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The values of relative risk aversion and prudence: a context-free interpretation

by
Louis Eeckhoudt, Johanna Etner, Fred Schroyen

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The values of relative risk aversion and prudence: a context-free interpretation

Louis Eeckhoudt
Ieseg School of Management (L. E. M., Lille) and CORE (Louvain)

Johanna Etner
CES (Paris 1) and LIRAES (University of Paris Descartes)

Fred Schroyen
Norwegian School of Economics and Business Administration (Bergen)
and Health Economics Bergen

Abstract  In this paper we apply to multiplicative lotteries the idea of preference for "harm disaggregation" that was used for additive lotteries in order to interpret the signs of successive derivatives of a utility function. In this way, we can explain in general terms why the values of the coefficients of relative risk aversion and relative prudence are usually compared respectively to 1 and 2. We also show how these values partition the sets of risk averse and/or prudent decision makers into two subgroups.

Keywords: Relative Risk Aversion, Relative Prudence

JEL Classification: D81

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1 Introduction

Recently, Eeckhoudt - Schlesinger (2006) have given an interpretation of the signs of successive derivatives of a von Neumann-Morgenstern (vNM) utility function \( u(\cdot) \) by reference to a preference for harm disaggregation applied to additive lotteries. Of course, the sign of successive derivatives of \( u(\cdot) \) already gives much information about the decision maker’s preferences since it indicates the direction of various attitudes towards risks. However it is silent about the intensity of such preferences which—for the second and third derivatives—is usually characterized by the value of the coefficients of relative risk aversion (RRA) and relative prudence (RP).

As far as RRA is concerned, the importance of its level (and of its behavior with respect to wealth, here denoted \( x \)) has been known for a long time. Indeed, in a series of papers, dealing with portfolio or savings decisions as well as contingent claims models (such as Hahn (1970), Rothschild - Stiglitz (1971), Fishburn - Porter (1976), Mitchell (1994), Chiu and Madden (2007)), it appears that many comparative statics results often depend, among other things, upon a comparison between unity and the value of the RRA coefficient (defined as \( -x \frac{w''(x)}{w'(x)} \)). This literature has been recently surveyed by Meyer - Meyer (2005). Notice also that in the debate around the equity premium puzzle, the value taken by the (constant) coefficient of relative risk aversion plays a central role.

Since the concept of prudence is more recent than that of risk aversion, the notion of relative prudence (defined as \( -x \frac{w''(x)}{w'(x)} \)) is much less discussed than that of relative risk aversion. However, the scant literature that exists
suggests that the benchmark value for $R_P$ is 2 (see, e.g., Hadar - Seo (1990) and Choi - Kim - Snow (2001)). In these papers, it appears indeed that a second order dominant shift in the return of a risky asset increases its demand if $R_P$ is lower than 2. These results are summarized in Gollier (2001, pp 60-61).

As the models discussed in these papers suggest, the comparisons between $R_{RA}$ and unity on the one hand and between $R_P$ and 2 on the other, are indications of the intensity of risk aversion or prudence, respectively. In this sense, the benchmark values of 1 and 2 for risk aversion and prudence partition the sets of risk averse and prudent decision makers each into two subgroups: those who are a little risk averse or prudent and those who are a very risk averse or prudent.

So far, the literature has discussed these benchmark values in a specific institutional context, to wit that of competitive markets for risky assets.\footnote{There are two exceptions that we are aware of. The first is a paper by Choi - Menezes (1985) who discuss the value of $R_{RA}$ from the concept of a "probability premium". More recently, White (2008) underlines the pertinence of the comparison between $R_P$ and 2 in a bargaining game framework.} The purpose of this paper is to present a comparison of simple lotteries which enables us to elicit in general terms whether relative risk aversion (relative prudence) exceeds the values of 1 (2). The advantage of our approach is twofold. First, it does not rely upon a specific institutional context, and second, it is easily amenable to an experimental implementation. Our procedure applies to multiplicative lotteries an approach similar to the one adopted by Eeckhoudt - Schlesinger (2006) for additive lotteries. The transition from the additive case to the multiplicative one will enable us to interpret in simple
and general terms the benchmark values for $RRA$ and $RP$.

