Dynamic Investment and Preferences over the Resolution of Risk

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Abstract

Decision makers evaluate risky prospects differently when they are resolved over the span of multiple periods ("dynamic risk"), rather than in "one shot". This finding is both a robust laboratory result, and is thought to drive important macroeconomic phenomena. However the underlying cause of this finding is poorly understood. It has been commonly attributed to a cognitive error, but was recently characterized as the result of *non-standard preferences over the resolution of risk*, a class of models which have received significant attention in the literature. I test the hypothesis that differences in risk attitudes between one-shot risk and dynamic risk are driven by these preferences by conducting a series of two experimental tasks. In the first, subjects' preferences over the resolution of risk are elicited on an individual level. In the second, subjects participate in a standard dynamic risky investment task. I exploit natural subject heterogeneity to test whether preferences elicited in the first task describe investment behavior in the second. I find that they do, suggesting that risk attitudes in environments with dynamic risk are driven by non-standard preferences over the resolution of risk.

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