Chapters 1-4

The Economists' view of Risk Aversion and the Behavioral Response

The study of risk has its roots in economics, with attempts to define risk and measure risk aversion going back several centuries. Early in chapter 2, we describe an experiment with a gamble by Bernouli that laid the foundations of conventional economic theory on risk aversion, where individuals with well-behaved utility functions make reasoned judgments when confronted with risk. In chapter 3, we examine the evidence on risk aversion and conclude that individuals do not always behave in rational ways when faced with risk. In particular, we look at the implications of the findings in behavioral economics and finance for risk management. In chapter 4, we return to more traditional economics to look at how the models for measuring risk and estimating expected returns have evolved over time.

Just as a note of warning to the reader, these chapters say little directly about risk management. By their very nature, they use language that is familiar to economics - utility functions and risk aversion coefficients – that is abstract to the rest of us. Risk management, though, has its beginnings here, with an understanding of risk and its consequences. There are insights on human behavior in these chapters that may prove useful in constructing risk management systems and in understanding why they sometimes break down.

Chapter	*Questions for Risk Management*
1	What is risk?
2	How do we measure risk aversion? Why do we care about risk aversion?
3	How do human beings behave when confronted with risk? What do the known quirks in human behavior mean for risk management?
4	How do we measure risk? How have risk measures evolved over time?