Expected Utility Theory

Let Ω be a probability space

A gamble is a random variable where the quantity represents "money" or "consumption"

Suppose that x_1 and x_2 are "gambles"

Which gamble is preferred?

Generally: gains are less important than losses

Von Neumann-Morgenstern Preferences

Gambles are compared using a numeric valued utility function

$u(x)$ is the utility from consuming *x*

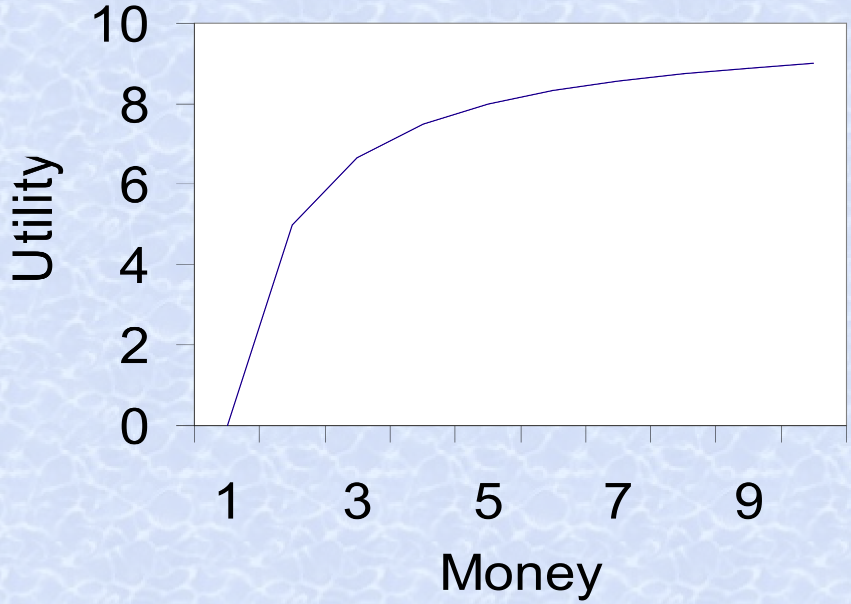
x_1 is at least as good (strictly better than) as x_2

$Eu(x_1) \geq (>) Eu(x_2)$

risk neutrality: $u(x) = x$

Example

$u(x) = 10 - 10/x$



Money versus Utility

Money payoffs for player 1

	H	T
U	5	1
D	4	2

Utility payoffs for player 1

	H	T
U	8	0
D	7.5	5

Optimal Choices

If H and T have equal probability is it better to choose U or D?

