Skewed Noise∗

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Abstract

We study the attitude of decision makers to skewed noise. For a binary lottery that yields the better outcome with probability $p$, we identify noise around $p$ with a compound lottery that induces a distribution over the exact value of the probability and has an average value $p$. We propose and characterize a new notion of skewed distributions, and use a recursive non-expected utility to provide conditions under which rejection of symmetric noise implies rejection of negatively skewed noise, yet does not preclude acceptance of some positively skewed noise, in agreement with recent experimental evidence. In the context of decision making under uncertainty, our model permits the co-existence of aversion to symmetric ambiguity (as in Ellsberg’s paradox) and ambiguity seeking for low likelihood “good” events.

Keywords: Skewed distributions, compound lotteries, recursive non-expected utility, ambiguity aversion and seeking.

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1 Introduction

Standard models of decision making under risk assume that individuals obey the reduction of compound lotteries axiom, according to which a decision maker is indifferent between any multi-stage lottery and the simple lottery that induces the same probability distribution over final outcomes. Experimental and empirical evidence suggest, however, that this axiom is often violated. Individuals may have preferences over the timing of resolution of uncertainty, or they may distinguish between the source of risk in each stage and thus perceive risk as a multi-stage prospect, or they may care about the number and order of lotteries in which they participate.

The effect of such violations of the reduction axiom on behavior depends on the compound lotteries under consideration. Halevy [18] and Miao and Zhong [29], for example, consider preferences over two-stage lotteries and demonstrate that individuals are averse to the introduction of symmetric noise, that is, symmetric mean-preserving spread into the first-stage lottery. On the other hand, Boiney [5] found a significant effect of skewed noise, where majority of the subjects in his experiments opted for positively skewed noise, but rejected negatively skewed noise. Specifically, his subjects had to choose one of three prospects, in all of which the overall probability of success (which results in a prize $\bar{x}$) is $p$, and with the remaining probability $\bar{x} < p$ is received. In Option A the probability $p$ was given. Prospect B (resp., C) represents a negatively (positively) skewed distribution around $p$ in which it is very likely that the true probability slightly exceeds (falls below) $p$ but it is also possible, albeit unlikely, that the true probability is much lower (higher). Boiney’s main finding is that most subjects prefer C to A and A to B. Moreover, these preferences are robust to different values of $\bar{x} > \bar{x}$ and $p$.

In Boiney’s experiment, the underlying probability of success $p$ was the same in all options. In recent experiments, Abdellaoui, Klibanoff, and Placido [1] and Abdellaoui, l’Haridon, and Nebout [2] found strong evidence that aversion

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1See, among others, Kahneman and Tversky [21], Bernasconi and Loomes [4], Conlisk [10], and Harrison, Martinez-Correa, and Swarthout [19].
to compound risk (i.e., noise) is an increasing function of $p$. In particular, their results are consistent with a greater aversion to negatively skewed noise around high probabilities than to positively skewed noise around small probabilities.

In this paper we propose a model that can accommodate the behavioral patterns discussed above. For a binary lottery $(\pi, p; x, 1 - p)$ with $\pi > x$, we identify noise around $p$ with a two-stage lottery that induces a distribution over the exact value of the probability and has an average value $p$. We introduce and characterize a new notion of skewness, and use a version of Segal’s [33] recursive non-expected utility model to outline conditions under which a decision maker who always rejects symmetric noise will also reject any negatively skewed noise but may seek some positively skewed noise.

We apply our model to the recently documented phenomenon of some ambiguity seeking in the context of decision making under uncertainty. The recursive model was first suggested by Segal [32] as a way to analyze attitudes towards ambiguity. Under this interpretation, ambiguity is identified as a two-stage lottery, where the first stage captures the decision makers subjective uncertainty about the true probability distribution over the states of the world, and the second stage determines the probability of each outcome, conditional on the probability distribution that has been realized. Our model permits the co-existence of aversion to symmetric ambiguity (as in Ellsberg’s [16] famous paradox) and ambiguity seeking in situations where the decision maker anticipates a bad outcome, yet believes that there is a small chance that things are not as bad as they seem. Simple intuition, as well as some experimental evidence, suggests that in this case the decision maker might not want to know the exact values of the probabilities, perhaps in order to “keep hope alive” despite the unfavorable odds.

The fact that the recursive evaluation of two-stage lotteries in Segal’s model is done using non-expected utility functionals is key to our analysis. It is easy to see that if the decision maker uses the same expected utility functional in each stage he will be indifferent to noise. In addition, a version of the model in which the two stages are evaluated using different expected utility functionals (Kreps and Porteus [23], Klibanoff, Marinacci, and Mukerji [25])
cannot accommodate the co-existence of rejecting all symmetric noise while still accepting some positively skewed noise, that is, if the decision maker rejects symmetric noise, then he rejects all noise. Another related model is Dillenberger [13], who analyzed a special form of the recursive model in which the two stages are evaluated by the same non-expected utility functional, and studied a property called preferences for one-shot resolution of uncertainty. In the language of our paper, this property means that the decision maker rejects all noise.\footnote{The class of functionals that, when applied recursively, display preferences for one-shot resolution of uncertainty is characterized in Cerreia Vioglio, Dillenberger, and Ortoleva [7].}

This paper confines attention to the analysis of attitudes to noise related to the probability of success $p$ in a binary prospect. In reality the decision maker may face lotteries with many outcomes and the probabilities of receiving each of them may be uncertain. We deal only with binary lotteries since when there are many outcomes their probabilities depend on each other and therefore skewed noise over the probability of one event may affect noises over other probabilities in too many ways. This complication is avoided when there are only two outcomes — whatever the decision maker believes about the probability of receiving $\mathfrak{p}$ completely determines his beliefs regarding the probability of receiving $\mathfrak{x}$. Note that while the underlying lottery is binary, the noise itself (that is, the distribution over the value of $p$) may have many possible values or may even be continuous.

The rest of the paper is organized as follows: Section 2 describes the analytical framework and introduces notations and definitions that will be used in our main analysis. Section 3 defines and characterizes skewed distributions. Section 4 studies attitudes towards skewed noises and states our main behavioral results. Section 5 studies ambiguity aversion and seeking. All proofs are relegated to an appendix.
2 The model

Fix two monetary outcomes \( \bar{x} > x \). The underlying lottery we consider is the binary prospect \((\bar{x}, p; x, 1-p)\), which pays \( \bar{x} \) with probability \( p \) and \( x \) otherwise. We identify this lottery with the number \( p \in [0,1] \) and analyze noise around \( p \) as a two-stage lottery, denoted by \( \langle p_1, q_1; \ldots; p_n, q_n \rangle \), that yields with probability \( q_i \) the lottery \((\bar{x}, p_i; x, 1-p_i)\), \( i = 1, 2, \ldots, n \), and satisfies \( \sum_i p_i q_i = p \). Let

\[
\mathcal{L}_2 = \{ \langle p_1, q_1; \ldots; p_n, q_n \rangle : p_i, q_i \in [0,1], i = 1, 2, \ldots, n, \text{ and } \sum_i q_i = 1 \}.
\]

Let \( \succeq \) be a complete and transitive preference relation over \( \mathcal{L}_2 \), which is represented by \( U : \mathcal{L}_2 \to \mathbb{R} \). Throughout the paper we confine our attention to preferences that admit the following representation:

\[
U (\langle p_1, q_1; \ldots; p_n, q_n \rangle) = V (c(p_1), q_1; \ldots; c(p_n), q_n) \tag{1}
\]

where \( V \) is a functional over simple (finite support) one-stage lotteries over the interval \([x, \bar{x}]\) and \( c \) is a certainty equivalent function (not necessarily the one obtained from \( V \)).

According to this model, the decision maker evaluates a two-stage lottery \( \langle p_1, q_1; \ldots; p_n, q_n \rangle \) recursively. He first replaces each of the second-stage lotteries with its certainty equivalent, \( c(p_i) \). This results in a one-stage lottery over the certainty equivalents, \((c(p_1), q_1; \ldots; c(p_n), q_n)\), which he then evaluates using the functional \( V \).

We assume throughout that \( V \) is monotonic with respect to first-order stochastic dominance and continuous with respect to the weak topology.

There are several reasons that lead us to study this special case of \( U \). First, it explicitly captures the sequentiality aspect of two-stage lotteries, by distinguishing between the evaluations made in each stage (\( V \) and \( c \) in the first

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\(^3\)The function \( c : [0,1] \to \mathbb{R} \) is a certainty equivalent function if for some \( W \) over one-stage lotteries, \( W (c(p), 1) = W (x, p; \bar{x}, 1-p) \).

\(^4\)The functional \( V \) thus represents some underlying complete and transitive binary relation over simple lotteries, which is used in the first stage to evaluate lotteries over the certainty equivalents of the second stage. To avoid confusion with the main preferences over \( \mathcal{L}_2 \), we will impose all the assumptions in the text directly on \( V \).
and second stage, respectively). Second, it allows us to state our results using familiar and easy to interpret conditions that are imposed on the functional $V$, which do not necessarily carry over to a general $U$. Finally, the model is a special case of the recursive non-expected utility model of Segal [33]. This facilitates the comparison of our results with other models.

We identify simple lotteries with their cumulative distribution functions, denoted by capital letters ($F$, $G$, and $H$). Denote by $\mathcal{F}$ the set of all cumulative distribution functions of simple lotteries over $[x, \bar{x}]$. We assume that $V$ satisfies the assumptions below (specific conditions on $c$ will be discussed only in the relevant section). These assumptions are common in the literature on decision making under risk.

