Lecture 2: Utility-Based Portfolio Choice

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Portfolio Management

Second Term 2019

Outline and objectives

- Choice under uncertainty: dominance

- Choice under uncertainty: mean-variance criterion

- Axioms of choice under certainty

- Preference representation theorem and its meaning

- Expected utility theorem

- Definition and characterization of risk averse behavior

- Risk-loving and risk neutral investors

- How to measure and compare risk aversion: ARA and RRA coefficients

- Commonly employed utility functions of monetary wealth

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Key Concepts/1

- Most financial assets (securities) are risky, i.e., they can be characterized as contracts that give different payoffs in different, mutually exclusive states of the world

- Assume that investors are able to quantify such uncertainty on future states using standard probability distributions, e.g.,

State	Security A		Security B		Security C	
	Payoff	Prob.	Payoff	Prob.	Payoff	Prob.
i	20	3/15	18	3/15	18	3/15
ii	18	5/15	18	5/15	16	5/15
iii	14	4/15	10	4/15	12	4/15
iv	10	2/15	5	2/15	12	2/15
v	6	1/15	5	1/15	8	1/15

- Criteria of choice under uncertainty may be complete or incomplete: a complete criterion is always able to rank all securities or investment opportunities on the basis of their objective features; an incomplete criterion is not

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Key Concepts/2

- A starkly incomplete criterion is strong dominance: A security (strongly) dominates another security (on a state-by-state basis), if the former pays as much as the latter in all states of nature, and strictly more in at least one state

- We assume that rational (== non-satiated, who prefer more to less) investors, always prefer dominant securities over dominated ones

- Dominance escapes a definition of risk

- Because in general, a security yields payoffs that in some states are larger and in some other states are smaller than under any other, the best known approach consists of summarizing the distributions of asset returns through their mean and variance

- This is the logical foundation of mean-variance dominance, that however remains incomplete

- Under MV, risk is identified with the variance of returns/payoffs

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Key Concepts/3

- However, also MV dominance is incomplete:

State	Security A		Security B		Security C	
	Payoff	Prob.	Payoff	Prob.	Payoff	Prob.
i	20	3/15	18	3/15	18	3/15
ii	18	5/15	18	5/15	16	5/15
iii	14	4/15	10	4/15	12	4/15
iv	10	2/15	5	2/15	12	2/15
v	6	1/15	5	1/15	8	1/15
Mean	15.47		13.27		14.27	
Variance	16.78		28.46		8.46	

- Because of its incompleteness, the MV criterion can at best only isolate a subset of securities that are not dominated by any other

- This will be later called the MV efficient set

- How can we overcome the pervasive incompleteness that the two criteria imply?

- We develop a theory of utility-based portfolio decisions in conditions of uncertainty

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Key Concepts/4

- Formally, the starting point is preference relation, denoted as $\gtrsim$

- Rationality means that you can always express a precise preference between any pair of bundles, that you should not contradict yourself when asked to express preferences over three or more bundles in successive pairs...

- ... and some additional technical conditions that prevent the possibility that by considering long sequences of converging bundles you may express equivocal choices

- Such properties are formally derived from axioms of choice

- The first step is that under such axioms, there exists a continuous, time-invariant, real-valued ordinal utility function $u(\cdot)$ that ranks bundles in the same way as $\gtrsim$

- Under rationality the ranking of bundles that you may determine on a qualitative basis using your preferences $\gtrsim$ corresponds to the ranking derived from the utility function $u(\cdot)$

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Key Concepts/5

- $u(\cdot)$ is an ordinal function, i.e., its precise values have no economic meaning; it is just used to rank bundles/perspectives

- These concepts generalize to case of choice under uncertainty

- Under certainty, the choice is among consumption baskets with known characteristics; under uncertainty, the objects of choice are vectors of state-contingent monetary payoffs

- Disentangling preferences from probabilities is a complex problem that simplifies to a maximization under assumptions

- Such a problem admits a straightforward, indeed linear, solution under special assumptions, called the expected utility theorem

- Under the EUT, there exists a cardinal, continuous, time-invariant, real-valued Von Neumann-Morgenstern (VNM) felicity function of money $U(\cdot)$, such that for any two lotteries/gambles /securities (i.e., probability distributions of monetary payoffs) x and y, $x \succsim y$ if and only   if $E[U(x)] \geq E[U(y)]$
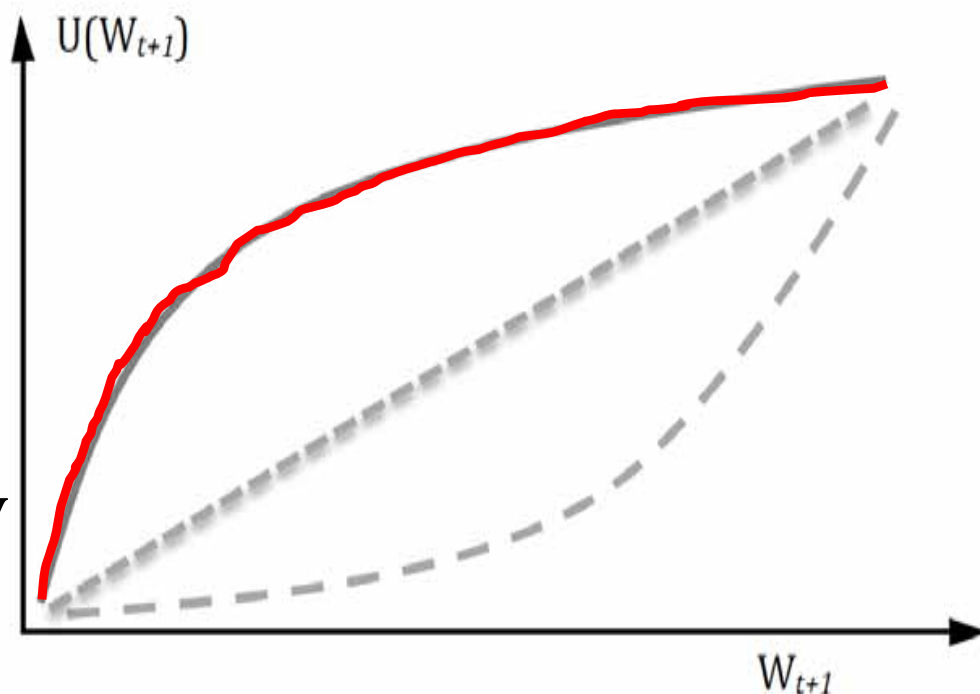
Key Concepts/6