Our paper is organized as follows. In the next section, after a brief exposition of the preference for harm disaggregation applied to additive lotteries, we illustrate the equivalent concept for multiplicative risks. The comparison between the two cases gives the intuition for the results presented in section 3 where the benchmark values are formally obtained. We then briefly conclude.

2 Multiplicative risks and the preference for harm disaggregation

In order to introduce the case of multiplicative risks, we briefly present the additive lotteries used in Eeckhoudt - Schlesinger (2006) to interpret the signs of the second and third derivatives of $u(\cdot)$.

Consider a decision maker endowed with an initial wealth, $x$, who faces the prospect of two losses ($-l$ and $-m$) occurring each with probability $\frac{1}{2}$. If this individual exhibits a preference for harm disaggregation, he will prefer $B_0$ to $A_0$ where
With these additive losses it is easily shown that $B_0 \succeq A_0$ implies and is implied by risk aversion ($u''(\cdot) < 0$).

In order to define prudence replace one of the two losses (say $-l$) by a zero mean risk $\tilde{\theta}$ which is also a harm for a risk averse decision maker. Preference for harm disaggregation then means a preference for $B_1$ to $A_1$ where

Again the additive nature of the harms leads to the conclusion that $B_1 \succeq A_1$ implies and is implied by prudence ($u''' > 0$).

Turning now to the multiplicative counterpart, the two potential losses
are expressed as shares of wealth denoted respectively \( k \) and \( r \) with \( 0 < k < 1 \) and \( 0 < r < 1 \). The decision maker can now apportion the harms in two different ways yielding lotteries \( A_2 \) and \( B_2 \) defined by

\[
A_2 : \begin{cases}
0.5 & \text{with probability } 0.5 \\
x(1-k)(1-r) & \text{with probability } 0.5
\end{cases}
\]

\[
B_2 : \begin{cases}
0.5 & \text{with probability } 0.5 \\
x(1-k) & \text{with probability } 0.5
\end{cases}
\]

The preference relationship between \( B_2 \) and \( A_2 \) is now more subtle than it was for the choice between \( B_0 \) and \( A_0 \). As for \( B_0 \), the disaggregation of harms that occurs in \( B_2 \) gives an advantage to this lottery. However \( A_2 \) has also its own advantage: the proportional loss \((1-r)\) now applies to a lower wealth level \((x(1-k))\) so that the expected final wealth of \( A_2 \) exceeds that of \( B_2 \). Hence it is clear that risk aversion alone (linked to the preference for harm disaggregation) cannot justify a preference for \( B_2 \). As we formally show in the next section, for \( B_2 \) to be preferred to \( A_2 \), risk aversion must be strong enough in the sense that \( RRA \geq 1 \). Another and equivalent way of interpreting the comparison between \( B_2 \) and \( A_2 \) (and also below for the comparison between \( B_3 \) and \( A_3 \)) is to notice that \( B_2 \) contains "inner" results while \( A_2 \) has "extreme" ones. Indeed we necessarily have

\[
x(1-k)(1-r) < x(1-k) \quad \text{and} \quad x(1-r) < x.
\]

Of course this feature of \( B_2 \) is attractive for risk averse decision makers. However, as we observed before, the expected value of lottery \( A_2 \) is higher and thus \( RRA \) must exceed one for \( B_2 \) to be chosen.