**Definition 1** $V$ is quasi concave if for any $F, G \in \mathcal{F}$ and $\lambda \in [0, 1]$,

$$V(F) \geq V(G) \implies V(\lambda F + (1 - \lambda) G) \geq V(G).$$

Quasi concavity implies preference for randomization among equally valued prospects. Together with risk aversion ($V(F) \geq V(G)$ whenever $G$ is a mean preserving spread of $F$), quasi concavity implies preference for portfolio diversification (Dekel [12]), which is an important feature when modeling markets of risky assets.\(^5\)

Following Machina [25], we assume that $V$ is smooth, in the sense that it is Fréchet differentiable, defined as follows.

**Definition 2** $V : \mathcal{F} \to \mathbb{R}$ is Fréchet differentiable if for every $F \in \mathcal{F}$ there exists a local utility function $u_F : [x, \bar{x}] \to \mathbb{R}$, such that for every $G \in \mathcal{F}$,

$$V(G) - V(F) = \int u_F(x)d[G(x) - F(x)] + o(\|G - F\|)$$

where $\|\cdot\|$ is the $L_1$-norm.

\(^5\)The evidence regarding the validity of quasi concavity is supportive yet inconclusive: while the experimental literature that documents violations of linear indifference curves (see, for example, Coombs and Huang [11]) found deviations in both directions, that is, either preference for or aversion to randomization, both Sopher and Narramore [34] and Dwenger, Kubler, and Weizsacker [15] found explicit evidence in support of quasi concavity.
To accommodate various types of systematic violations of the vNM independence axiom, Machina [25] suggested the following assumption on the behavior of the local utility function, which he labeled Hypothesis II: If $G$ first-order stochastically dominates $F$, then at every point $x$, the Arrow-Pratt measure of absolute risk aversion of the local utility $u_G$ is higher than that of $u_F$. For the purpose of our analysis, we only need a weaker notion of Hypothesis II, which requires the property to hold just for degenerate lotteries (i.e., Dirac measures), denoted by $\delta_y$. Formally,

**Definition 3** The Fréchet differentiable functional $V$ satisfies Weak Hypothesis II if for every $x$ and for every $y > z$,

$$\frac{-u'_G(x)}{u''_{\delta_y}(x)} \geq -\frac{-u'_F(x)}{u''_{\delta_z}(x)}.$$

### 3 Skewed Distributions

Our aim is to analyze attitudes to noise that is not symmetric around its mean. For that we need first to formally define the notion of a skewed distribution, which is the natural generalization of the concept of noise considered in experiments. For a distribution $F$ on $[a, b] \subset \mathbb{R}$ with expected value $\mu$ and for $\tau \geq 0$, let $\eta_1(F, \tau) = \int_{\mu - \tau}^{\mu} F(x)dx$ be the area below $F$ between $a$ and $\mu - \tau$ and $\eta_2(F, \tau) = \int_{\mu + \tau}^{b}[1 - F(x)]dx$ be the area above $F$ between $\mu + \tau$ and $b$ (see Figure 1). Note that $\eta_1(F, 0) = \eta_2(F, 0)$. If $F$ is symmetric around $\mu$, then for every $\tau$ these two values are the same. The following definition is based on the case where the left area is systematically larger than the right area.

**Definition 4** The lottery $X$ with the distribution $F$ on $[a, b]$ and expected value $\mu$ is negatively skewed if for every $\tau > 0$, $\eta_1(F, \tau) \geq \eta_2(F, \tau)$.

Similarly, positive skewness requires that $\eta_2(F, \tau) \geq \eta_1(F, \tau)$ for every $\tau > 0$.

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6Graphically, Hypothesis II implies that for given $x > y > z$, indifference curves in the probability triangle $\{(z, p; y, 1 - p - q; x, q) \in \mathbb{R}_+^2 \text{ and } p + q \leq 1\}$ are “fanning out”, that is, they become steeper as the probability of the good outcome $x$ rises and the probability of the bad outcome $z$ falls.
The following characterization of skewed distributions will play a key role in the proof of our main behavioral results, which we state in Section 4.

\textbf{Definition 5} Let $\mu$ be the expected value of a lottery $X$. Lottery $Y$ is obtained from $X$ by a negative symmetric split if $Y$ is the same as $X$, except for that one of the outcomes $x \leq \mu$ of $X$ is split into $x + \alpha$ and $x - \alpha$, each with half of the probability of $x$.

\textbf{Theorem 1} If the lottery $Y = (y_1, p_1; \ldots; y_n, p_n)$ with expected value $\mu$ is negatively skewed, then there is a sequence of lotteries $X_i$, each with expected value $\mu$, such that $X_1 = (\mu, 1)$, $X_i \rightarrow Y$, and $X_{i+1}$ is obtained from $X_i$ by a negative symmetric split. Conversely, any such sequence converges to a negatively skewed distribution.

The result for positively skewed distributions is analogues. The main difficulty in proving the first part of this theorem is the fact that whereas outcomes to the left of $\mu$ can be manipulated, any split that lands an outcome to the right of $\mu$ must hit its exact place according to $Y$, as we will not be able to touch it later again. To illustrate the constructive proof for a finite sequence, let $X = (3, 1)$ and $Y = (0, \frac{1}{4}; 4, \frac{3}{4})$, and obtain $X = (3, 1) \rightarrow (2, \frac{1}{2}; 4, \frac{1}{2}) \rightarrow (0, \frac{1}{4}; 4, \frac{1}{2} + \frac{1}{2}) = Y$. For a sequence that does not terminate, let $X = (5, 1)$.
and \( Y = (0, \frac{1}{6}; 6, \frac{5}{6}) \). Here we obtain

\[
X = (5, 1) \rightarrow (4, \frac{1}{2}; 6, \frac{1}{2}) \rightarrow (2, \frac{1}{4}; 6, \frac{3}{4}) \rightarrow (0, \frac{1}{5}; 4, \frac{1}{5}; 6, \frac{3}{4}) \rightarrow \ldots \\
(0, \frac{1}{2} \sum_1^n \frac{1}{2^n}; 4, \frac{1}{2} \sum_1^n \frac{1}{2^n}; 6, \frac{1}{2} + \sum_1^n \frac{1}{2^n}) \rightarrow \ldots (0, \frac{1}{6}; 6, \frac{5}{6}) = Y.
\]

Before proceeding, we note that our definition of skewness is stronger than a possible alternative according to which the distribution \( F \) with expected value \( \mu \) is negatively skewed if \( \int_{\mathbb{R}} (y - \mu)^3 dF(y) \leq 0 \). In fact, we show in Proposition 1 in the appendix that if \( F \) is negatively skewed as in Definition 4, then for all odd \( n \), \( \int_{\mathbb{R}} (y - \mu)^n dF(y) \leq 0. \)

Another related concept is the notion of increasing downside risk, which is characterized in Menezes, Geiss, and Tressler [28]. Distribution \( F \) has more downside risk than distribution \( G \) if one can move from \( G \) to \( F \) in a sequence that combines a mean-preserving spread of an outcome below the mean followed by a mean-preserving contraction of an outcome above the mean, in a way that the overall result is a transfer of risk from the right to the left of a distribution, keeping the variance intact. Our characterization involves a sequence of only negative symmetric splits, starting in the degenerate lottery that puts all the mass on the mean. In particular, our splits are not mean-variance-preserving and occur only in one side of the mean.

4 Skewed Noise

Recall our notation for two-stage lotteries of the form \( \langle p_1, q_1; \ldots; p_m, q_m \rangle \), where \( p_i \) stands for the simple lottery \( (x, p_i; x, 1 - p_i) \) and \( x > x \). The following definitions of rejection of symmetric and skewed noise are natural.

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7The converse is false. Let \( F \) be the distribution of the lottery \( (-10, \frac{1}{10}; 2, \frac{1}{10}; 0, \frac{4}{35}; 7, \frac{2}{7}) \) with \( \mu = 0 \). \( \mathbb{E} [(X - \mu)^3] = -6 < 0 \) and \( \mathbb{E} [(X - \mu)^{2n+1}] \) is decreasing with \( n \), hence all odd moments of \( F \) are negative. Nevertheless, the area below the distribution from \(-10\) to \(-5\) is \( \frac{1}{2} \), but the area above the distribution from \(5\) to \(10\) is \( \frac{7}{4} \), which means that \( F \) is not negatively skewed according to Definition 4.
Definition 6  The relation $\succeq$ rejects symmetric noise if for all $p$, $\alpha$, and $\varepsilon$,

$$\langle p, 1 \rangle \succeq \langle p - \alpha, \varepsilon; p, 1 - 2\varepsilon; p + \alpha, \varepsilon \rangle.$$ 

Definition 7  The relation $\succeq$ rejects negatively (resp., positively) skewed noise if for all $p \in (0, 1)$, $\langle p, 1 \rangle \succeq \langle p_1, q_1; \ldots; p_n, q_n \rangle$ whenever $\sum p_i q_i = p$ and the distribution of $(p_1, q_1; \ldots; p_n, q_n)$ is negatively (resp., positively) skewed.

