REALISTIC PREFERENCES

WHAT ARE YOU GOING TO LEARN?

- Richer utility functions that describe more realistically how people behave.

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- Mean-variance preferences treat upside and downside variance the same. But…
- Investors feel losses much more powerfully than any equivalent gains → PROSPECT THEORY

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- Only the first two moments matter in mean-variance preferences. But…
- People prefer positive skewness – like the chance of a big lottery payoff – and dislike negative skewness.

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- Subjective probabilities matter.
- The way people perceive probabilities differs from the actual distribution of returns – they especially tend overestimate the probability of disasters..

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- Bad times other than low means and high variances matter.
- Being rich or poor in absolute terms might not matter as much as whether you are rich or poor relative to your neighbor (or whether you were rich or poor relative in the past).

SUMMARY

- There are many richer models of utility that incorporate all of these considerations.