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Time Preference and Real Investment

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Abstract

This paper studies the investment timing problem of an entrepreneur with a non-tradable real option with undiversifiable risk. We find that the time preference can have a significant impact on the risk attitude toward the idiosyncratic risk, which results from the wealth effect on the implied option value. If the agent is impatient (patient), an increase in idiosyncratic volatility increases (decreases) the agent's value and delays (hastens) investment. This finding suggests several important implications and empirical predictions for investment decisions in private firms and public firms with concentrated ownership.

JEL classification: G11; G31; E2

Keywords: time preference, risk attitude, wealth effect, real option, idiosyncratic risk

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