State	Security A		Security B		Security C		Security D	
	Pay-off	Prob.	Pay-off	Prob.	Pay-off	Prob.	Payoff	Prob.
i	20	3/15	18	3/15	18	3/15	5	3/15
ii	18	5/15	18	5/15	16	5/15	14	4/15
iii	14	4/15	10	4/15	12	4/15	14	4/15
iv	10	2/15	5	2/15	12	2/15	18	2/15
v	6	1/15	5	1/15	8	1/15	18	1/15
$E[R_i]$	15.47		13.27		14.27		13.00	
Stdev$[R_i]$	4.10		5.33		2.91		4.29	
$E[ln R_i]$	2.693		2.477		2.635		2.483	

- EUT implies an enormous simplification: instead of combining probabilities and preferences over possible state-contingent payoffs in complicated ways, the probabilities are used to take the expectation of an index of preferences applied to payoffs

- Although VNM utility is cardinal, its unit of measure is unclear

- EU-based criteria are complete, they always rank all assets

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Key Concepts/7

- There are precise links between the shapes and mathematical properties of (VNM) utility functions (of wealth) U(·) and the preferences/behavior of investors

- We shall always assume non-satiated individuals, U'(W) > 0, i.e., investors prefer more wealth (consumption power) to less

- Given non-satiation, risk-averse investors would always reject a fair bet

- When U(·) is differentiable, risk aversion implies concavity

- Equivalently, the marginal utility of the investor declines as her wealth increases

- When U(·) is convex, or marginal utility of wealth increases with wealth, then the investor is a risk-lover

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Key Concepts/8

- One issue that is of interest both conceptually and practically is how to measure risk aversion and compare it across investors

- Because we know that linear affine, monotone increasing transforms of U(·) represent identical preferences, we cannot simply use the (sign and) magnitude of the second derivative of U(·) to measure and compare risk aversion

- We need a measure of risk aversion that is invariant to linear transformations

- Two widely used measures of this sort have been proposed by Pratt (1964) and Arrow (1971), the coefficients of absolute and relative risk aversion, respectively

$$ARA(W) \equiv -\frac{U''(W)}{U'(W)} \qquad RRA(W) \equiv -\frac{U''(W)}{U'(W)} W = ARA(W) \cdot W$$

- These are functions of investors' wealth, i.e., besides being positive for risk-averse investors, they may change with W

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Key Concepts/9

- Because they are unique up to monotone increasing, linear affine transforms, ARA and RRA can be used to rank individuals

- Both measures are local indices of risk aversion

- The four most common VNM felicity functions are

    Negative exponential, CARA $U(W) = 1 - e^{-\theta W}$ with $\theta > 0$

    Power, CRRA
    $$U(W) = \begin{cases} \dfrac{W^{1-\gamma}}{1-\gamma} & \gamma > 0, \gamma \neq 1 \\ lnW & \gamma = 1 \end{cases}$$
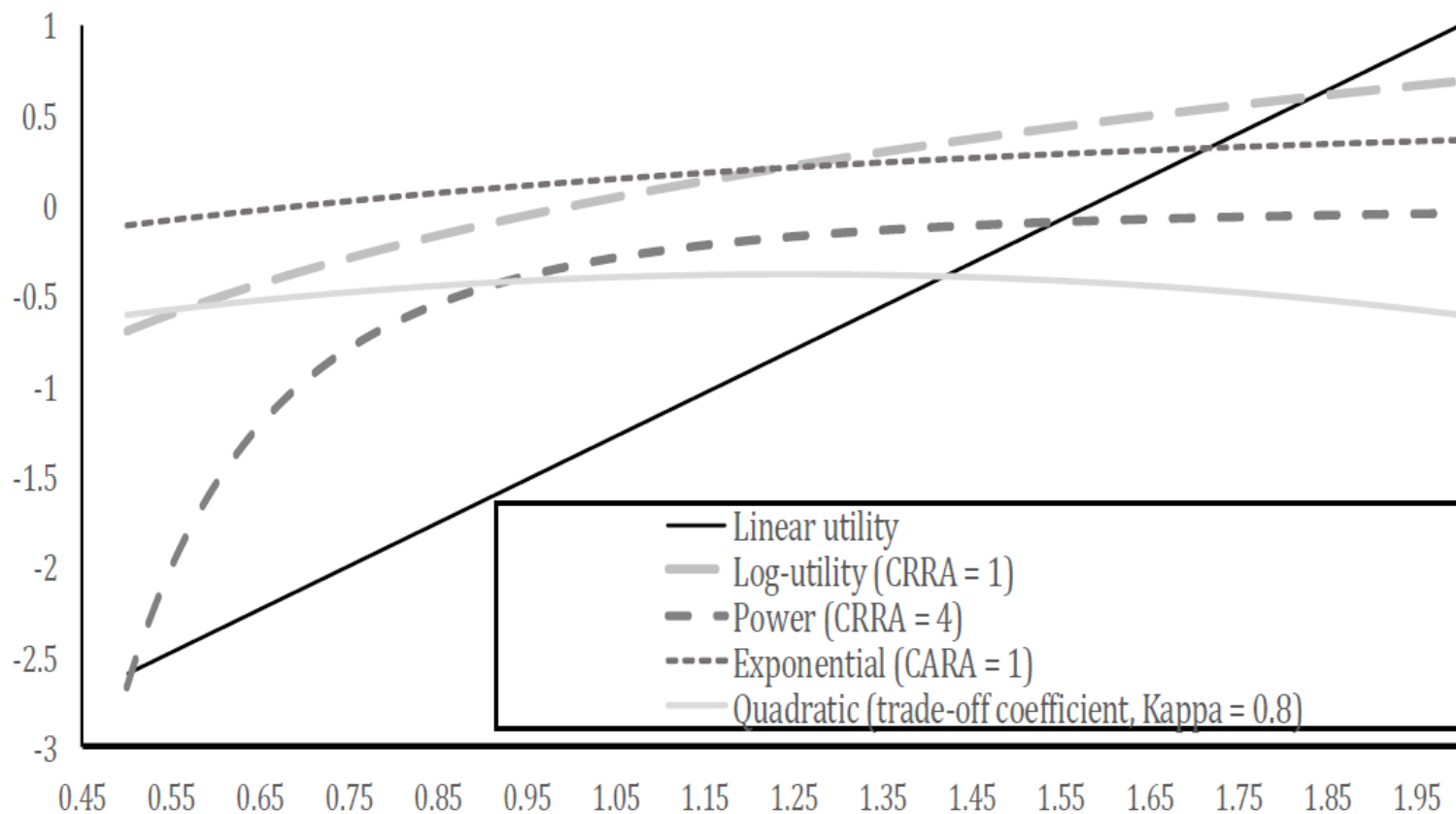
    Quadratic, IARA $U(W) = W - \dfrac{1}{2}\kappa W^2$ with $\kappa > 0$