As before, we assume that $\succeq$ over $\mathcal{L}_2$ can be represented as in eq. (1) by $U(\langle p_1, q_1; \ldots; p_n, q_n \rangle) = V((c(p_1), q_1; \ldots; c(p_n), q_n))$, where $V$ is a functional over simple lotteries and $c$ is a certainty equivalent function, with $c(p)$ being the certainty equivalent of $(\overline{x}, p; \underline{x}, 1-p)$. Denote the local utility of $V$ around $F$ by $u_F$. The two results of this section establish a connection between the rejection of symmetric and skewed noises. In particular, they show how together with the assumptions of Section 2, rejection of symmetric noise implies rejection of negatively skewed noise (Theorem 2), yet such a rejection is consistent with acceptance of some positively skewed noise (Theorem 3).

Theorem 2  Suppose (i) $V$ is quasi concave, Fréchet differentiable, and satisfies Weak Hypothesis II, and (ii) the preference relation $\succeq$ rejects symmetric noise. Then $\succeq$ rejects negatively skewed noise.

Theorem 2 provides sufficient conditions for rejection of negatively skewed noise. The conditions on $V$ are familiar and, as we have pointed out in the introduction and will further discuss in Sections 4.1 and 5, rejection of symmetric noise is empirically supported. The intuition behind the proof of the theorem is the following. Let $\delta_{c(p)}$ be the degenerate two stage lottery that with probability one yields $c(p)$. We show that in order to have a rejection of (a small) symmetric noise around $p$, the composition of $u_{\delta_{c(p)}}$ with the function $c$ must be concave.

But what happens when the symmetric noise is added not to $p$, but to a probability $p' < p$? If the probability that the true probability is $p'$ is (very) small, then we can still evaluate the noise using $u_{\delta_{c(p')}}$. Now $u_{\delta_{c(p')}}$ is assumed to be concave enough at $c(p')$ to reject such a noise. Since $p' < p$, Weak
Hypothesis II implies that \( u_{\delta_c(p)} \) is even more risk averse (or concave) at \( c(p') \) than \( u_{\delta_c(p')} \), hence the noise is bound to be rejected. Since, by Theorem 1, any negatively skewed noise \( Q \) around \( p \) can be obtained as the limit of negative symmetric splits, repeatedly applying Weak Hypothesis II implies that each such split will be rejected when evaluated using \( u_{\delta_c(p)} \) and the result follows.\(^8\)

The argument above depends on the assumption that \( u_{\delta_c(p)} \) is more concave at \( c(p') \) than \( u_{\delta_c(p')} \). But this relation reverses when \( p' > p \). By Weak Hypothesis II, it may now happen that the noise around \( p' > p \), evaluated using \( u_{\delta_c(p)} \), will be accepted as this local utility is less concave than \( u_{\delta_c(p')} \) at \( c(p') \). This is formalized in the following result, which provides sufficient conditions for acceptance of some positively skewed noise. It is this theorem that distinguishes our model from other known models that cannot accommodate rejections of all symmetric noise with acceptance of some positively skewed noise.

**Theorem 3** Under the assumptions of Theorem 2, if for \( p' > p \)

\[
\frac{u_{\delta_c(p)}(c(p')) - u_{\delta_c(p)}(c(p))}{p' - p} > u'_{\delta_c(p)}(c(p))c'(p)
\]

then for a sufficiently small \( \varepsilon > 0 \) and for \( p(\varepsilon) \) such that \((1 - \varepsilon)p(\varepsilon) + \varepsilon p' = p\), \( \succeq \) accepts positively skewed noise of the form \( (p(\varepsilon), 1 - \varepsilon; p', \varepsilon) \) around \( p \). However, if for all \( p' > p \) eq. (2) is not satisfied, then all such noises will be rejected.

Graphically, inequality (2) requires the slope of the chord connecting the points \( p \) and \( p' \) on the graph of the composition of \( u_{\delta_c(p)} \) (the local utility of \( V \) around \( \delta_c(p) \)) with \( c \) (the certainty equivalent function of the lottery \((\tau, p; x, 1 - p)\)) to be steeper than the slope of this function at \( p \) (see Fig. 2). Note that if this composition is globally concave, then inequality (2) is never satisfied. The condition thus requires that this composition is at least somewhere convex, and as we assume rejection of symmetric noise around \( \delta_c(p) \), we know that this convexity must occur for \( p' \) sufficiently larger than \( p \).

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\(^8\)More precisely, by Fréchet differentiability, each such split will also be rejected by \( \succeq \). Quasi concavity then implies that \( (p, 1) \succeq Q \).
The shape of the local utility in Fig. 2 resembles the vNM utility suggested by Friedman and Savage [17] to explain why decision makers may buy insurance, yet participate in lotteries with high potential prizes but with negative expected return. Our analysis shares some of this intuition. The lottery is not over monetary payoffs, but over the probability of success in a lottery over the possible outcomes $\pi$ and $x$. But here too, decision makers holding the lottery $(\pi, p; x, 1 - p)$ find the small likelihood of winning a high outcome (that is, a high probability $p'$ of winning $\pi$) attractive, and agree that the alternative probability of winning goes down slightly below the original probability $p$ so that on average the winning probability of winning $\pi$ remains intact. However, they are not willing to move in the opposite direction. They will reject a small likelihood to win $x$ with a low probability $p'$, even though they are compensated such that the alternative probability goes up slightly above the original one, keeping the same average probability.

![Figure 2: Inequality (2)](image)

Continuity of $\succeq$ and the reverse implication of Theorem 3 imply the following conclusion, establishing the link between properties of the local utility at $p$ and acceptance of positively skewed noise.
Conclusion 1 If for all $p' > p$ inequality (2) is not satisfied, then for a sufficiently small $\varepsilon > 0$ and for all $p_1, \ldots, p_n > p$, the decision maker will reject all positively skewed noise of the form $\langle p(\varepsilon), 1-\varepsilon; p_1, \varepsilon_1; \ldots; p_n, \varepsilon_n \rangle$ where $\sum \varepsilon_i = \varepsilon$ and $(1 - \varepsilon)p(\varepsilon) + \sum \varepsilon_i p_i = p$.

It is left to verify that the conditions of Theorem 3 are not empty. Let $V(c_{p_1}, q_1; \ldots; c_{p_n}, q_n) = E[w(c_p)] \times E[c_p]$, where $w(x) = \frac{\zeta x - x^\zeta}{\zeta - 1}$ and $c(p) = \beta p + (1 - \beta)p^\kappa$. For $\zeta = 1.024$, $\beta = 0.15$, $\kappa = 1.1$, $p = 0.0002$, and $q = 0.7$, we show in Appendix B that all the assumptions of Theorem 3 are satisfied. We also show that for every $p > 0$, if $q$ is sufficiently small, then with this $V$, the decision maker will prefer the noise $\langle p, q; 0, 1-q \rangle$ over $\langle pq; 1 \rangle$. To guarantee this property, it is enough to establish that the first non-zero derivative of $V(c(pq), 1) - V(c(p), q; 0, 1-q)$ with respect to $q$ at $q = 0$ is negative.

4.1 Remarks

By Theorem 2, our model can rank any two lotteries over probabilities with the same mean that relate to one another by a sequence of negative symmetric splits (as in Definition 5), as long as the split in step $n$ is done to an outcome below the certainty equivalent of the lottery obtained in step $n - 1$, so that Weak Hypothesis II can be invoked. A sufficient condition for this — which implies that our model ranks the two lotteries directly, and without any further assumptions — is that it is always the worst outcome (that is, the lowest second-stage probability of the good prize) in the support that we split in half. For example, the lottery $\langle \frac{1}{2}, \frac{4}{10}; \frac{9}{10}, \frac{6}{10} \rangle$ is preferred to $\langle \frac{4}{10}, \frac{2}{10}; \frac{9}{10}, \frac{6}{10} \rangle$, which, in turn, is preferred to $\langle \frac{3}{10}, \frac{1}{2}; \frac{1}{10}, \frac{6}{10}; \frac{2}{10}, \frac{9}{10}, \frac{6}{10} \rangle$, etc.

Theorems 2 and 3 do not restrict the location of the skewed distribution, but it is reasonable to find negatively skewed distributions over the value of the probability $p$ when $p$ is high, and positively skewed distributions when $p$ is low. The theorems are thus consistent with the empirical observation we mention below that decision makers reject negatively skewed distributions concerning high probability of a good event, but seek such distributions when the probability of the good event is low. Note that the two theorems do not
rule out possible rejection of negatively skewed noise around low values of $p$ or acceptance of positively skewed noise around high values of $p$. To the best of our knowledge there is no evidence for such behavior, but our main aim is to suggest a model that is flexible enough not to tie together attitudes towards the two different noises rather than to impose additional restrictions.

Our results can explain some of the findings in Abdellaoui, l’Haridon, and Nebout [2]. They consider an underlying binary lottery that yields €50 with probability $r$ and 0 otherwise. For different values of $r$ and $q$, subjects report the number $m$ such that $\langle m, 1 \rangle \sim \langle r, q; 0, 1-q \rangle$. For many values of $r$, subjects preferred the positively skewed noise $\langle r, \frac{1}{3}; 0, \frac{2}{3} \rangle$ over its reduced version, $\langle \frac{r}{3}, 1 \rangle$ (that is, $m > \frac{r}{3}$). On the other hand, the results were less systematic for $q = \frac{2}{3}$, although most subjects reject the negatively skewed noise $\langle \frac{1}{2}, \frac{2}{3}; 0, \frac{1}{3} \rangle$.