To elicit the intensity of prudence, replace one of the proportional losses
(say $-r$) by a zero mean risky return, $\bar{\varepsilon} \in [-1, \infty)$, which is disliked by a risk averse decision maker. Hence we now have to compare lotteries $A_3$ and $B_3$ defined as:

$$A_3 \xrightarrow{1/2} x(1-k)(1+\bar{\varepsilon}) \xrightarrow{1/2} x$$

$$B_3 \xrightarrow{1/2} x(1-k) \xrightarrow{1/2} x(1+\bar{\varepsilon})$$

The harms are better apportioned in $B_3$ than in $A_3$ since the two harms never jointly occur in each of the two states of nature and this disaggregation of the two harms is positively appreciated by a prudent individual. But $A_3$ has—for a risk averse individual—the advantage of a lower variance\footnote{Notice that—contrary to what happened for $A_2$ and $B_2$—the lotteries $A_3$ and $B_3$ have the same expected value of final wealth.} since the random return is applied to a lower wealth $(x(1-k))$ instead of $x$ for $B_3$. Hence, a decision maker will prefer $B_3$ only if prudence is high enough. We show in the next section that this occurs when $RP \geq 2$.

### 3 Benchmark values

We now examine how the comparison between the lotteries described in section 2 are expressed in an expected utility (EU) framework and we consider the case of a risk averse ($u''(\cdot) < 0$) and prudent ($u'''(\cdot) > 0$) decision maker. In proposition 1 we establish a one to one link between the choice among $B_2$ and $A_2$ on the one hand and the benchmark value for $RRA$ on the other.
hand. Proposition 2 does the same for the choice among $B_3$ and $A_3$ and the
benchmark value for $RP$.

**Proposition 1**  
For an EU risk averse decision maker, $B_2 \succeq A_2$ for any pair $(k, r) \in (0, 1)^2$ if and only if $RRA(X) \geq 1$ for any wealth $X > 0$.

**Proof.** Consider a decision maker, endowed with initial wealth $x$, faces
with the two lotteries $A_2$ and $B_2$. Then we have that for any pair $(k, r) \in (0, 1)^2$,

$$B_2 \succeq A_2$$

\[ \Downarrow \]

$$\frac{1}{2} u [x (1 - k)] + \frac{1}{2} u [x (1 - r)] \geq \frac{1}{2} u [x (1 - k)(1 - r)] + \frac{1}{2} u [x]$$

\[ \Downarrow \]

$$u [x (1 - k)] - u [x] \geq u [x (1 - k)(1 - r)] - u [x (1 - r)]. \quad (1)$$

(i) **sufficiency.** Define a function $v(\cdot)$ such that $v (r, k; x) \overset{\text{def}}{=} u [x (1 - k)(1 - r)] - u [x (1 - r)]$. Then $B_2 \succeq A_2$ iff $v (0, k; x) \geq v (r, k; x)$ for all $k \in (0, 1)$,

$x \in R_0^+$. A sufficient condition for $B_2 \succeq A_2$ is thus that

$$v_r (r, k; x) \leq 0$$

\[ \Downarrow \]

$$-x (1 - k) u' [x (1 - k) (1 - r)] + xu' [x (1 - r)] \leq 0$$

\[ \Downarrow \]

$$u' [x (1 - r)] \leq (1 - k) u' [x (1 - k) (1 - r)].$$
Now define function $w$ such that $w(r, k, x) \equiv (1 - k) u'[x(1 - k)(1 - r)]$. A sufficient condition for $B_2 \succeq A_2$ (all $r \in (0, 1)$, $x \in R_0^+$), is then that $w(r, k, x)$ is an increasing function in $k$, that is

$$w_k(r, k, x) \geq 0 \text{ (all } (k, r) \in (0, 1)^2)$$

$$\Downarrow$$

$$-u'[x(1 - k)(1 - r)]$$

$$-x(1 - r)(1 - k) u''[x(1 - k)(1 - r)] \geq 0 \text{ (all } (k, r) \in (0, 1)^2)$$

$$\Downarrow$$

$$1 + \frac{x u''[X]}{u'[X]} \leq 0 \text{ (all } X > 0).$$

So that, $RRA \geq 1$ (all $X > 0$) implies $B_2 \succeq A_2$.