    Linear, risk-neutral $U(W) = a + bW$ with $b > 0$

- Quadratic utility poses a few problems: e.g., the investor is not nonsatiated for all wealth levels; she is satiated below the bliss

- These functions are called linear risk tolerance (LRT) utility functions (alternatively, HARA, hyperbolic absolute risk aversion, because their ARA(W) defines a hyperbola)

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Key Concepts/11

Different types of VNM utility of wealth functions

Legend:
- Linear utility
- Log-utility (CRRA = 1)
- Power (CRRA = 4)
- Exponential (CARA = 1)
- Quadratic (trade-off coefficient, Kappa = 0.8)

- All functions, apart from the linear, risk-neutral function, are concave
- No special meaning (or lack thereof) ought to be attached to the fact that all utility functions are negative for some wealth levels (in fact, a few are always negative for all wealth levels)

The Formal Set Up

- Most financial assets (securities) are risky, i.e., they can be characterized as contracts that give different (K) payoffs in different states of the world to occur at a future point in time

  - The assets of interest are said to belong to some **asset menu**

  - Only one state will occur, though investors do not know, at the outset, which one, i.e., the states are mutually exclusive

  - The description of each state is complete and exhaustive

  - the set of states, S, is given exogenously and cannot be affected by the choices of the investors

- Standard probability theory is used to capture the uncertainty on the payoffs of securities, for instance:

State	Security A		Security B		Security C	
	Payoff	Prob.	Payoff	Prob.	Payoff	Prob.
i	20	3/15	18	3/15	18	3/15
ii	18	5/15	18	5/15	16	5/15
iii	14	4/15	10	4/15	12	4/15
iv	10	2/15	5	2/15	12	2/15
v	6	1/15	5	1/15	8	1/15

The Formal Set Up

- Investors' task is a complex one and the optimal choice will result from three distinct sets of (interacting) factors:
    1. An investor's **aversion toward or tolerance for risk**
    2. Some measure of the **quantity of risk**
    3. **How risk attitudes interact with the subjective uncertainties** associated with available assets to determine an investor's desired portfolio holdings (demands)
    - In the table, it is not evident why a rational investor ought to prefer security C over security A (if any)
    - An investor who pays more for security C than for A may be motivated by a desire to avoid the low payoff of 6 of the latter
    - Unclear how such inclinations against risk may be balanced off in the light of the probability distribution that characterizes different states
- The criteria of choice under uncertainty may be **complete or incomplete**: a complete criterion is always able to rank all securities or investment opportunities on the basis of their objective features; an incomplete criterion is not

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Choice under uncertainty: (strong) dominance

A security (strongly) dominates another security (on a state-by-state basis), if the former pays as much as the latter in all states of nature, and strictly more in at least one state

- Complete criteria form a good basis for portfolio choice
    - E.g., an investor may rank all available assets and to invest in some pre-determined fraction starting from the top of the resulting ranking
- A starkly incomplete criterion is strong dominance
- A security (strongly) dominates another security (on a state-by-state basis), if the former pays as much as the latter in all states of nature, and strictly more in at least one state
    - All rational individuals would prefer the dominant security to the security that it dominates
    - Here rational means that the investor is non-satiated, that is, she always prefers strictly more consumption (hence, monetary outcomes that may be used to finance such consumption) to less consumption
- The following example shows that strong dominance often does not allow to rank assets or portfolios

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Choice under uncertainty: (strong) dominance

State	Security A			Security B			Security C	
	Payoff	Prob.	D	Payoff	Prob.	D	Payoff	Prob.
i	20	3/15	>	18	3/15	=	18	3/15
ii	18	5/15	=	18	5/15	>	16	5/15
iii	14	4/15	>	10	4/15	<	12	4/15
iv	10	2/15	>	5	2/15	<	12	2/15
v	6	1/15	>	5	1/15	<	8	1/15

o For instance, security B does not dominate security C and security A does not dominate security C

o Hence, both securities A and C are not dominated by any other security, while security B is (by security A)

o A rational investor may then decide to select between assets A and C, ignoring B

o However, she cannot find an equivalently strong rule to decide to decide between security A and C, hence the criterion is incomplete

▪ The strength of dominance is that it escapes a definition of risk

▪ However, in general, a security yields payoffs that in some states are larger and in some other states are smaller than under any other

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Choice under uncertainty: mean-variance (dominance)

A security MV-dominates another security if it is characterized by a higher expectation and by lower variance of payoffs than another one

