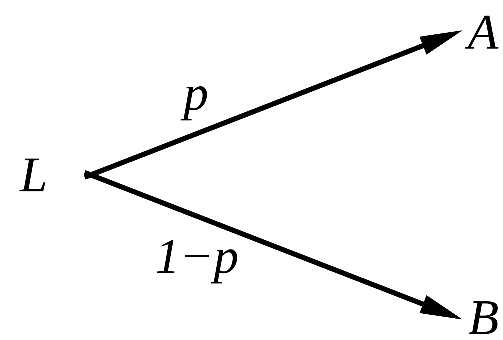
◊ Utilities

◊ Money

◊ Value of information

Preferences

An agent chooses among prizes (A, B, etc.) and lotteries, i.e., situations with uncertain prizes



Lottery $L = [p, A;\ (1-p), B]$

Notation:

$A \succ B$	A preferred to B
$A \sim B$	indifference between A and B
$A \succsim B$	B not preferred to A

Rational preferences

Idea: preferences of a rational agent must obey constraints.

Rational preferences $\Rightarrow$

behavior describable as maximization of expected utility

Constraints:

<u>Orderability</u>

$(A \succ B) \vee (B \succ A) \vee (A \sim B)$

<u>Transitivity</u>

$(A \succ B) \wedge (B \succ C) \;\Rightarrow\; (A \succ C)$

<u>Continuity</u>

$A \succ B \succ C \;\Rightarrow\; \exists\, p \;\; [p, A;\; 1-p, C] \sim B$

<u>Substitutability</u>

$A \sim B \;\Rightarrow\; [p, A;\; 1-p, C] \sim [p, B; 1-p, C]$

<u>Monotonicity</u>

$A \succ B \;\Rightarrow\; (p \geq q \;\Leftrightarrow\; [p, A;\; 1-p, B] \succsim [q, A;\; 1-q, B])$

Rational preferences contd.

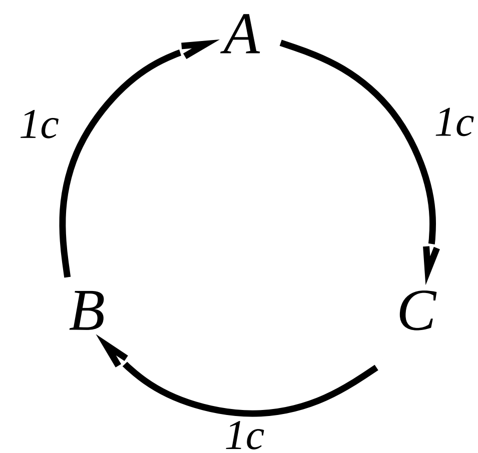
Violating the constraints leads to self-evident irrationality

For example: an agent with intransitive preferences can be induced to give away all its money

If $B \succ C$, then an agent who has C would pay (say) 1 cent to get B

If $A \succ B$, then an agent who has B would pay (say) 1 cent to get A

If $C \succ A$, then an agent who has A would pay (say) 1 cent to get C



Maximizing expected utility

Theorem (Ramsey, 1931; von Neumann and Morgenstern, 1944):
Given preferences satisfying the constraints
there exists a real-valued function U such that

$$U(A) \geq U(B) \quad \Leftrightarrow \quad A \succsim B$$
$$U([p_1, S_1;\ \ldots\ ;\ p_n, S_n]) = \sum_i p_i U(S_i)$$

MEU principle:
Choose the action that maximizes expected utility

Note: an agent can be entirely rational (consistent with MEU)
without ever representing or manipulating utilities and probabilities

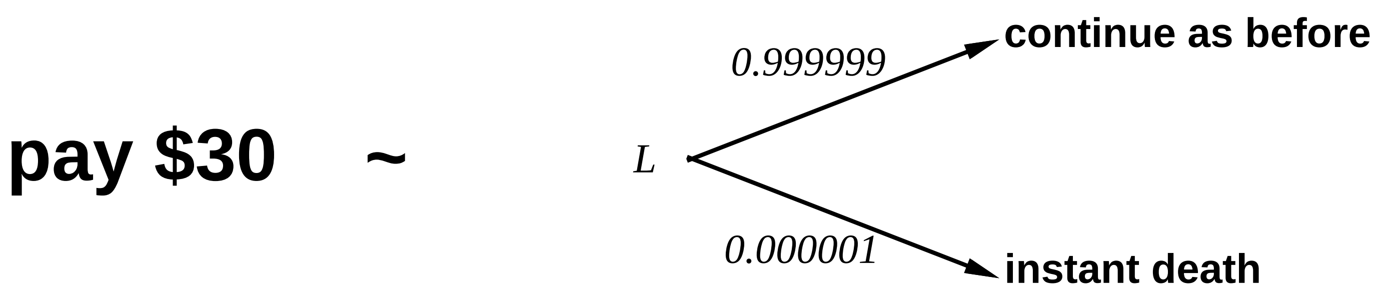
E.g., a lookup table for perfect tictactoe

Utilities

Utilities map states to real numbers. Which numbers?