(ii) necessity. Consider the gambles $B_2$ and $A_2$ with $r = k = \delta$, a small positive number. Using a second order Taylor expansion of $u[x(1 - \delta)]$ and $u[x(1 - \delta)^2]$ around $\delta = 0$, inequality (1) can be written as

$$-u''(x)x^2\delta^2 \geq u'(x)x\delta^2 + O(\delta^3)$$

$$\Downarrow$$

$$-\frac{u''(x)x}{u'(x)} \geq 1 + \frac{1}{u'(x)} \frac{O(\delta^3)}{\delta^2},$$

with $\lim_{\delta \to 0} \frac{O(\delta^3)}{\delta^2} = 0$. We have established that $B_2 \succeq A_2$ for any pair $(k, r) \in (0, 1)^2$ implies $RRA(X) \geq 1$ for any $X > 0$. ■

At this stage, notice the difference between additive and multiplicative risks. For additive risks, as shown in Eeckhoudt - Schlesinger (2006), concav-
ity of the utility function (i.e., risk aversion) is sufficient to justify a preference for disaggregating additive sure harms. Our analysis shows that for multiplicative harms, matters are less simple. In this case—as already mentioned in section 2—harm disaggregation conflicts with a reduction in the mean final wealth and the first effect dominates if and only if $RRA > 1$. In the contrary case, the mean wealth effect dominates and $A_2$ is preferred to $B_2$.\textsuperscript{3}

Another interpretation of this result can be obtained by considering the logarithmic utility function ($u(x) = \ln(x)$) for which $RRA$ is constant and equal to unity.\textsuperscript{4} In this case, $A_2 \sim B_2$ since

$$\frac{1}{2} \ln (x (1 - k)) + \frac{1}{2} \ln (x (1 - r)) = \frac{1}{2} \ln (x (1 - k)(1 - r)) + \frac{1}{2} \ln (x).$$

If one concavifies $\ln(x)$ by taking an increasing and concave transformation $h(\cdot)$ ($h' > 0$ and $h'' < 0$), the resulting utility function $v(x) = h[\ln(x)]$ will exhibit a coefficient of $RRA$ which exceeds unity (see appendix) so that $B_2$ is then preferred to $A_2$. In fact, with the logarithmic utility the apportionment effect and the mean wealth one exactly compensate each other. By concavifying the logarithmic utility (so that $RRA > 1$) more weight is given to the apportionment effect and $B_2$ is then strictly preferred to $A_2$.

We now turn, in proposition 2, to the relationship between relative prudence and the choice among lotteries $B_3$ and $A_3$.

\textsuperscript{3}For example, Chiu and Madden (2007) obtain that some criminal activities are less desirable when risk increases if the individual admits a $RRA$ smaller than 1.

\textsuperscript{4}We thank a referee for pointing out this interpretation. Notice that in an important paper on multiplicative background risks, Franke - Schlesinger - Stapleton (2006) use also this tool.
Proposition 2  For an EU risk averse and prudent decision maker, \( B_3 \succeq A_3 \) for any \( k \in (0, 1) \) and \( \tilde{\varepsilon} \in [-1, \infty) \) if and only if \( RP(X) \geq 2 \) for any wealth \( X > 0 \).