There are other experimental findings that, while not directly covered by our main result, provide a supportive evidence to the idea that positively and negatively skewed noises are differently evaluated, with a clear indication that most subjects are more averse to the former, as well as for the pattern of more compound-risk aversion for high probabilities than for low probabilities, and even for compound risk seeking for low probabilities (see, for example, Abdellaoui, Klibanoff, and Placido [1], Kahn and Sarin [20], Viscusi and Chesson [37], and Masatlioglu, Orhun, and Raymond [27]).

5 Ambiguity aversion and seeking

Ambiguity aversion is one of the most investigated phenomenon in decision theory. Ambiguity refers to situations where a decision maker does not know the exact probabilities of some events. The claim that individuals systematically prefer betting on events with known rather than with unknown probabilities (ambiguity aversion) was first suggested in a series of thought experiments by Ellsberg [16]. Importantly, as we discuss below, the unknown probabilities in Ellsberg’s examples relate to events that are completely symmetric.

While Ellsberg-type behavior seems intuitive and is widely documented, there are situations where decision makers actually prefer not to know the
probabilities with much preciseness. Suppose a person suspects that there is a high probability that he will face a bad outcome (severe loss of money, serious illness, criminal conviction, etc.). Yet he believes that there is some (small) chance things are not as bad as they seem (Federal regulations will prevent the bank from taking possession of his home, it is really nothing, they won’t be able to prove it). These beliefs might emerge, for example, from consulting with a number of experts (such as accountants, doctors, lawyers) who disagree in their opinions; the vast majority of which are negative but some believe the risk is much less likely. Does the decision maker really want to know the exact probabilities of these events? The main distinction between the sort of ambiguity in Ellsberg’s experiment and the ambiguity in the last examples is that the latter is asymmetric and, in particular, positively skewed. On the other hand, if the decision maker expects a good outcome with high probability, he would probably prefer to know this probability for sure, rather than knowing that there is actually a small chance that things are not that good. In other words, negatively skewed ambiguity may well be undesired.

There is indeed a growing experimental literature that challenges the assumption of global ambiguity aversion (see a recent survey by Trautmann and van de Kuilen [35]). A typical finding is that individuals are ambiguity averse for moderate and high likelihood events, but ambiguity seeking for unlikely events. This idea was suggested by Ellsberg himself (see Becker and Bronwson [3, fn. 4]) and was reported in Kocher, Lahno, and Trautmann [22] and Dimmock, Kouwenberg, Mitchell, and Peijnenburg [14]. Camerer and Webber [6] pointed out that such pattern may be due to perceived skewness, which distorts the mean of the ambiguous distributions of high and low probabilities.

The recursive model was suggested by Segal [32] as a way to capture ambiguity attitudes. Under this interpretation, ambiguity is identified as two-stage lotteries. The first stage captures the decision maker’s uncertainty about the true probability distribution over the states of the world (the true composition of the urn in Ellsberg’s example), and the second stage determines the probability of each outcome, conditional on the probability distribution that has been realized. Holding the prior probability distribution over states fixed, an
ambiguity averse decision maker prefers the objective (unambiguous) simple lottery to any (ambiguous) compound one, while an ambiguity seeker displays the opposite preferences.

Our model is consistent with the co-existence of aversion to both symmetric ambiguity (as in Ellsberg’s paradox) and ambiguity seeking for low-probability events. To illustrate, consider (i) a risky urn containing $n > 2$ balls numbered 1 to $n$, and (ii) an ambiguous urn also containing $n$ balls, each marked by a number from the set $\{1, 2, \ldots, n\}$, but in an unknown composition. Betting that a specific number will not be drawn from the risky urn corresponds to the simple lottery with probability of success $\frac{n-1}{n}$. While we don’t know what distribution over the composition of the ambiguous urn does the decision maker hold, it is reasonable to invoke symmetry arguments. Let $(m_1, \ldots, m_n)$ be a possible distribution of the numbers in the ambiguous urn, indicating that number $i$ appears $m_i$ times (of course, $\sum_i m_i = n$). Symmetry arguments require that the decision maker believes that this composition is as likely as any one of its permutations. Unless the decision maker believes that there are at most two balls marked with the same number, the same bet over the ambiguous urn corresponds to a compound lottery that induces a negatively skewed distribution around $\frac{n-1}{n}$. The hypotheses of Theorem 2 imply that the bet from the risky urn is preferred.

Consider now the same two urns, but the bet is on a specific number drawn from each of them. The new bet from the risky urn corresponds to the simple lottery with probability of success $\frac{1}{n}$, while the new bet over the ambiguous urn corresponds to to compound lottery that induces a positively skewed distribution around $\frac{1}{n}$. Our results permit preferences for the ambiguous bet, especially where $n$ is large.

Lastly, note that if $n = 2$ then the two bets above are identical and correspond to Ellsberg’s famed two-urn paradox. In this case our model indeed predicts ambiguity aversion, that is, preferences for the bet from the risky urn.

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9To see this, let $F$ be the distribution of the decision maker’s beliefs. Note that $F$ is non-decreasing and constant on $[\frac{i}{n}, \frac{i+1}{n})$ for $i \leq n - 1$. Since $\eta_1(F, 0) = \eta_2(F, 0)$ (see Section 4) and $Pr(\frac{n-k}{n}) > 0$ for some $k$ with $n \geq k > 2$, it must be that $1 - Pr(1) - Pr(\frac{n-1}{n}) < Pr(1)$, from which the result readily follows.
Appendix A: Proofs

Proof of Theorem 1: Lemma 1 proves part 1 of the theorem for binary lotteries \( Y \). After a preparatory claim (Lemma 2), the general case of this part is proved in Lemma 3 for lotteries \( Y \) with \( F_Y(\mu) \geq \frac{1}{2} \), and for all lotteries in Lemma 4. That this can be done with bounded shifts is proved in Lemma 5. Part 2 of the theorem is proved in Lemma 6.

Lemma 1 Let \( Y = (x, r; z, 1 - r) \) with mean \( E[Y] = \mu \), \( x < z \), and \( r \leq \frac{1}{2} \). Then there is a sequence of lotteries \( X_i \) with expected value \( \mu \) such that \( X_1 = (\mu, 1) \), \( X_i \rightarrow Y \), and \( X_{i+1} \) is obtained from \( X_i \) by a negative symmetric split. Moreover, if \( r_i \) and \( r'_i \) are the probabilities of \( x \) and \( z \) in \( X_i \), then \( r_i \uparrow r \) and \( r'_i \uparrow 1 - r \).

Proof: The main idea of the proof is to have at each step at most five outcomes: \( x, \mu, z \), and up to two outcomes between \( x \) and \( \mu \). In a typical move either \( \mu \) or one of the outcomes between \( x \) and \( \mu \), denote it \( w \), is split “as far as possible,” which means:

1. If \( w \in (x, \frac{x + \mu}{2}] \), then split its probability between \( x \) and \( w + (w - x) = 2w - x \). Observe that \( x < 2w - x \leq \mu \).
2. If \( w \in [\frac{x + z}{2}, \mu] \), then split its probability between \( z \) and \( w - (z - w) = 2w - z \). Observe that \( x \leq 2w - z < \mu \).
3. If \( w \in (\frac{x + \mu}{2}, \frac{x + z}{2}) \), then split its probability between \( \mu \) and \( w - (\mu - w) = 2w - \mu \). Observe that \( x < 2w - \mu < \mu \).

If \( r = \frac{1}{2} \), that is, if \( \mu = \frac{x + z}{2} \) then the sequence terminates after the first split. We will therefore assume that \( r < \frac{1}{2} \). Observe that this procedures never split the probabilities of \( x \) and \( z \) hence these probabilities form increasing sequences. We identify and analyze three cases: a. For every \( i \) the support of \( X_i \) is \( \{x, y_i, z\} \). b. There is \( k > 1 \) such that the support of \( X_k \) is \( \{x, \mu, z\} \). c. Case b does not happen, but there is \( k > 1 \) such that the support of \( X_k \) is
\{x, w_k, \mu, z\}. We also show that if for all \(i > 1\), \(\mu\) is not in the support of \(X_i\), then case \(a\) prevails.