Standard approach to assessment of human utilities:

- compare a given state A to a standard lottery L_p that has
  - "best possible prize" $u_\top$ with probability p
  - "worst possible catastrophe" $u_\bot$ with probability $(1-p)$
- adjust lottery probability p until $A \sim L_p$



Utility scales

Normalized utilities: $u_\top = 1.0$, $u_\perp = 0.0$

Micromorts: one-millionth chance of death
useful for Russian roulette, paying to reduce product risks, etc.

QALYs: quality-adjusted life years
useful for medical decisions involving substantial risk

Note: behavior is **invariant** w.r.t. +ve linear transformation

$$U'(x) = k_1 U(x) + k_2 \quad \text{where } k_1 > 0$$

With deterministic prizes only (no lottery choices), only ordinal utility can be determined, i.e., total order on prizes

Money

Money does **not** behave as a utility function

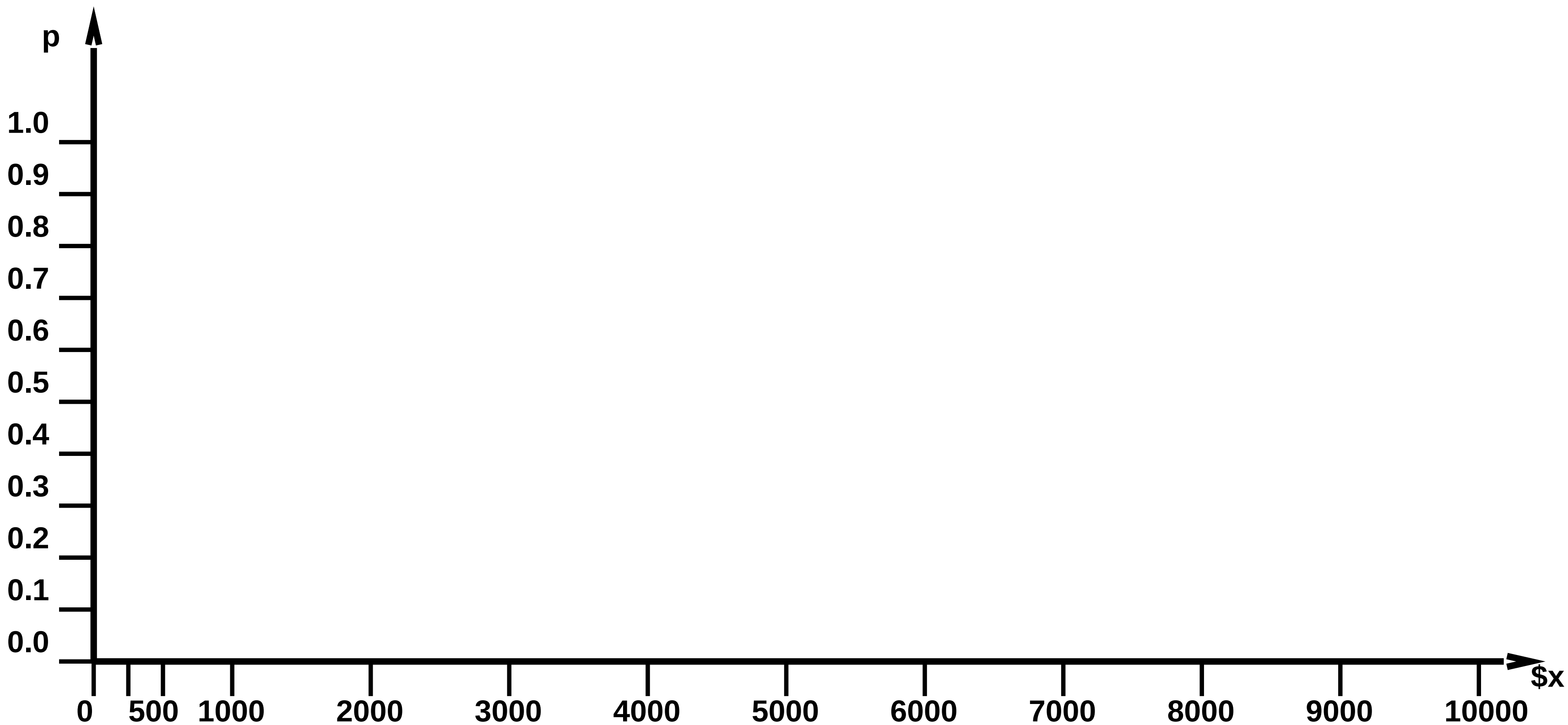
Given a lottery L with expected monetary value $EMV(L)$,
usually $U(L) < U(EMV(L))$, i.e., people are risk-averse

Utility curve: for what probability p am I indifferent between a prize x and a lottery $[p, \$M;\ (1-p), \$0]$ for large M?