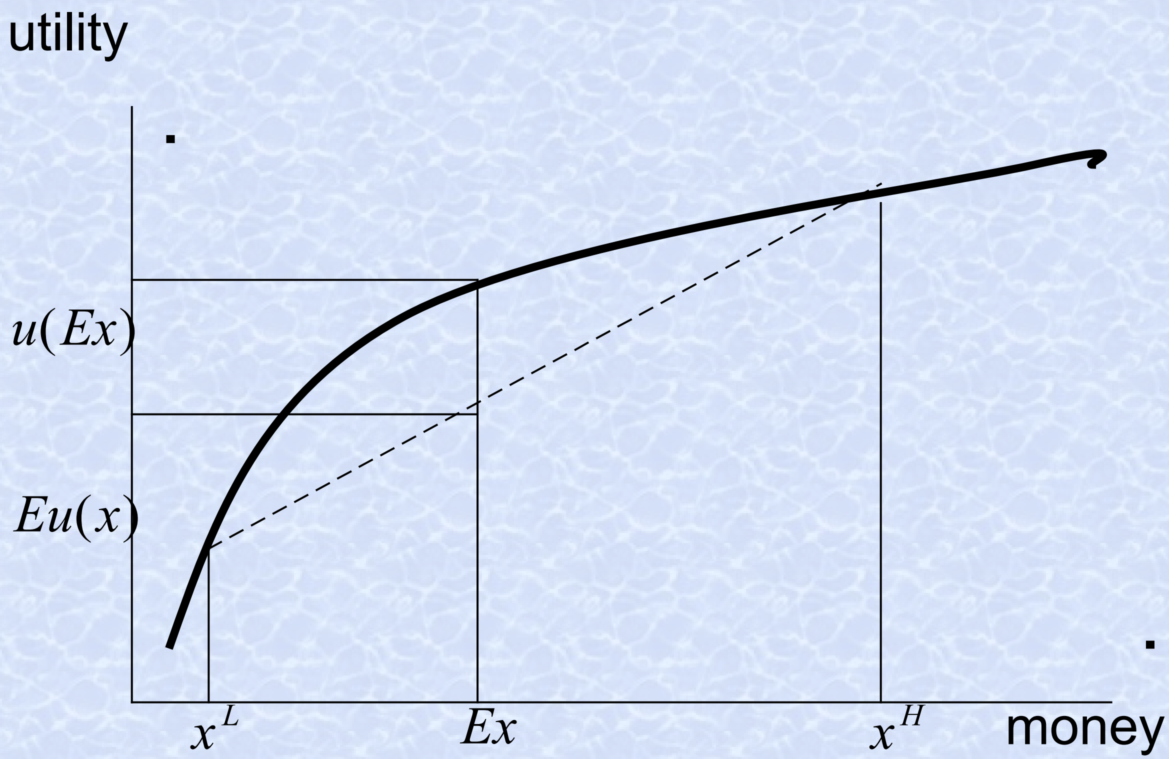
	Expected money	Expected utility
U	3	4
D	3	6.25

Choose D

Risk Aversion

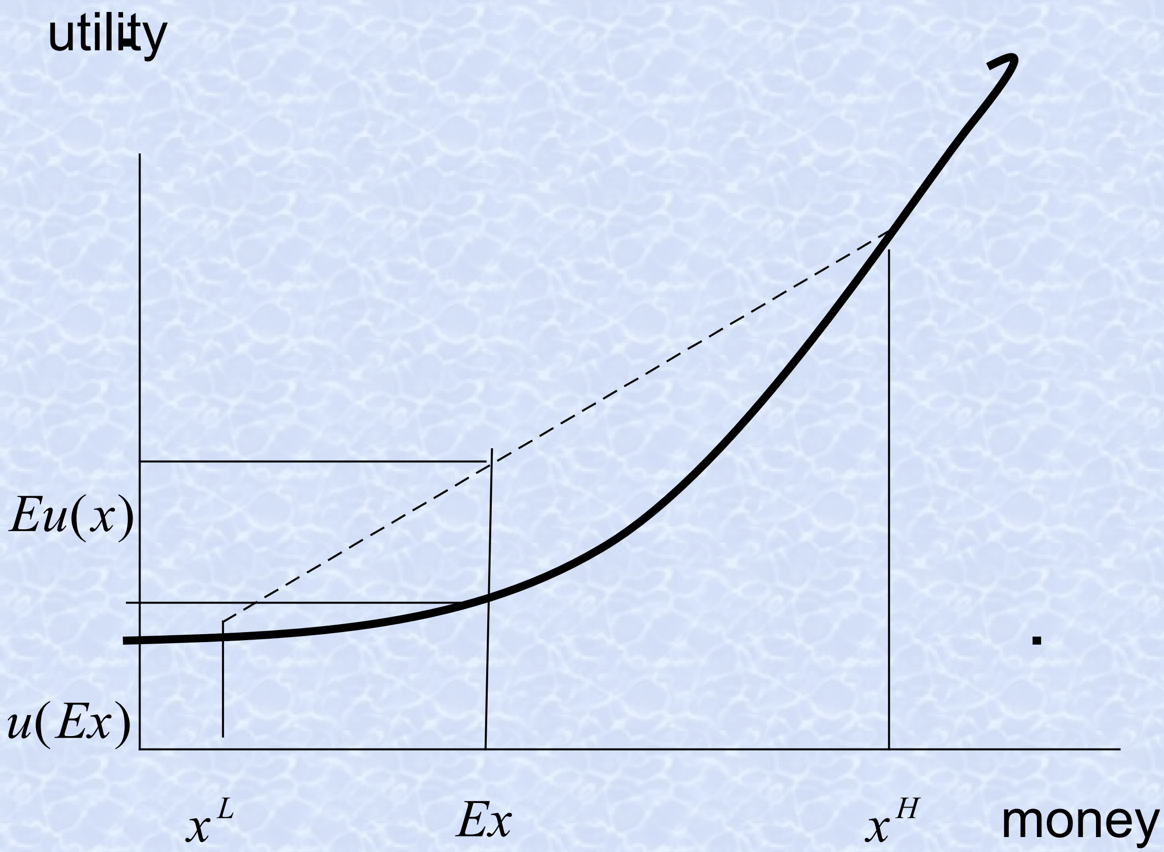
Would you rather get a gamble *x* or get the expected value of the gamble E*x* for sure? Suppose that the gamble is x^L with probability *p* and x^H with probability 1-*p*

