A Model of Stochastic Utility Smoothing

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Abstract

We propose, in a stochastic dynamic setting, an axiomatic model of loss aversion in choice under risk, where a reference-dependent structure expresses a concern about intertemporal substitutability. A key feature of our model is an introduction of a new form of recursive preferences in which the ranking of future risk depends on current consumption. The explicit form of loss aversion is then derived by adopting a notion of utility smoothing suggested by experimental studies in riskless intertemporal choices.

Keywords: loss aversion, recursive preferences, reference-dependent preferences, utility smoothing

JEL Classification: D81, D90