Proof. Consider the possibility of a zero-mean risk of return, \( \tilde{\varepsilon} \). Lottery \( B_3 \) is preferred to lottery \( A_3 \) iff for all zero-mean random variables, \( \tilde{\varepsilon} \in [-1, \infty) \), and all \( k \) in \((0, 1)\),

\[
\frac{1}{2} u[x (1 - k)] + \frac{1}{2} E u[x (1 + \tilde{\varepsilon})] \geq \frac{1}{2} E u[x (1 - k) (1 + \tilde{\varepsilon})] + \frac{1}{2} u[x] \quad \Downarrow \\
E u[x (1 + \tilde{\varepsilon})] - u[x] \geq E u[x (1 - k) (1 + \tilde{\varepsilon})] - u[x (1 - k)]. \tag{2}
\]

(i) sufficiency. As previously, define function \( v(\cdot) \) such that \( v(k, x) \overset{\text{def}}{=} E u[x (1 - k) (1 + \tilde{\varepsilon})] - u[x (1 - k)] \). Then \( B_3 \succeq A_3 \) (for all \( k \in (0, 1) \)) iff \( v(0, x) \geq v(k, x) \) (all \( k \in (0, 1), x \in R^+_0 \)). A sufficient condition for \( B_3 \succeq A_3 \) is then that

\[
v_k(k, x) \leq 0 \quad \Downarrow \quad -x E (1 + \tilde{\varepsilon}) u' [x (1 - k) (1 + \tilde{\varepsilon})] + xu' [x (1 - k)] \leq 0 \quad \Downarrow \\
u' [x (1 - k)] \leq E (1 + \tilde{\varepsilon}) u' [x (1 - k) (1 + \tilde{\varepsilon})].
\]

We now define function \( w(\cdot) \) such that \( w(k, \varepsilon, x) \overset{\text{def}}{=} (1 + \varepsilon) u' [x (1 - k) (1 + \varepsilon)] \).

Remembering that \( E \tilde{\varepsilon} = 0 \) and \( var \tilde{\varepsilon} > 0 \), we can write that \( B_3 \succeq A_3 \) (for
all \( k \in (0, 1), \) all \( x \in R_0^+ \) if \( Ew(k, \tilde{\varepsilon}, x) \geq w(k, E\tilde{\varepsilon}, x). \) This condition is satisfied if \( w(\cdot) \) is strictly convex for all \( \varepsilon \in [-1, \infty), \) that is

\[
w_{\varepsilon \varepsilon}(k, \varepsilon, x) \geq 0 \quad \text{(for all } k \in (0, 1), x \in R_0^+ \text{)}
\]

\[
\Downarrow
\]

\[
2x (1 - k) u'' [x (1 - k) (1 + \varepsilon)] + x^2 (1 - k)^2 (1 + \varepsilon) u''' [x (1 - k) (1 + \varepsilon)] \geq 0 \quad \text{(for all } k \in (0, 1), \varepsilon \in [-1, \infty))
\]

\[
\Downarrow
\]

\[
2 + Xu''(X) u''(X) \leq 0 \quad \text{(for all } X > 0).\]

So that \( RP \geq 2 \Rightarrow B_3 \succeq A_3. \)

(ii) necessity. Consider the gambles \( B_3 \) and \( A_3 \) with \( \tilde{\varepsilon} \) being a random variable taking on the values \( k \) and \( -k \) with equal probability. Let \( k \) be a small positive number. Inequality (2) then becomes

\[
\frac{1}{2} u [x (1 + k)] + \frac{1}{2} u [x (1 - k)] - u [x] \geq
\]

\[
\frac{1}{2} u [x (1 - k^2)] + \frac{1}{2} u [x (1 - k^2)] - u [x (1 - k)]. \tag{3}
\]

Using a third order Taylor expansion of \( u[x (1 + k)], u [x (1 - k^2)] \) around \( k = 0, \) inequality (3) can be written as

\[
2u''(x)x^2 k^3 \geq -u'''(x)x^3 k^3 + O(k^4)
\]

\[
\Downarrow
\]

\[
2 \leq \frac{u'''(x)x}{u''(x)} + \frac{1}{u''(x)x^2} \frac{O(k^4)}{k^3}.
\]

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with $\lim_{k \to 0} \frac{O(k^4)}{k^3} = 0$. We have established that $B_3 \succeq A_3$ for any pair $k \in (0, 1)$ and any $\tilde{\varepsilon} \in [-1, \infty)$ implies $RP(X) \geq 2$ for any $X > 0$. ■

A comment similar to the one made for risk aversion applies for prudence. When the sure loss and the zero-mean risk are additive, positive prudence ($u''' > 0$) implies a preference for harm disaggregation. However, in the multiplicative case the condition is more demanding: the preference for harm disaggregation requires that prudence be strong enough ($RP \geq 2$).

