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Risk Aversion with Two Risks: A Theoretical Extension

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Abstract

We identify new conditions ensuring risk aversion in the sense of Arrow-Pratt in a two-argument utility framework in which a financial risk is accompanied by a background risk. Our results generalize the findings of Finkelshtain et al. (1999). We consider a sequence of possible dependence among risks. We also provide an empirical example showing that second-order expectation dependence cannot be ignored in determining risk aversion with two risks.

Key words: Risk aversion; Risk apportionment; Background risk; Expectation dependence; Bivariate utility function

JEL classification: D81

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