Concavity



What happens as *p* changes?

Risk Loving



Knee Breakers

risk loving because the loss function is truncated

- you have 1000 and owe a gambling debt of 2000
- double or nothing is a good bet: lose and you still get your knees broken; win and you escape

other applications:

- sporting contests: “the Hail Mary pass”
- the game of banks and regulators

Applications

- Investment: risky portfolio? Stocks or bonds?
- Insurance: auto insurance company charges a premium
  - diversification
  - but hard risk difficult to insure
  - example: industrial decline, everyone should pay, but how to get them to do it?
  - some economists do not really understand competition and see *market failure* everywhere
  - some "libertarian" non-economists see market failure nowhere
  - in fact market failure is a problem with insurance for large risks

Risk premium

y a random amount with $Ey = 0, Ey^2 = 1$

relative risk premium ρ

$u(x - \rho x) = Eu(x + \sigma y x)$

$x - \rho x$ is the *certainty equivalent* of the gamble

$$u(x) - \rho x u'(x) = Eu(x) + \sigma x u'(x) y + (1/2)\sigma^2 x^2 u''(x) y^2$$

$$= u(x) + (1/2)\sigma^2 x^2 u''(x)$$

$\rho = -\dfrac{u''(x)x}{u'(x)}$ *coefficient of relative risk aversion*

Constant Relative Risk Aversion

$u(x) = \dfrac{x^{1-\rho}}{1-\rho}$ also known as "constant elasticity of substitution" or CES

$\rho \geq 0$

$$-\frac{u''(x)x}{u'(x)} = \frac{\rho x^{-\rho-1}x}{x^{-\rho}} = \rho$$

$\rho = 0$ linear, risk neutral

$\rho = 1$ $u(x) = \log(x)$

useful for empirical work and growth theory, perhaps about two?

Example

Logarithmic utility, good approximation in many circumstances

$u(x) = \log \mathrm{x}$

endowment: $x_0 = 100$

two investments of 10

stock: 75% gain of 20, 25% no gain

bond: certain gain of 12

	utility	
endowment	$\log 100$	4.605
stock	$.75 \log 110 + .25 \log 90$	4.650
bond	$\log 102$	4.625

What if?

Endowment: $x_0 = 1000$

two investments of 100

stock: 75% gain of 200, 25% no gain

bond: certain gain of 120

Concepts

- **expected utility**
- **risk aversion**, risk loving, **risk neutral**
- insurance, market failure
- concavity and convexity
- risk premium, certainty equivalent
- **coefficient of relative risk aversion**

Skill

given different investments with different risky returns and a constant relative risk aversion utility function

find which is the superior investment

determine how the answer depends upon risk aversion