- When this is the case, the best known approach at this point consists of summarizing the distributions of asset returns through their **mean and variance**:

$$E[R_i] = \sum_{s=1}^{S} Prob(state = s)R_i(s)$$

$$Var[R_i] = \sum_{s=1}^{S} Prob(state = s)[R_i(s) - E[R_i]]^2$$

- Under mean-variance (MV), the variance of payoffs measures risk
- MV dominance establishes that a security dominates another one in a mean variance sense, if the former is characterized by a higher expected payoff and a by lower variance of payoffs
  - o The following example shows how mean and variance are used to rank different securities
  - o Both securities A and C are more attractive than asset B as they have a higher mean return and a lower variance

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Choice under uncertainty: mean-variance (dominance)

State	Security A		Security B		Security C	
	Payoff	Prob.	Payoff	Prob.	Payoff	Prob.
i	20	3/15	18	3/15	18	3/15
ii	18	5/15	18	5/15	16	5/15
iii	14	4/15	10	4/15	12	4/15
iv	10	2/15	5	2/15	12	2/15
v	6	1/15	5	1/15	8	1/15
Mean	15.47		13.27		14.27	
Variance	16.78		28.46		8.46	

- o However, security A fails to dominate security C (and vice versa) in a mean-variance sense

- Similarly to dominance, also MV is an incomplete criterion, i.e., pairs of securities exist that cannot be simply ranked by this criterion

- Because of its incompleteness, the MV criterion can at best only isolate a subset of securities that are not dominated by any others

  - o E.g., security B, being dominated by both securities A and C, can be ruled out from portfolio selection

  - o However, neither security A nor C can be ruled out because they belong to the set of non-dominated assets

Utility-based choice under certainty

- Modern microeconomic theory describes individual behavior as the result of a process of optimization under constraints
    - The objective is determined by individual preferences
    - Constraints depend on an investor's wealth and on market prices
- To develop such a rational theory of choice under certainty, we postulate the existence of a preference relation, represented by the symbol $\succsim$
- For two bundles a and b, we can express preferences as: when $a \succsim b$, for the investor in question, bundle a is strictly preferred to bundle b, or she is indifferent between them
- Pure indifference is denoted by $a \sim b$, strict preference by $a \succ b$
- In such a framework of choice rationality derives from a set of axioms

① Completeness: Every investor is able to decide whether she prefers a to b, b to a, or both, in which case she is indifferent with respect to the two bundles; for any two bundles a and b, either $a \succ b$ or $b \succ a$ or both; if both conditions hold, we say that the investor is indifferent btw. the bundles

Utility-based choice under certainty

Under the axioms of choice, a continuous, time-invariant, real-valued ordinal utility function $u(\cdot)$ that ranks bundles in the same way as $\succsim$

② **Transitivity**: For bundles a, b, and c, if $a \succsim b$ and $b \succsim c$, then $a \succsim c$

③ **Continuity**: Let $\{x_n\}$ and $\{y_n\}$ be two sequences of consumption bundles such that $x_n \to x$ and $y_n \to y$ as $n \to \infty$. The preference relation $\succsim$ is continuous if and only if $x_n \succsim y_n$ for all n, then the same relationship is preserved in the limit, $x \succsim y$

- Completeness, transitivity, and continuity are **sufficient** to guarantee the existence of a **continuous**, time-invariant, real-valued **ordinal** utility function $u(\cdot)$, such that for any two objects of choice a and b,

$$a \succsim b \ \text{ if and only } \ \text{if } u(a) \geq u(b)$$

- Equivalently, a decision-maker, instead of optimizing by searching and choosing the best possible bundle of goods and services, may simply maximize the utility function $u(\cdot)$ (possibly, subject to constraints)
  - Because of the continuity axiom, $u(\cdot)$ is a continuous function
  - Because $u(\cdot)$ is an **ordinal function**, no special meaning may be attached to its values, i.e., the exact size of the difference $u(a) - u(b) \geq 0$ is not

Utility-based choice under certainty

Given $u(\cdot)$ and a **monotone increasing transformation $v(\cdot)$**, the function $v(u(\cdot))$ represents the same preferences as the original $u(\cdot)$

- o Different investors will be characterized by heterogeneous preferences and as such will express different utility functions, as identified by heterogeneous shapes and features of their $u(\cdot)$ functions
- o However, because $a \succsim b$ if and only if $u(a) \geq u(b)$, any monotone increasing transformation $v(\cdot)$ will be such that $v(u(a)) \geq v(u(b))$, or, assuming $v(\cdot)$ monotone increasing cannot change the ranking

- Given a utility function $u(\cdot)$ and a generic monotone increasing transformation $v(\cdot)$, the function $v(u(\cdot))$ represents the same preferences as the original utility function $u(\cdot)$
  - o E.g., if $u(a) \geq u(b)$, $(u(a))^3 \geq (u(b))^3$ (note that $d((u)^3)/du = 3(u)^2 > 0$) and the function $(u(\cdot))^3$ represents the same preference relation $\succsim$ as $u(\cdot)$
  - o This is a direct consequence of the chain rule of standard differential calculus. If we define $l(\cdot) \equiv v(u(\cdot))$, then $l'(\cdot) \equiv v'(u(\cdot))u'(\cdot) > 0$

- These concepts and the use of utility functions can be generalized to the case of choice under uncertainty concerning securities and random payoffs

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Utility-based choice under uncertainty

o Ranking vectors of monetary payoffs involves more than pure elements of taste or preferences

o E.g., when selecting between some stock A that pays out well during recessions and poorly during expansions and some stock B that pays out according to an opposite pattern, it is essential to forecasts the probabilities of recessions and expansions

- Disentangling pure preferences from probability assessments is a complex problem that simplifies to a manageable maximization problem only under special assumptions, when the expected utility theorem (EUT) applies

- Under the EUT, an investor's ranking over assets with uncertain monetary payoffs may be represented by an index combining, in the most elementary way (i.e., linearly):

① a preference ordering on the state-specific payoffs

② the state probabilities associated to these payoffs

- The EUT simplifies the complex interaction between probabilities and preferences over payoffs in a linear way, i.e., by a simple sum of products