\(a\). The simplest case is when for every \(i\) the support of \(X_i\) has three outcomes at most, \(x < y_i < z\). By construction, the probability of \(y_i\) is \(\frac{1}{2}\), hence \(X_i\) puts \(1 - \frac{1}{2}\) probability on \(x\) and \(z\). In the limit these converge to a lottery over \(x\) and \(z\) only, and since for every \(i\), \(E[X_i] = \mu\), this limit must be \(Y\). For the former, let \(X = (3, 1)\) and \(Y = (0, \frac{1}{4}; 4, \frac{1}{4} + \frac{1}{2})\) and obtain

\[ X = (3, 1) \rightarrow (2, \frac{1}{2}; 4, \frac{1}{2}) \rightarrow (0, \frac{1}{4}; 4, \frac{1}{4} + \frac{1}{2}) = Y. \]

For a sequence that does not terminate, let \(X = (5, 1)\) and \(Y = (0, \frac{1}{6}; 6, \frac{7}{6})\). Here we obtain

\[ X = (5, 1) \rightarrow (4, \frac{1}{2}; 6, \frac{1}{2}) \rightarrow (2, \frac{1}{4}; 6, \frac{3}{4}) \rightarrow (0, \frac{1}{8}; 4, \frac{1}{8}; 6, \frac{3}{4}) \rightarrow \ldots \]

\[ (0, \frac{1}{2} \sum_1^n \frac{1}{2}; 4, \frac{1}{2} + \sum_1^n \frac{1}{2}) \rightarrow \ldots (0, \frac{1}{6}; 6, \frac{7}{6}) = Y. \]

\(b\). Suppose now that even though at a certain step the obtained lottery has more than three outcomes, it is nevertheless the case that after \(k\) splits we reach a lottery of the form \(X_k = (x, p_k; \mu, q_k; z, 1 - p_k - q_k)\). For example, let \(X = (17, 1)\) and \(Y = (24, \frac{17}{24}; 0, \frac{7}{24})\). The first five splits are

\[ X = (17, 1) \rightarrow (10, \frac{1}{2}; 24, \frac{1}{2}) \rightarrow (3, \frac{1}{4}; 17, \frac{1}{4}; 24, \frac{1}{2}) \rightarrow (0, \frac{1}{8}; 6, \frac{1}{8}; 17, \frac{1}{4}; 24, \frac{1}{2}) \rightarrow (0, \frac{7}{32}; 17, \frac{1}{4}; 24, \frac{17}{32}) \]

By construction \(k \geq 2\) and \(q_k \leq \frac{1}{4}\). Repeating these \(k\) steps \(j\) times will yield the lottery \(X_{jk} = (x, p_{jk}; \mu, q_{jk}; z, 1 - p_{jk} - q_{jk}) \rightarrow Y\) as \(q_{jk} \rightarrow 0\) and as the expected value of all lotteries is \(\mu\), \(p_{jk} \uparrow r\) and \(1 - p_{jk} - q_{jk} \uparrow 1 - r\).

\(c\). If at each stage \(X_i\) puts no probability on \(\mu\) then we are in case \(a\). The reason is that as splits of type 3 do not happen, in each stage the probability of the outcome between \(x\) and \(z\) is split between a new such outcome and either \(x\) or \(z\), and the number of different outcomes is still no more than three.
Suppose therefore that at each stage $X_i$ puts positive probability on at least one outcome $w$ strictly between $x$ and $\mu$ (although these outcomes $w$ may change from one lottery $X_i$ to another) and at some stage $X_i$ puts (again) positive probability on $\mu$. Let $k \geq 2$ be the first split that puts positive probability on $\mu$. We consider two cases.

$c_1$. $k = 2$: In the first step, the probability of $\mu$ is divided between $z$ and $2\mu - z$ and in the second step the probability of $2\mu - z$ is split and half of it is shifted back to $\mu$ (see for example the second split in eq. (3) above). In other words, the first split is of type 2 while the second is of type 3. By the description of the latter,

$$\frac{x + \mu}{2} < 2\mu - z < \frac{x + z}{2} \iff \frac{2}{3} < \frac{\mu - x}{z - x} < \frac{3}{4} \quad (4)$$

The other one quarter of the original probability of $\mu$ is shifted from $2\mu - z$ to

$$2\mu - z - (\mu - [2\mu - z]) = 3\mu - 2z < \frac{x + \mu}{2} \iff 4(z - x) \geq 5(\mu - x)$$

Which is satisfied by eq. (4). Therefore, in the next step a split of type 1 will be used, and one eighth of the original probability of $\mu$ will be shifted away from $2\mu - z$ to $x$. In other words, in three steps $\frac{5}{8}$ of the original probability of $\mu$ is shifted to $x$ and $z$, one quarter of it is back at $\mu$, and one eighth of it is now on an outcome $w_1 < \mu$. ⋄

$c_2$. $k \geq 3$: For example, $X = (29, 1)$ and $Y = (48, \frac{29}{48}, 0, \frac{19}{48})$. Then

$$\begin{align*}
X &= (29, 1) \rightarrow (10, \frac{1}{2}; 48, \frac{1}{2}) \rightarrow (0, \frac{1}{4}; 20, \frac{1}{4}; 48, \frac{1}{2}) \\
&\quad \rightarrow (0, \frac{1}{4}; 11, \frac{1}{8}; 29, \frac{1}{8}; 48, \frac{1}{2}) \rightarrow \ldots
\end{align*} \quad (5)$$

After $k$ splits $\frac{1}{2^k}$ of the original probability of $\mu$ is shifted back to $\mu$ and $\frac{1}{2^k}$ is shifted to another outcome $w_1 < \mu$. The rest of the original probability is split (not necessarily equally) between $x$ and $z$. ⋄

Let $\ell = \max\{k, 3\}$. We now construct inductively a sequence of cycles, where the length of cycle $j$ is $\ell + j - 1$. Such a cycle will end with the
probability distributed over \( x < w_j < \mu < z \). Denote the probability of \( \mu \) by \( p_j \) and that of \( w_j \) by \( q_j \). We show that \( p_j + q_j \rightarrow 0 \). The probabilities of \( x \) and \( z \) are such that the expected value is kept at \( \mu \), and as \( p_j + q_j \rightarrow 0 \), it will follow that the probabilities of \( x \) and \( z \) go up to \( r \) and \( 1 - r \), respectively. In the example of eq. (5), \( \ell = 3 \), the length of the first cycle (where \( j = 1 \)) is 3, and \( w_1 = 11 \).

Suppose that we’ve finished the first \( j \) cycles. Cycle \( j + 1 \) starts with splitting the \( p_j \) probability of \( \mu \) to \( \{x, w_1, \mu, z\} \) as in the first cycle. One of the outcomes along this sequence may be \( w_j \), but we will continue to split only the “new” probability of this outcome (and will not yet touch the probability \( q_j \) of \( w_j \)). At the end of this part of the new cycle, the probability is distributed over \( x, w_1, w_j, \mu, \) and \( z \). At least half of \( p_j \), the earlier probability of \( \mu \), is shifted to \( \{x, z\} \), and the probabilities of both these outcomes did not decrease. Continuing the example of eq. (5), the first part of the second cycle (where \( j = 1 \)) is

\[
(0, \frac{1}{2}; 11, \frac{1}{8}; 29, \frac{1}{5}; 48, \frac{1}{2}) \rightarrow (0, \frac{1}{4}; 10, \frac{1}{16}; 11, \frac{1}{8}; 48, \frac{9}{16}) \rightarrow \\
(0, \frac{9}{32}; 11, \frac{1}{8}; 20, \frac{1}{32}; 48, \frac{9}{16}) \rightarrow (0, \frac{9}{32}; 11, \frac{9}{64}; 29, \frac{1}{64}; 48, \frac{9}{16})
\]

The second part of cycle \( j + 1 \) begins with \( j - 1 \) splits starting with \( w_1 \). At the end of these steps, the probability is spread over \( x, w_j, \mu, \) and \( z \). Split the probability of \( w_j \) between an element of \( \{x, \mu, z\} \) and \( w_{j+1} \) which is not in this set to get \( p_{j+1} \) and \( q_{j+1} \). In the above example, as \( j = 1 \) there is only one split at this stage to

\[
(0, \frac{45}{128}; 22, \frac{9}{128}; 29, \frac{1}{64}; 48, \frac{9}{16})
\]

And \( w_2 = 22 \). The first part of the third cycle (\( j = 2 \)) leads to

\[
(0, \frac{91}{256}; 11, \frac{1}{512}; 22, \frac{9}{128}; 29, \frac{1}{512}; 48, \frac{73}{128})
\]
The second part of this cycle has two splits. Of \( w_1 = 11 \) into 0 and 22, and then of \( w_2 = 22 \) into \( \mu = 29 \) and \( w_3 = 15 \).

\[
\rightarrow (0, \frac{365}{1024}, 22, \frac{73}{1024}, 29, \frac{1}{512}, 48, \frac{73}{128}) \rightarrow (0, \frac{365}{1024}, 15, \frac{73}{2048}, 29, \frac{77}{2048}, 48, \frac{73}{128})
\]

We now show that for every \( j \),

\[
p_{j+2} + q_{j+2} \leq \frac{3}{4}(p_j + q_j)
\]

We first observe that for every \( j \), \( p_{j+1} + q_{j+1} < p_j + q_j \). This is due to the fact that the rest of the probability is spread over \( x \) and \( z \), the probability of \( z \) must increase (because of the initial split in the probability of \( \mu \)), and the probabilities of \( x \) and \( z \) cannot go down.

When moving from \((p_j, q_j)\) to \((p_{j+2}, q_{j+2})\), half of \( p_j \) is switched to \( z \). Later on, half of \( q_j \) is switched either to \( x \) or \( z \), or to \( \mu \), in which case half of it (that is, one quarter of \( q_j \) will be switched to \( z \) on the move from \( p_{j+1} \) to \( p_{j+2} \). This proves inequality (6), hence the lemma.

\[\square\]

**Lemma 2** Let \( X = (x_1, p_1; \ldots; x_n, p_n) \) and \( Y = (y_1, q_1; \ldots; y_m, q_m) \) where \( x_1 \leq \ldots \leq x_n \) and \( y_1 \leq \ldots \leq y_m \) be two lotteries such that \( X \) dominates \( Y \) by second-order stochastic dominance. Then there is a sequence of lotteries \( X_i \) such that \( X_1 = X \), \( X_i \rightarrow Y \), \( X_{i+1} \) is obtained from \( X_i \) by a symmetric (not necessarily always negative or always positive) split of one of the outcomes of \( X_i \), all the outcomes of \( X_i \) are between \( y_1 \) and \( y_m \), and the probabilities the lotteries \( X_i \) put on \( y_1 \) and \( y_m \) go up to \( q_1 \) and \( q_m \), respectively.