An interesting interpretation of proposition 2 can again be given through a transformation $h(\cdot)$ ($h' > 0, h'' < 0$ and $h''' > 0^5$) of function $u(x) = \ln(x)$. In an EU framework with a logarithmic utility, $A_3 \sim B_3$ since

$$\frac{1}{2}E \ln(x(1-k)(1+\tilde{\varepsilon})) + \frac{1}{2} \ln(x) = \frac{1}{2} \ln(x(1-k)) + \frac{1}{2}E \ln(x(1+\tilde{\varepsilon})).$$

In this case, the better apportionment in $B_3$ is exactly compensated for by its higher variance of final wealth. If besides $h' > 0$ and $h'' < 0$, the transformation $h$ also satisfies $h''' > 0$, then $RP$ exceeds 2 (see appendix) and again more weight is attached to the apportionment effect so that $B_3 \succ A_3$.

Before concluding, let us mention that the benchmark values of $RRA$ and $RP$ could also be related to a willingness to trade-off different moments of the lotteries. In the comparison between $B_2$ and $A_2$, final wealth has not only a lower mean in $B_2$ but also a lower variance. As far as $B_3$ and $A_3$ are concerned, these lotteries yield the same expected final wealth but the higher variance of $B_3$ is compensated for by a lower skewness.$^6$

$^5$h''' > 0$ corresponds to a convexification of $h'$.

$^6$A detailed discussion of these trade-offs between the successive moments can be found.
4 Conclusion

The existing literature on savings, insurance and portfolio choices under risk has revealed that quite often comparative statics results depend, among other things, upon the values of the coefficients of relative risk aversion and relative prudence. More specifically the benchmark values of $\text{RRA}$ and $\text{RP}$, taken into consideration inside these models, are respectively 1 and 2.

In this paper, we have given a more fundamental interpretation of these benchmark values which is independent of the institutional environment in which the choice is made. This result has been obtained by applying to multiplicative risks the notion of risk apportionment that was used for additive risks in order to justify the alternating signs of successive derivatives of the vNM utility function.

Finally, we believe that the relatively simple nature of the lotteries involved should easily allow for an experimental determination of individual risk attitudes.

References


5 Appendix

Let us define function $v(\cdot)$ such as $v(x) = h(\ln x)$ with, for all $y \in R$, $h'(y) > 0$ and $h''(y) < 0$. We then obtain

$$v'(x) = h'(\ln x) \times \frac{1}{x}, \text{ and}$$

$$v''(x) = h''(\ln x) \times \frac{1}{x^2} - h'(\ln x) \times \frac{1}{x^2},$$

so that the coefficient of relative risk aversion becomes

$$RRA_v = -\frac{h''(\ln x)}{h'(\ln x)} + 1.$$
Under $h'(y) > 0$ and $h''(y) < 0$, $RRA_v$ necessarily exceeds unity.

Similarly, the coefficient of relative prudence is given by

$$RP_v = -x \frac{v'''(x)}{v''(x)}$$

$$= -x \frac{h'''(\ln x) x^{-3} - 3h''(\ln x) x^{-3} + 2h'(\ln x) x^{-3}}{h''(\ln x) x^{-2} - h'(\ln x) x^{-2}}$$

$$= \frac{-h'''(\ln x) + h''(\ln x)}{h''(\ln x) - h'(\ln x)} + 2.$$

Under $h'(y) > 0$, $h''(y) < 0$ and $h'''(y) > 0$, $RP_v$ necessarily exceeds two.