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The expected utility theorem

Under the assumptions of the EUT, one ranks assets/securities on the basis of the expectation of the utility of their payoffs across states

- Under the six axioms specified below, there exists a **cardinal**, **continuous**, time-invariant, real-valued Von Neumann-Morgenstern **(VNM) felicity function of money U(·)**, such that for any two lotteries/gambles/securities (i.e., probability distributions of monetary payoffs) x and y,

$$x \succsim y \quad \text{if and only} \quad \text{if } E[U(x)] \geq E[U(y)]$$

where for a generic lottery z (e.g., one that pays out either x or y),

$$\mathbb{U}(z) \equiv E[U(z)] = \sum_{s=1}^{S} Prob(state = s)U(z(s))$$

- The perceived, cardinal happiness of a complex and risky menu of options, is given by the weighted average of the satisfaction derived from each such individual option, weighted by the probabilities
  - In the following example we use a VNM utility function $U(z) = \ln(z)$
  - Rankings by EU criterion differ from MV: while according the latter only securities B and D are dominated (by A and C), and hence A and C cannot be ranked, according to EU, security A ranks above security C (and B and D)

The expected utility theorem: supporting axioms

State	Security A		Security B		Security C		Security D	
	Pay-off	Prob.	Pay-off	Prob.	Pay-off	Prob.	Payoff	Prob.
i	20	3/15	18	3/15	18	3/15	5	3/15
ii	18	5/15	18	5/15	16	5/15	14	4/15
iii	14	4/15	10	4/15	12	4/15	14	4/15
iv	10	2/15	5	2/15	12	2/15	18	2/15
v	6	1/15	5	1/15	8	1/15	18	1/15
$E[R_i]$	15.47		13.27		14.27		13.00	
$Stdev[R_i]$	4.10		5.33		2.91		4.29	
$E[lnR_i]$	2.693		2.477		2.635		2.483	

o This example shows one fundamental advantage of EUT-based criteria over dominance and MV criteria: its **completeness**

o What are the axioms supporting the EUT?

o These concerns **lotteries** (x, y; π), which indicates a game that offers payoff x with probability π and payoff y with probability 1 - π

① **Lottery reduction and consistency**: (i) (x, y; 1) = x; (ii) (x, y; π) = (y, x; 1 - π); (iii) (x, z; π) = (x, y; π +(1 - π)q) if z = (x, y; q)

o Axiom means investors are concerned with net cumulative probability of each outcome and are able to see through the way the lotteries are set up

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The expected utility theorem: supporting axioms

The axioms supporting the EUT are (i) lottery reduction, (ii) comple-teness, (iii) transitivity, (iv) continuity, (v) independence of irrelevant alternatives; (vi) certainty equivalence

- o   This is demanding in terms of computational skills required of investors
- ② **Completeness**: The investor is always able to decide whether she prefers z to l, l to z, or both, in which case she is indifferent
- ③ **Transitivity**: For any lotteries z, l, and h, if $z \succsim l$ and $l \succsim h$, then $z \succsim h$
- ④ **Continuity**: The preference relation is continuous as established earlier
- ⑤ **Independence of irrelevant alternatives**: Let $(x, y; \pi)$ and $(x, z; \pi)$ be any two lotteries; then, $y \succsim z$ if and only if $(x, y; \pi) \succsim (x, z; \pi)$; this implies that $(x, y; \pi_1) \succsim (x, z; \pi_2)$ if and only if $\pi_1 \geq \pi_2$, i.e., preferences are independent of beliefs, as summarized by state probabilities
- o   A bundle of goods or monetary amount remains preferred even though it is received under conditions of uncertainty, through a lottery
- ⑥ **Certainty equivalence**: Let x, y, z be payoffs for which $x > y > z$, then there exists a monetary amount CE (certainty equivalent) such that $(x, z; \pi) \sim$ CE

- ■ Arbitrary monotone transformations of cardinal utility functions do not preserve ordering over lotteries

The EUT: linear affine transformations

Any linear affine, monotone increasing transformation of a VNM utility function $(V(\cdot) = a + bU(\cdot), b > 0)$ represents the same preferences

- Arbitrary monotone transformations of cardinal utility functions do not preserve ordering over lotteries

- Are preference defined by the EUT unique up to some kind of transformations as standard $u(\cdot)$ functions were?

- The VNM representation is preserved under linear affine, increasing transformations: if $U(\cdot)$ is a VNM felicity function, then

$$V(\cdot) = a + bU(\cdot) \quad b > 0 \quad \text{is also a VNM felicity}$$

  o This is because $V((x,y;\pi)) = a + bU((x,y;\pi))$
    $$= a + b[\pi U(x) + (1-\pi)U(y)]$$
    $$= \pi[a + bU(x)] + (1-\pi)[a + bU(y)] = \pi V(x) + (1-\pi)V(y)$$

  o E.g., if John's felicity function is $U_{John}(R_i) = \ln(R_i)$ and Mary's felicity is instead $U_{Mary}(R_i) = -2 + 4\ln(R_i)$, Mary and John will share the same preferences

  o However, when $U_{Mary}(R_i) = +1000 - \ln(R_i)$ or $U_{Mary}(R_i) = (\ln(R_i))^3$, this will not be the case