**Proof:** From Rothschild and Stiglitz [31, p. 236] we know that we can present \( Y \) as \((y_{11}, q_{11}; \ldots; y_{nn}, q_{nn})\) such that \( \sum_j q_{kj} = p_k \) and \( \sum_j q_{kj}y_{kj}/p_k = x_k \), \( k = 1, \ldots, n \).

Let \( Z = (z_1, r_1; \ldots; z_{\ell}, r_{\ell}) \) such that \( z_1 < \ldots < z_\ell \) and \( E[Z] = z \). Let \( Z_0 = (z, 1) \). One can move from \( Z_0 \) to \( Z \) in at most \( \ell \) steps, where at each step some of the probability of \( z \) is split into two outcomes of \( Z \) without affecting
the expected value of the lottery, in the following way. If
\[
\frac{r_1z_1 + r_\ell z_\ell}{r_1 + r_\ell} \geq z
\] (7)
then move \( r_1 \) probability to \( z_1 \) and \( r'_\ell \) \( \leq r_\ell \) to \( z_\ell \) such that \( r_1'z_1 + r'_\ell z_\ell = z(r_1 + r'_\ell) \). However, if the sign of the inequality in (7) is reversed, then move \( r_\ell \) probability to \( z_\ell \) and \( r'_1 \) \( \leq r_1 \) probability to \( z_1 \) such that \( r_1'z_1 + r_\ell z_\ell = z(r'_1 + r_\ell) \). Either way the move shifted all the required probability from \( z \) to one of the outcomes of \( Z \) without changing the expected value of the lottery.

Consequently, one can move from \( X \) to \( Y \) in \( \ell^2 \) steps, where at each step some probability of an outcomes of \( X \) is split between two outcomes of \( Y \). By Lemma 1, each such split can be obtained as the limit of symmetric splits (recall that we do not require in the current lemma that the symmetric splits will be negative or positive splits). That all the outcomes of the obtained lotteries are between \( y_1 \) and \( y_m \), and that the probabilities these put on \( y_1 \) and \( y_m \) go up to \( q_1 \) and \( q_m \) follow by Lemma 1.

Lemma 3 Let \( Y = (y_1, p_1; \ldots; y_n, p_n) \), \( y_1 \leq \ldots \leq y_n \), with expected value \( \mu \) be negatively skewed such that \( F_Y(\mu) \geq \frac{1}{2} \). Then there is a sequence of lotteries \( X_i \) with expected value \( \mu \) such that \( X_1 = (\mu, 1) \), \( X_i \rightarrow Y \), and \( X_{i+1} \) is obtained from \( X_i \) by a negative symmetric split. Moreover, if \( r_i \) and \( r'_i \) are the probabilities of \( y_1 \) and \( y_n \) in \( X_i \), then \( r_i \uparrow p_1 \) and \( r'_i \uparrow p_n \).

**Proof:** Suppose wlg that \( y_{j^*} = \mu \) (of course, it may be that \( p_{j^*} = 0 \)). Since \( F_Y(y_{j^*}) \geq \frac{1}{2} \), it follows that \( t := \sum_{j=j^*+1}^np_j \leq \frac{1}{2} \). As \( Y \) is negatively skewed, \( y_n - \mu \leq \mu - y_1 \), hence \( 2\mu - y_n \geq y_1 \). Let \( m = n - j^* \) be the number of outcomes of \( Y \) that are strictly above the expected value \( \mu \). Move from \( X_1 \) to \( X_m = (2\mu - y_n, p_n; \ldots; 2\mu - y_{j^*+1}, p_{j^*+1}; y_{j^*}, 1 - 2t; y_{j^*+1}, p_{j^*+1}; \ldots; y_n, p_n) \) by repeatedly splitting probabilities away from \( \mu \). All these splits are symmetric, hence negative symmetric splits.
Next we show that $Y$ is a mean preserving spread of $X_m$. Obviously, $E[X_m] = E[Y] = \mu$. Integrating by parts, we have for $x \geq \mu$

$$y_n - \mu = \int_{y_1}^{y_n} F_Y(z)dz = \int_{y_1}^{x} F_Y(z)dz + \int_{x}^{y_n} F_Y(z)dz$$

$$y_n - \mu = \int_{y_1}^{y_n} F_{X_m}(z)dz = \int_{y_1}^{x} F_{X_m}(z)dz + \int_{x}^{y_n} F_{X_m}(z)dz$$

Since $F_Y$ and $F_{X_m}$ coincide for $z \geq \mu$, we have, for $x \geq \mu$, $\int_{y_1}^{x} F_{X_m}(z)dz = \int_{y_1}^{x} F_Y(z)dz$ and in particular, $\int_{y_1}^{x} F_{X_m}(z)dz \leq \int_{y_1}^{x} F_Y(z)dz$.

For $x < \mu$ it follows by the assumption that $Y$ is negatively skewed and by the construction of $X_m$ as a symmetric lottery around $\mu$ that

$$\int_{y_1}^{x} F_{X_m}(z)dz = \int_{2\mu - x}^{2\mu - y_1} [1 - F_{X_m}(z)]dz = \int_{2\mu - x}^{2\mu - y_1} [1 - F_Y(z)]dz \leq \int_{y_1}^{x} F_Y(z)dz$$

Since to the right of $\mu$, $X_m$ and $Y$ coincide, we can view the left side of $Y$ as a mean preserving spread of the left side of $X_m$. By Lemma 2 the left side of $Y$ is the limit of symmetric mean preserving spreads of the left side of $X_m$. Moreover, all these splits take place between $y_1$ and $\mu$ and are therefore negative symmetric splits. By Lemma 2 it also follows that $r_i \uparrow p_1$ and $r_i' \uparrow p_n$. \hfill \Box

We now show that Lemma 3 holds without the restriction $F_Y(\mu) \geq \frac{1}{2}$.

**Lemma 4** Let $Y$ with expected value $\mu$ be negatively skewed. Then there is a sequence of lotteries $X_i$ with expected value $\mu$ such that $X_1 = (\mu, 1)$, $X_i \rightarrow Y$, and $X_{i+1}$ is obtained from $X_i$ by a negative symmetric split.

**Proof:** The first step in the proof of Lemma 3 was to create a symmetric distribution around $\mu$ such that its upper tail (above $\mu$) agrees with $F_Y$. Obviously this can be done only if $F_Y(\mu) \geq \frac{1}{2}$, which is no longer assumed. Instead, we apply the proof of Lemma 3 successively to mixtures of $F_Y$ and $\delta_\mu$, the distribution that yields $\mu$ with probability one.

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Suppose that $F_Y(\mu) = \lambda < \frac{1}{2}$. Let $\gamma = 1/2(1 - \lambda)$ and define $Z$ to be the lottery obtained from the distribution $\gamma F_Y + (1 - \gamma)\delta_{\mu}$. Observe that

$$F_Z(\mu) = \gamma F_Y(\mu) + (1 - \gamma)\delta_{\mu}(\mu) = \frac{\lambda}{2(1 - \lambda)} + \frac{1 - 2\lambda}{2(1 - \lambda)} = \frac{1}{2}$$

It follows that the lotteries $Z$ and $(\mu, 1)$ satisfy the conditions of Lemma 3, and therefore there is a sequence of lotteries $X_i$ with expected value $\mu$ such that $X_1 = (\mu, 1)$, $X_i \to Z$, and $X_{i+1}$ is obtained from $X_i$ by a negative symmetric split. This is done in two stages. First we create a symmetric distribution around $\mu$ that agrees with $Z$ above $\mu$ (denote the number of splits needed in this stage by $t$), and then we manipulate the part of the distribution which is weakly to the left of $\mu$ by taking successive symmetric splits (which are all negative symmetric splits when related to $\mu$) to get nearer and nearer to the second-order stochastically dominated left side of $Z$ as in Lemma 2. Observe that the highest outcome of this part of the distribution $Z$ is $\mu$, and its probability is $1 - \gamma$. By Lemma 2, for every $k \geq 1$ there is $\ell_k$ such that after $\ell_k$ splits of this second phase the probability of $\mu$ will be at least $r_k = (1 - \gamma)(1 - \frac{1}{k+1})$ and $\|X_{t+\ell_k} - Z\| < \frac{1}{k}$.

The first cycle will end after $t + \ell_1$ splits with the distribution $F_{Z_1}$. Observe that the probabilities of the outcomes to the right of $\mu$ in $Z_1$ are those of the lottery $Y$ multiplied by $\gamma$. The first part of second cycle will be the same as the first cycle, applied to the $r_k$ conditional probability of $\mu$. At the end of this part we’ll get the lottery $Z'_1$ which is the same as $Z_1$, conditional on the probability of $\mu$. We now continue the second cycle by splitting the combination of $Z_1$ and $Z'_1$ for the total of $t + \ell_1 + \ell_2$ steps. As we continue to add such cycles inductively we get closer and closer to $Y$, hence the lemma. □

Next we show that part 1 of the theorem can be achieved by using bounded spreads. The first steps in the proof of Lemma 3 involve shifting probabilities from $\mu$ to all the outcomes of $Y$ to the right of $\mu$, and these outcomes are not more than $\max y_i - \mu$ away from $\mu$. All other shifts are symmetric shifts involving only outcomes to the left of $\mu$. The next lemma shows that such shifts can be achieved as the limit of symmetric bounded shifts.
Lemma 5 Let $Z = (z - \alpha, \frac{1}{2}; z + \alpha, \frac{1}{2})$ and let $\varepsilon > 0$. Then there is a sequence of lotteries $Z_i$ such that $Z_0 = (z, 1)$, $Z_i \to Z$, and $Z_{i+1}$ is obtained from $Z_i$ by a symmetric (not necessarily negative or positive) split of size smaller than $\varepsilon$.