Define $U(M) = 1.0$ and set $U(x) = pU(M) = p$

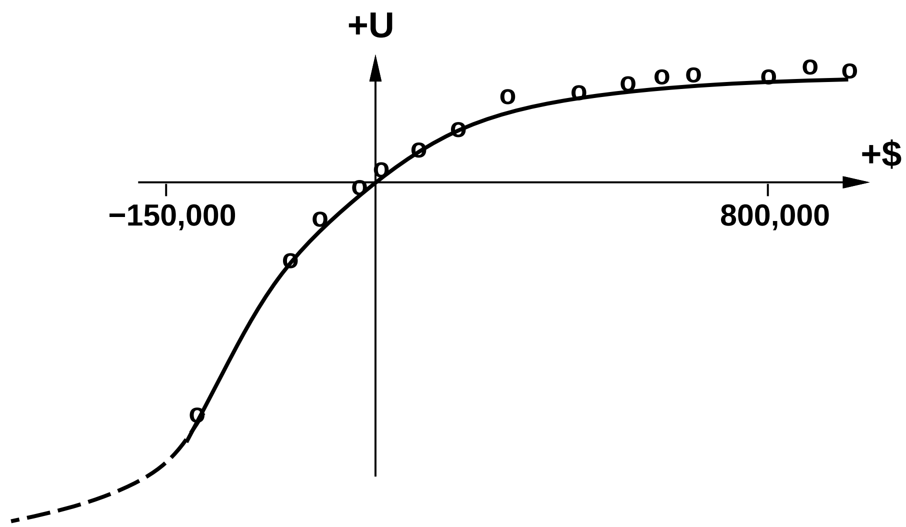
Student group utility

For each x, adjust p until half the class votes for lottery (M=10,000)



Money

Typical empirical data, extrapolated with risk-prone behavior:



Value of information

Idea: compute value of acquiring each possible piece of evidence

Example: buying oil drilling rights

Two blocks A and B, exactly one has oil, worth k

Prior probabilities 0.5 each, mutually exclusive

Current price of each block is $k/2$

"Consultant" offers accurate survey of A. Fair price?

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minus expected value of best action without information
Survey may say "oil in A" or "no oil in A", **prob. 0.5 each** (given!)
$= [0.5 \times$ value of "buy A" given "oil in A"
$+ 0.5 \times$ value of "buy B" given "no oil in A"]
– $0.5 \times k/2$
$= [(0.5 \times k/2) + (0.5 \times k/2)] - (0.5 \times k/2) = k/4$

General formula

Current evidence E, current best action α
Possible action outcomes S_i, potential new evidence E_j

$$EU(\alpha|E) = \max_a \Sigma_i \, U(S_i) \, P(S_i|E, a)$$

Suppose we knew $E_j = e_{jk}$, then we would choose $\alpha_{e_{jk}}$ s.t.

$$EU(\alpha_{e_{jk}}|E, E_j = e_{jk}) = \max_a \Sigma_i \, U(S_i) \, P(S_i|E, a, E_j = e_{jk})$$

E_j is a random variable whose value is *currently* unknown
$\Rightarrow$ must compute expected gain over all possible values:

$$VPI_E(E_j) = \left(\Sigma_k \, P(E_j = e_{jk}|E) EU(\alpha_{e_{jk}}|E, E_j = e_{jk})\right) - EU(\alpha|E)$$

(VPI = value of perfect information)

Properties of VPI

Nonnegative—in **expectation**, not **post hoc**

$$\forall\, j, E \;\; VPI_E(E_j) \geq 0$$

Nonadditive—consider, e.g., obtaining E_j twice

$$VPI_E(E_j, E_k) \neq VPI_E(E_j) + VPI_E(E_k)$$

Order-independent

$$VPI_E(E_j, E_k) = VPI_E(E_j) + VPI_{E,E_j}(E_k) = VPI_E(E_k) + VPI_{E,E_k}(E_j)$$

Note: when more than one piece of evidence can be gathered,
maximizing VPI for each to select one is not always optimal
$\Rightarrow$ evidence-gathering becomes a **sequential** decision problem

Example Problem (from 16.11 in text)

A used-car buyer is deciding whether to buy car c_1. There is time to carry out at most one test, and that t_1 is the test of car c_1. The buyer's estimate is that c_1 has a 70% chance of being in good shape.

A car can be in good shape (quality q^+) or bad shape (quality q^-), and the tests might help to indicate what shape the car is in. Car c_1 costs $1500, and its market value is $2000 if it is in good shape; if not, $700 in repairs will be needed to make it in good shape.

Assume:
$P(q^+|pass(c_1,t_1)) = 0.8$, $P(q^-|pass(c_1,t_1)) = 0.2$
$P(q^+|fail(c_1,t_1)) = 0.4$, $P(q^-|fail(c_1,t_1)) = 0.6$
$P(pass(c_1,t_1)) = 0.75$, $P(fail(c_1,t_1)) = 0.25$

Q1: Calculate the optimal decisions (a) before any test, and (b) given either a pass or a fail, and their expected utilities.

Q2: Calculate the value of information of the test.