1.7: Risk Aversion

While the concept of risk aversion has been addressed briefly in the previous discussion of stocks and bonds, this is a topic worth exploing ring in more detail as it is a critical assumption underlying the analysis that will be covered as the semester unfolds. Risk aversion refers to the idea that investors don't like risk. All else equal, if two investments have the same expected return investors will choose the one with the least risk. However, risk aversion does not mean investors avoid risk at all costs…only that they need to be paid to take on extra risk. If investors were risk minimizers instead of merely risk averse, the stock market would not exist as investors would not take the risk associated with investing in stocks, regardless of the higher expected return. Investors will take on extra risk, assuming they receive ADEQUATE compensation for doing so.

Does adequate seem like a vague word? It should, because it is intentionally vague. The reason for this is because people have different levels of risk aversion depending on their personality, their age, their income, and several other factors. Some people are highly risk averse (needing significantly higher expected return to take on a little more risk) while others are only mildly risk averse (needing only slightly higher expected return to take on significantly more risk). To summarize:

- We will assume all investors are risk averse
- Risk aversion implies investors do not like risk
- If two investments have the same expected return, investors will choose the one with the least risk
- Risk aversion is NOT risk minimization, investors will take on more risk if they are adequately compensated for that risk
- The level of risk aversion varies from individual to individual