Proof: The claim is interesting only when $\varepsilon < \alpha$. Fix $n$ such that $\varepsilon > \frac{\alpha}{n}$. We show that the lemma can be proved by choosing the size of the splits to be $\frac{\alpha}{n}$. Consider the $2n + 1$ points $z_k = z + \frac{k}{n}$, $k = -n, \ldots, n$ and construct the sequence $\{Z_i\}$ where $Z_i = (z - \alpha, p_i, -\alpha; z - \frac{n-1}{n}\alpha, p_i, -\alpha + \frac{1}{n} \alpha, \ldots; z + \alpha, p_i, n)$ as follows.

The index $i$ is odd: Let $z_j$ be the highest outcome in $\{z, \ldots, z + \frac{n-1}{n}\alpha\}$ with the highest probability in $Z_{i-1}$. Formally, $j$ satisfies:

- $0 \leq j \leq n - 1$
- $p_{i-1,j} \geq p_{i-1,k}$ for all $k$
- If for some $j' \in \{0, \ldots, n-1\}$, $p_{i-1,j'} \geq p_{i-1,k}$ for all $k$, then $j \geq j'$.

Split the probability of $z_j$ between $z_j - \frac{\alpha}{n}$ and $z_j + \frac{\alpha}{n}$ (i.e., between $z_{j-1}$ and $z_{j+1}$). That is, $p_{i,j-1} = p_{i-1,j-1} + \frac{1}{2}p_{i-1,j}$, $p_{i,j+1} = p_{i-1,j+1} + \frac{1}{2}p_{i-1,j}$, $p_{i,j} = 0$, and for all $k \neq j - 1, j, j + 1$, $p_{i,k} = p_{i-1,k}$.

The index $i$ is even: In this step we create the mirror split of the one done in the previous step. Formally, If $j$ of the previous stage is zero, do nothing. Otherwise, split the probability of $z_{-j}$ between $z_{-j} - \frac{\alpha}{n}$ and $z_{-j} + \frac{\alpha}{n}$. That is, $p_{i,-j-1} = p_{i-1,-j-1} + \frac{1}{2}p_{i-1,-j}$, $p_{i,-j+1} = p_{i-1,-j+1} + \frac{1}{2}p_{i-1,-j}$, $p_{i,-j} = 0$, and for all $k \neq -j - 1, -j, -j + 1$, $p_{i,k} = p_{i-1,k}$.

After each pair of these steps, the probability distribution is symmetric around $z$. Also, the sequences $\{p_{i,-\alpha}\}$ and $\{p_{i,\alpha}\}$ are non decreasing. Being bounded by $\frac{1}{2}$, they converge to a limit $L$. Our aim is to show that $L = \frac{1}{2}$. Suppose not. Then at each step the highest probability of $\{p_{i-1,-\alpha+\frac{1}{n}}, \ldots, p_{i-1,\alpha-\frac{1}{n}}\}$ must be at least $\ell := (1 - 2L)/(2n - 1) > 0$. The variance of $Z_i$ is bounded from above by the variance of $(\mu - \alpha, \frac{1}{2}; \mu + \alpha, \frac{1}{2})$, which is $\alpha^2$. Splitting $p$ probability from $z$ to $z - \frac{\alpha}{n}$ and $z + \frac{\alpha}{n}$ will increase the variance by $p^2(\alpha^2)$. Likewise, for $k \neq -n, 0, n$, splitting $p$ probability from $z + \frac{k\alpha}{n}$ to $z + \frac{(k+1)\alpha}{n}$ and
will increase the variance by $\frac{p}{2} \left( \frac{\alpha}{n} \right)^2$. Therefore, for positive even $i$ we have

$$\sigma^2(Z_i) - \sigma^2(Z_{i-2}) \geq \frac{1 - 2L}{2n - 1} \left( \frac{\alpha}{n} \right)^2$$

If $L < \frac{1}{2}$, then after enough steps the variance of $Z_i$ will exceed $\alpha^2$, a contradiction. \qed

That we can prove the theorem for all lotteries $Y$ follows by the fact that a countable set of countable sequences is countable. To finish the proof of the theorem, we need the following result:

**Lemma 6** Consider the sequence $\{X_i\}$ of lotteries where $X_1 = (\mu, 1)$ and $X_{i+1}$ is obtained from $X_i$ by a negative symmetric split. Then the distributions $F_i$ of $X_i$ converge (in the $L^1$ topology) to a negatively skewed distribution with expected value $\mu$.

**Proof:** That such sequences converge follows from the fact that a symmetric split will increase the variance of the distribution, but as all distributions are over the bounded $[\underline{x}, \bar{x}]$ segment of $\mathbb{R}$, the variances of the distributions increase to a limit. Replacing $(x, p)$ with $(x - \alpha, \frac{p}{2}; x + \alpha, \frac{p}{2})$ increases the variance of the distribution by

$$\frac{p}{2} (x - \alpha - \mu)^2 + \frac{p}{2} (x + \alpha - \mu)^2 - p(x - \mu)^2 = p\alpha^2$$

and therefore the distance between two successive distributions in the sequences in bounded by $\bar{x} - \underline{x}$ times the change in the variance. The sum of the changes in the variances is bounded, as is therefore the sum of distances between successive distributions, hence Cauchy criterion is satisfied and the sequence converges.

Next we prove that the limit is a negatively skewed distribution with expected value $\mu$. Let $F$ be the distribution of $X = (x_1, p_1; \ldots; x_n, p_n)$ with expected value $\mu$ be negatively skewed. Suppose w.l.o.g. that $x_1 \leq \mu$, and break it symmetrically to obtain $X' = (x_1 - \alpha, \frac{p_1}{2}; x_1 + \alpha, \frac{p_1}{2}; x_2, p_2; \ldots; x_n, p_n)$ with the distribution $F'$. Note that $E[X'] = \mu$. Consider the following two cases.
Case 1: $x_1 + \alpha \leq \mu$. Then for all $\tau$, $\eta_2(F', \tau) = \eta_2(F', \tau)$. For $\tau$ such that $\mu - \tau < x_1 - \alpha$ or such that $x_1 + \alpha \leq \mu - \tau$, $\eta_1(F', \tau) = \eta_1(F, \tau) - \eta_2(F', \tau)$. For $\tau$ such that $x_1 - \alpha < \mu - \tau < x_1$, $\eta_1(F', \tau) = \eta_1(F, \tau) + [(\mu - \tau) - (x_1 - \alpha)] \frac{p_1}{2} > 
eta_1(F, \tau) \geq \eta_2(F, \tau) = \eta_2(F', \tau)$. Finally, for $\tau$ such that $x_1 < \mu - \tau < x_1 + \alpha (\leq \mu)$, $\eta_1(F', \tau) = \eta_1(F, \tau) + [(x_1 + \alpha) - (\mu - \tau)] \frac{p_1}{2} > \eta_1(F, \tau) \geq \eta_2(F, \tau) = \eta_2(F', \tau)$.

Case 2: $x_1 + \alpha > \mu$. Then for all $\tau$ such that $\mu + \tau \geq x_1 + \alpha$, $\eta_2(F, \tau) = \eta_2(F', \tau)$. For $\tau$ such that $\mu - \tau \leq x_1 - \alpha$, $\eta_1(F', \tau) = \eta_1(F, \tau) - \eta_2(F, \tau) = \eta_2(F', \tau)$. For $\tau$ such that $x_1 - \alpha < \mu - \tau < x_1$, $\eta_1(F', \tau) = \eta_1(F, \tau) + [(\mu - \tau) - (x_1 - \alpha)] \frac{p_1}{2} \geq \eta_2(F, \tau) + [(\mu - \tau) - (x_1 - \alpha)] \frac{p_1}{2} \geq \eta_2(F, \tau) + \max\{0, (x_1 + \alpha) - (\mu + \tau)\} \frac{p_1}{2} = \eta_2(F', \tau)$. Finally, for $\tau$ such that $\mu - \tau > x_1$, $\eta_1(F', \tau) = \eta_1(F, \tau) + [(x_1 + \alpha) - (\mu - \tau)] \frac{p_1}{2} \geq \eta_2(F, \tau) + \max\{0, (x_1 + \alpha) - (\mu + \tau)\} \frac{p_1}{2} = \eta_2(F', \tau)$.

If $X_n \rightarrow Y$, all have the same expected value and for all $n$, $X_n$ is negatively skewed, then so is $Y$.

Remark 1 The two parts of Theorem 1 do not create a simple if and only if statement, because the support of the limit distribution $F$ in part 2 need not be finite. On the other hand, part 1 of the theorem does not hold for continuous distributions. By the definition of negative symmetric splits, if the probability of $x > \mu$ in $X_i$ is $p$, then for all $j > i$, the probability of $x$ in $X_j$ must be at least $p$. It thus follows that the distribution $F$ cannot be continuous above $\mu$. However, it can be shown that if $F$ with expected value $\mu$ is negatively skewed, then there is a sequence of finite negatively skewed distributions $F_n$, each with expected value $\mu$, such that $F_n \rightarrow F$. This enables us to use Theorem 1 even for continuous distributions.

