

RISK AND INFORMATION

Consumer Behaviour under Uncertainties

18 September 2020

DESCRIBING RISKY OUTCOMES: BUYING LOTTERIES

- Investment: 100 this year and there are three possible outcomes to happen next year
 - A: the value goes up by 20%
 - B: the value remains the same
 - C: the value could fall by 20%
- Given the chance (or likelihood, or probability) that each outcome will take place is 0.3, 0.4, and 0.3 respectively.

EXPECTED VALUE & VARIANCE

- Expected Variance: A measure of the average payoff that a lottery will generate.
- Variance:
 - the measure of the riskiness of the investment
 - The sum of the probability-weighted squared deviations of the possible outcome
- Standard Deviation
 - The square root of the variance

UTILITY FUNCTIONS AND RISK PREFERENCES

- Risk – averse decision maker
- Risk – lover decision maker
- Risk – neutral decision maker

BEARING AND ELIMINATING RISKS

- risk premium: the necessary difference between the expected value of an investment and the payoff of a sure thing to make the decision maker indifferent between the investment and the sure thing.

ANALYZING RISKING DECISIONS

- Using decision tree: a diagram that describes options available to a decision maker as well as the risky events that can occur at each point in time.