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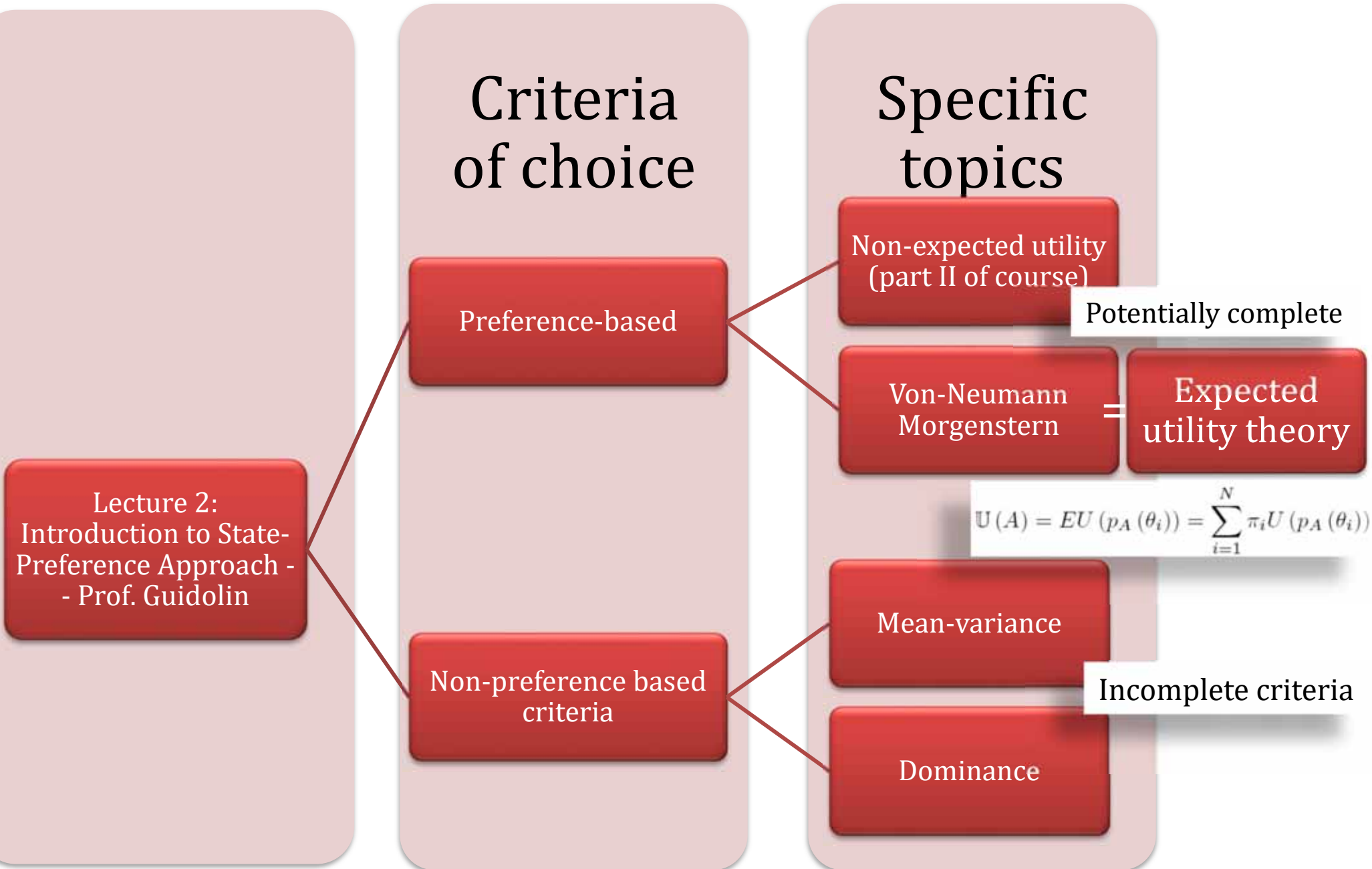
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Completeness of EUT-induced rankings

Different VNM felicity functions may induce rather different rankings of lotteries/securities/portfolios, but these will always be complete

- This example shows that the type of felicity function assumed for an investor may matter a lot
- Instead of a log-utility function, assume $U(R_i) = -(R_i)^{-1} = -1/R_i$

State	Security A		Security B		Security C		Security D	
	Pay-off	Prob.	Payoff	Prob.	Payoff	Prob.	Payoff	Prob.
i	20	3/15	18	3/15	18	3/15	5	3/15
ii	18	5/15	18	5/15	16	5/15	14	4/15
iii	14	4/15	10	4/15	12	4/15	14	4/15
iv	10	2/15	5	2/15	12	2/15	18	2/15
v	6	1/15	5	1/15	8	1/15	18	1/15
$E[R_i]$	15.47		13.27		14.27		13.00	
$Stdev[R_i]$	4.10		5.33		2.91		4.29	
$-E[1/(R_i)]$	-0.073		-0.096		-0.074		-0.094	

- While under a logarithmic utility function, it was security A to be ranked on top of all others, now security A and C are basically on par
- The log and $U(R_i) = -1/R_i$ are related functions but the second implies larger risk aversion

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Representing preferences: A quick re-cap

Criteria of choice

Specific topics

Non-expected utility (part II of course)

Preference-based

Potentially complete

Von-Neumann Morgenstern $=$ Expected utility theory

$$\mathbb{U}(A) = EU\left(p_A\left(\theta_i\right)\right) = \sum_{i=1}^{N} \pi_i U\left(p_A\left(\theta_i\right)\right)$$

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Mean-variance

Non-preference based criteria

Incomplete criteria

Dominance

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Measuring Risk Aversion

- Given a specification of probabilities, the utility function of monetary wealth U(·) that uniquely characterizes an investor
  - Alternative assumptions on U(·) identify an investor's tolerance or aversion to risk
  - If the utility function $u(·)$ that depends on the quantities purchased and consumed of M goods, $u(x_1, x_2, ..., x_M)$, is increasing, and all prices are strictly positive, it can be shown that the utility of wealth will be strictly increasing in total wealth W, U'(W) > 0
- We shall always assume non-satiated individuals, U'(W) > 0
- To understand what risk aversion means, consider a bet where the investor either receives an amount h with probability ½ or must pay an amount h with probability ½, so the in expectation it is fair
- The intuitive notion of "being averse to risk" is that that for any level of wealth W, an investor would not wish to enter in such a bet:

$$U(W) > \frac{1}{2}U(W + h) + \frac{1}{2}U(W - h) = E[U(W + H)]$$

  utility of wealth with no gamble exceeds expected utility of wealth+gamble
  - H is a 0-mean variable that takes value h w/prob. ½ and $-h$ with prob. ½