Proof of Theorem 2: The two-stage lottery $\langle r - \alpha, \varepsilon; r, 1 - 2\varepsilon; r + \alpha, \varepsilon \rangle$ translates in the recursive model into the lottery $(c(r - \alpha), \varepsilon; c(r), 1 - 2\varepsilon; c(r + \alpha), \varepsilon)$. Since the decision maker always rejects symmetric noise, it follows that the local utility $u_{s_{s_{s_{s}}}}$ satisfies

$$u_{s_{s_{s_{s}}}}(c(r)) \geq \frac{1}{2} u_{s_{s_{s_{s}}}}(c(r - \alpha)) + \frac{1}{2} u_{s_{s_{s_{s}}}}(c(r + \alpha)).$$
By Weak Hypothesis II, for every \( p \geq r \),

\[
\begin{align*}
\delta_{c(p)}(c(r)) & \geq \frac{1}{2} \delta_{c(p)}(c(r - \alpha)) + \frac{1}{2} \delta_{c(p)}(c(r + \alpha)).
\end{align*}
\]

(8)

Consider first the lottery over the probabilities given by \( Q = \langle p_1, q_1; \ldots; p_m, q_m \rangle \) where \( \sum q_i p_i = p \) (we deal with the distributions with non-finite support at the end of the proof). If \( Q \) is negatively skewed, then it follows by Theorem 1 that there is a sequence of lotteries \( \tilde{Q}_i = \langle p_i, 1; q_i, \ldots; p_i, n_i, q_i, 1 \rangle \rightarrow Q \) such that \( \tilde{Q}_1 = \langle p, 1 \rangle \) and for all \( i \), \( \tilde{Q}_{i+1} \) is obtained from \( \tilde{Q}_i \) by a negative symmetric split. For each \( i \), let \( \tilde{Q}_i = (c(p_{i,1}), q_{i,1}; \ldots; c(p_{i,n_i}), q_{i,n_i}) \). Suppose \( p_{i,j} \) is split into \( p_{i,j} - \alpha \) and \( p_{i,j} + \alpha \). By eq. (8), as \( p > p_{i,j} \),

\[
E[u_{\delta_{c(p)}}(\tilde{Q}_i)] = q_{i,j} u_{\delta_{c(p)}}(c(p_{i,j})) + \sum_{m \neq j} q_{i,m} u_{\delta_{c(p)}}(c(p_{i,m})) 
= \frac{1}{2} q_{i,j} u_{\delta_{c(p)}}(c(p_{i,j} - \alpha)) + \frac{1}{2} q_{i,j} u_{\delta_{c(p)}}(c(p_{i,j} + \alpha)) + \sum_{m \neq j} q_{i,m} u_{\delta_{c(p)}}(c(p_{i,m})) = E[u_{\delta_{c(p)}}(\tilde{Q}_{i+1})].
\]

As \( \tilde{Q}_i \rightarrow Q \), and as for all \( i \), \( u_{\delta_{c(p)}}(c(p)) \geq E[u_{\delta_{p}}(\tilde{Q}_i)] \), it follows by continuity that \( u_{\delta_{c(p)}}(c(p)) \geq E[u_{\delta_{c(p)}}(\tilde{Q})] \). By Fréchet Differentiability

\[
\frac{\partial}{\partial \varepsilon} V \left( \varepsilon \tilde{Q} + (1 - \varepsilon)\delta_{c(p)} \right) \Bigg|_{\varepsilon = 0} \leq 0.
\]

Quasi-concavity now implies that \( V(\delta_{c(p)}) \geq V(\tilde{Q}) \), or \( \langle p, 1 \rangle \succeq Q \). Finally, as preferences are continuous, it follows by that the theorem holds for all \( Q \), even if its support is not finite (see Remark 1 at the end of the proof of Theorem 1).

\[\blacksquare\]

**Proof of Theorem 3:** Consider the two-stage lottery \( L(\varepsilon) = \langle p(\varepsilon), 1 - \varepsilon \varepsilon; q, \varepsilon \rangle \) such that \( (1 - \varepsilon)p(\varepsilon) + \varepsilon q = K \) and \( q > p := p(0) = K \). That is, \( p(\varepsilon) = (K - \varepsilon q)/(1 - \varepsilon) \). As before, \( c(r) \) is the certainty equivalent of \( (1, r; 0, 1 - r) \), and let \( v(\varepsilon) := V(c(p(\varepsilon)), 1 - \varepsilon; c(q), \varepsilon) \) be the value of \( L(\varepsilon) \). Let \( F(\varepsilon) \) be the
distribution of \((c(p(\varepsilon)), 1 - \varepsilon; c(q), \varepsilon)\), let \(F^* = F(0) = \delta_{c(p)}\), and let \(u_{F^*}\) be the local utility of \(V\) at \(F^*\). Observe that

\[
\| F(\varepsilon) - F^* \| = \\
(1 - \varepsilon)[c(p) - c(p(\varepsilon))] + \varepsilon[c(q) - c(p)] = \\
-(1 - \varepsilon)[c'(p)p'(0)\varepsilon + o(\varepsilon)] + \varepsilon[c(q) - c(p)] = \\
[c(q) - c(p) - c'(p)p'(0)]\varepsilon + [c'(p)p'(0)]\varepsilon^2 - (1 - \varepsilon)o(\varepsilon)
\]

We get:

\[
\frac{v(\varepsilon) - v(0)}{\varepsilon} = \\
\frac{V(c(p(\varepsilon)), 1 - \varepsilon; c(q), \varepsilon) - V(c(p), 1)}{\varepsilon} = \\
\frac{(1 - \varepsilon)U_{F^*}(c(p(\varepsilon))) + \varepsilon U_{F^*}(c(q)) - U_{F^*}(c(p))}{\varepsilon} + o(\| F(\varepsilon) - F^* \|) = \\
\frac{U_{F^*}(c(p(\varepsilon))) - U_{F^*}(c(p))}{\varepsilon} + U_{F^*}(c(q)) - U_{F^*}(c(p(\varepsilon))) + \\
o(\| F(\varepsilon) - F^* \|) \xrightarrow{\varepsilon \rightarrow 0} \\
U'_{F^*}(c(p))c'(p)p'(0) + U_{F^*}(c(q)) - U_{F^*}(c(p)) = \\
U'_{F^*}(c(p))c'(p)(p - q) + U_{F^*}(c(q)) - U_{F^*}(c(p)) > 0 \iff \\
\frac{U_{F^*}(c(q)) - U_{F^*}(c(p))}{q - p} > U'_{F^*}(c(p))c'(p)
\]

It follows by the last equivalence that if inequality (2) is never satisfied, then all the binary positively skewed noises of the theorem will be rejected. ■

**Proposition 1** If \(X\) with distribution \(F\) and expected value \(\mu\) is negatively skewed as in Definition 4, then for all odd \(n\), \(\int_x^\infty (y - \mu)^n dF(y) \leq 0\).

**Proof of Proposition 1:** Let the lottery \(Y\) be obtained from the lottery \(Z\) by a negative symmetric split and denote by \(x\) their common mean. Denote
the distributions of $Y$ and $Z$ by $F$ and $G$. Since for $t < 0$ and odd $n$, $t^n$ is a concave function, it follows that if $z_i + \alpha \leq x$, then
\[
\int_{\mathbb{R}} (t-x)^n dF(t) - \int_{\mathbb{R}} (t-x)^n dG(t) =
\]
\[
\frac{p_i}{2} [(z_i - \alpha - x)^n + (z_i + \alpha - x)^n] - p_i (z_i - x)^n \leq 0
\]  
(9)

If $z_i + \alpha > x$, then let $\xi = z_i - x$ and obtain
\[
\frac{p_i}{2} [(z_i - \alpha - x)^n + (z_i + \alpha - x)^n] - p_i (z_i - x)^n =
\]
\[
\frac{p_i}{2} \xi^n + \frac{p_i}{2} \sum_{j=1}^{n-1} \binom{n}{2j-1} \xi^{2j-1} \alpha^{n-2j+1} - \frac{p_i}{2} \sum_{j=0}^{n-1} \binom{n}{2j} \xi^{2j} \alpha^{n-2j} +
\]
\[
\frac{p_i}{2} \xi^n + \frac{p_i}{2} \sum_{j=1}^{n-1} \binom{n}{2j-1} \xi^{2j-1} \alpha^{n-2j+1} + \frac{p_i}{2} \sum_{j=0}^{n-1} \binom{n}{2j} \xi^{2j} \alpha^{n-2j} - p_i \xi^n =
\]
\[
\frac{p_i}{2} \xi^n + \frac{p_i}{2} \sum_{j=1}^{n-1} \binom{n}{2j-1} \xi^{2j-1} \alpha^{n-2j+1} \leq 0
\]

Since $X$ with expected value $\mu$ is negatively skewed it follows by Theorem 1 that it can be obtain as the limit of a sequence of negative symmetric splits. At $\delta_\mu$ (the distribution of $(\mu, 1)$), $\int_{\mathbb{R}} (y-\mu)^n d\delta_\mu = 0$. The claim follows by the fact that each negative symmetric split reduces the value of the integral. ■

References


