

A Comparative Statics Approach to Higher-Order Absolute Risk Aversion

Higher-order risk attitudes are related to higher-order moments of risk, and are unequivocally characterized by the signs and levels of higher-order derivatives of utility functions. In contrast to the direction of higher-order risk aversion, the intensity of higher-order risk aversion beyond the Arrow-Pratt measure of absolute risk aversion is far from conclusive. The purpose of this paper is to use a comparative statics approach to give a choice-theoretic interpretation to a completely general measure of higher-order absolute risk aversion. This is done by focusing on a family of probability distributions that can be ranked in a way that individuals who are more higher-order risk averse than a reference individual possess the same ordering as the reference individual, but not vice versa, a sort of comparative statics results. We show that such a family of probability distributions exists and can be completely characterized by a singlecrossing property. We offer two applications that examine the choice of effort and the willingness to pay for stochastic improvements. Intuitive comparative statics results emerge when we compare the behavior of individuals who differ in their measures of higher-order absolute risk aversion, indicating that these measures indeed capture the intensities of higher-order risk aversion.



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Professor Keith K.P. WONG is the Director of School of Economics and Finance of the University of Hong Kong. Keith's research is mainly theoretical and can be divided into three areas: corporate finance, risk management, and real options. Beginning with his Ph.D. dissertation, Keith's research on corporate finance focuses on integrating financial contract theory with industrial organization theories. Since 1998, Keith has done research on risk management that examines the issues of how risk-averse firms should hedge their exposure to various sources of uncertainty (e.g., exchange rate risk, price risk, and liquidity risk) in general, and the optimality of using options as a hedging instrument in particular. Firms' preferences towards risk, regret, and ambiguity, as well as state-dependent preferences are studied. Keith's papers are published in Journal of Financial and Quantitative Analysis, Management Science, Journal of Business, Review of Accounting Studies, Journal of Economic Dynamics and Control, International Economic Review, Journal of International Money and Finance, European Economic Review, Journal of Banking & Finance, Review of Finance, and others.

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***** All are Welcome *****