Defining Risk Aversion

A risk-averse investor is one who always prefers the utility of the expected value of a fair bet to the expectation of the utility of the same bet; when her VNM U(·) is differentiable, the U(·) must be concave

- This inequality can be satisfied for all wealth levels W if the agent's utility function has the form below

- We say the utility function is (strictly) concave

- Equivalently, the slope of U(·) decreases as the investor gets wealthier

- The marginal utility (MU), U'(W) ≡ d(U(W))/dW decreases as W grows larger

- If U'(W) decreases, then U''(W) < 0

  - Positive deviations from a fixed average wealth do not help as much as the negative ones hurt

  - The segment connecting W – h and W + h lies below the utility function

U(W$_{t+1}$)

U(W$_{t+1}$+h)

U(E[W$_{t+1}$])

E[U(W$_{t+1}$)]

U(W$_{t+1}$-h)

W$_{t+1}$-h   E[W$_{t+1}$]   W$_{t+1}$+h
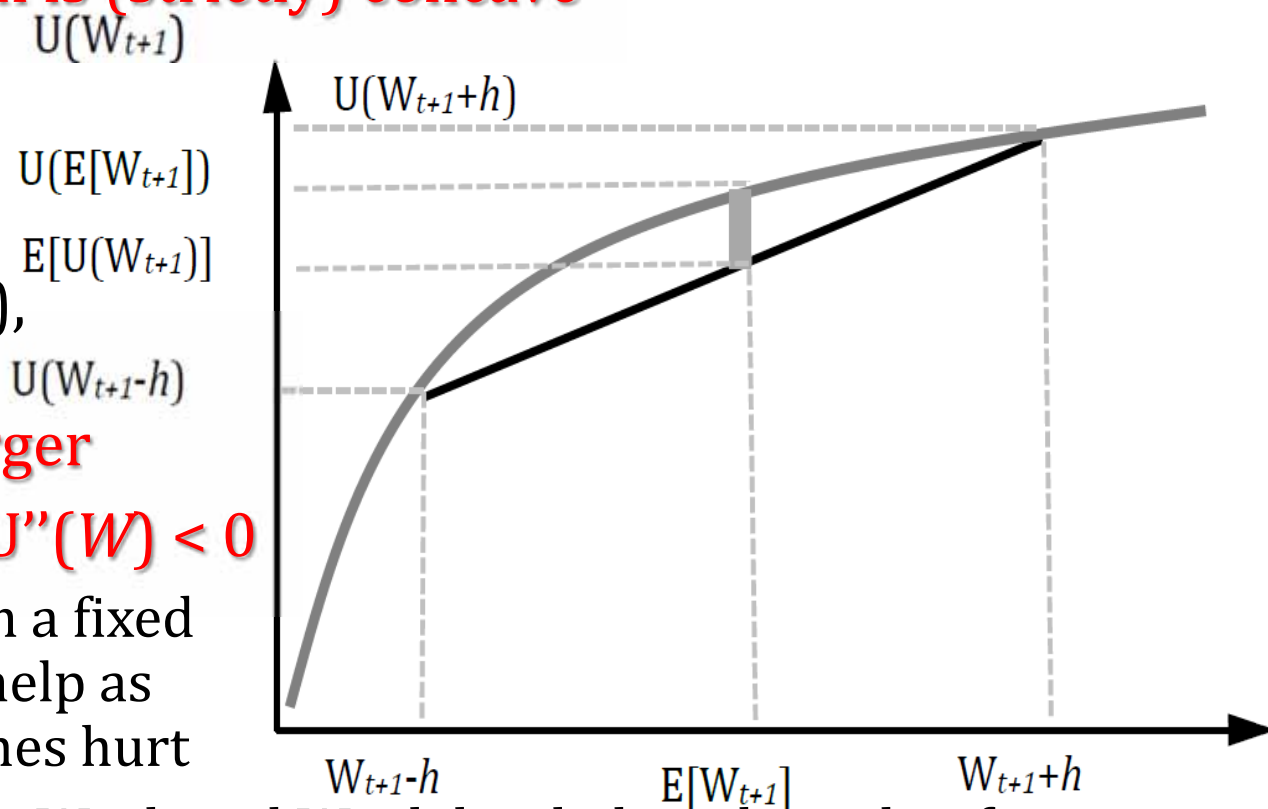
Other Risk Preference Types

A risk-loving (neutral) investor is one who always prefers (is indifferent to) the expectation of the utility of a fair bet to the utility of the expected value of the bet; if U(·) is differentiable, the U(·) must be convex (linear)

- We obtain risk-loving behavior when

$$U(W) < \frac{1}{2}U(W + h) + \frac{1}{2}U(W - h) = E[U(W + H)]$$

- When this inequality is satisfied for all wealth levels, we say the utility function is (strictly) convex

- Equivalently, the slope of U(·) increases as the investor gets wealthier

- The marginal utility (MU), U'(W) ≡ d(U(W))/dW increases as W grows larger

- If U'(W) decreases, then U''(W) > 0

    o Positive deviations from a fixed average wealth give more happiness than the unhappiness caused by negative deviations

- The case of risk neutral investors obtains if U'(W) is constant

    o From standard integration of the marginal utility function, it follows that U'(W) = $b \Rightarrow$ U(W) = $a + b$W, a linear utility function

Absolute and Relative Risk Aversion Coefficients

- How can we manage to measure risk aversion and compare the risk aversion of different decision makers?

