10.1 Uncertainty and Risk Aversion 1

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choices over lotteries

$A \succ B$
$B \succ A$
$A \sim B$

<u>Expected Utility Theorem</u>

Let w_i be possible wealth outcomes & f_i be their probabilities

There exists a function $u(w_i)$ such that the lottery with the highest $E(u(w))$ is preferred

Risk neutral: Highest $E(w) = \sum_i f_i w_i$

we use it as an as if model

Independence: suppose $A \succ B$

a compound lottery

A w/ prob h & C w/ prob 1-h

B w/ prob h & C w/ prob 1-h