- Given that under mild conditions, risk aversion is equivalent to U''(W)<0 for all wealth levels, one simplistic idea is to measure risk aversion on the basis of the second derivative of U(·)

  o E.g., John is more risk averse than Mary is iff |U$_{John}$''(W)| > |U$_{Mary}$''(W)|

- Unfortunately, this approach leads to an inconsistency because when U$_{John}$(W) = a + bU$_{Mary}$(W) with b > 0 and b ≠ 1 , clearly U''$_{John}$(W) = bU$_{Mary}$''(W) ≠ U$_{Mary}$''(W) > 0

- But we know that by construction, John and Mary have the same preferences for risky gambles and therefore that it makes no sense to state the John is more risk averse than Mary

- Two famous measures that escape these drawbacks are the coefficients of absolute/relative risk aversion:

$$ARA(W) \equiv -\frac{U''(W)}{U'(W)} \qquad RRA(W) \equiv -\frac{U''(W)}{U'(W)}W = ARA(W) \cdot W$$

  o Because MU(W) is a function of wealth, ARA(W) and RRA(W) are too

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Absolute and Relative Risk Aversion Coefficients

Both ARA(W) and RRA(W) are invariant to linear monotonic transforms; this occurs because both are "scaled" at the denominator U'(W)

- o If nonzero, the reciprocal of the measure of absolute risk aversion, T(W) $\equiv 1/\text{ARA}(W)$ can be used as a measure of risk tolerance

- o When ARA is constant, RRA(W) must be a linear (increasing) function of wealth; when RRA is constant, then it must be the case that ARA(W) = RRA/W, a simple inverse function of wealth

- o ARA and RRA are invariant to linear monotonic transformations; e.g.,

$$ARA_{John}(W) \equiv -\frac{U''_{John}(W)}{U'_{John}(W)} = -\frac{bU''_{Mary}(W)}{bU'_{Mary}(W)} = -\frac{U''_{Mary}(W)}{U'_{Mary}(W)} = ARA_{Mary}(W)$$

- ■ To rank John and Mary's risk aversion, we need to verify whether ARA$_{John}$(W) > ARA$_{Mary}$(W) (or the opposite) for all wealth levels

  - o Same applies to their coefficient of relative risk aversion for all wealth

  - o Possible that for some intervals of wealth it may be (R)ARA$_{John}$(W) > (R)ARA$_{Mary}$(W) but for other levels/intervals the inequality be reversed

- ■ Both measures are local as they characterize the behavior of investors only when the risks (lotteries) considered are small

Introducing a Few Common Utility of Wealth Functions

- Our earlier examples have featured a few VNM utility functions, here we simply collect ideas on their functional form and properties

- Given an initial level of wealth W_0, a utility of money function, which relative to the starting point has the property $U(W)/U(W_0) = h(W - W_0)$, so that **utility reacts only to the absolute difference in wealth**, is of the **absolute risk aversion** type

- Only (non-satiated) function meeting this requirement is the **(negative) exponential**, where response to changes in $W - W_0$ is constant: $U(W) = 1 - e^{-\theta W}$ with $\theta > 0$

  - The textbook shows that this implies a constant ARA, and because of that the utility function is also referred to as CARA
  - As ARA(W) = θ, RRA(W) = ARA$(W)W = \theta W$, a linear function of wealth
  - RRA(W) depends on initial wealth level, relative quantities such as the percentage risk premium depend on initial wealth, which is problematic

- A **power, CRRA** utility function is
  - The **textbook proves** that in this case RRA$(W) = \gamma$

$$U(W) = \begin{cases} \dfrac{W^{1-\gamma}}{1-\gamma} & \gamma > 0, \gamma \neq 1 \\ \ln W & \gamma = 1 \end{cases}$$

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Introducing a Few Common Utility of Wealth Functions

- o As ARA(W) = RRA(W)/W = γ/W, an inverse function of wealth

- o The textbook reports numerical examples that emphasize that different utility functions (even within the same power family) imply—for the same bet—rather different estimates of CE and hence risk premia

- A very popular class of utility functions is the quadratic one:

$$U(W) = W - \frac{1}{2}\kappa W^2 \quad \text{with } \kappa > 0$$

- Because $U'(W) = 1 - \kappa W, U''(W) = -\kappa,$ this implies:

$$ARA(W) = -\frac{-\kappa}{1-\kappa W} = \frac{\kappa}{1-\kappa W} = \frac{\kappa}{W[(1/W)-\kappa]}$$

$$RRA(W) = -\frac{-\kappa W}{1-\kappa W} = \frac{\kappa}{[(1/W)-\kappa]}$$

- o A quadratic utility investor is not always risk averse: ARA(W) and RRA(W) are positive if and only if $\kappa < 1/W$, or if $W < W^*=1/\kappa$ = bliss point

- o In fact, $W < W^*=1/\kappa$ is also necessary and sufficient for the investor to be non-satiated, i.e., for the utility function to be monotone increasing

- One final VNM utility function is the linear one: U(W) = $a + bW, b > 0$

- U'(W)=b and U''(W)=0, imply that ARA(W) = RRA(W) = 0

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Introducing a Few Common Utility of Wealth Functions

- All these utility functions are strictly increasing and concave, have risk tolerance T(W) that depends of wealth in a linear affine fashion:

$$T_{exp}(W) = \frac{1}{\theta} \qquad T_{power}(W) = \frac{1}{\gamma}W \qquad T_{quadr}(W) = \frac{1}{\kappa} - W$$

- These functions are called linear risk tolerance (LRT) utility functions (alternatively, HARA utility functions, where HARA stands for hyperbolic absolute risk aversion, since ARA(W) defines a hyperbola)

- LRT utility functions have many attractive properties:

$$U(W) = \frac{\gamma}{1-\gamma}\left(\frac{\theta W}{\gamma} + \beta\right)^{1-\gamma} \quad \text{with} \quad \gamma \neq 1, \frac{\theta W}{\gamma} + \beta > 0, \theta > 0$$

- It is possible to check that

$$ARA(W) = \left(\frac{W}{\gamma} + \frac{\beta}{\theta}\right)^{-1}$$

  - When $\gamma \to +\infty$ and $\beta=1$, RRA(W) $\to \theta$ (the CARA case), and when $\beta=0$, RRA(W)=γ/W (the CRRA case)
  - Correspondingly, the risk tolerance function is $T_{HARA}(W) = \frac{\beta}{\theta} + \frac{W}{\gamma}$
  - It is clearly linear affine and increasing in wealth
  - This nests all cases reported above

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