14.12 Game Theory

Lecture 2: Decision Theory

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Road Map

1. Basic Concepts (Alternatives, preferences,…)
2. Ordinal representation of preferences
3. Cardinal representation – Expected utility theory
4. Applications: Risk sharing and Insurance
5. **Quiz**

Basic Concepts: Alternatives

- Agent chooses between the alternatives
- *X* = The set of all alternatives
- Alternatives are
  - Mutually exclusive, and
  - Exhaustive

Example

- Options = {Tea, Coffee}
- *X* = {
- T= Tea,
- C = Coffee,
- TC = Tea and Coffee,
- NT = Neither Tea nor Coffee}

Basic Concepts: Preferences

- A relation $\succcurlyeq$ (on X) is any subset of X×X.
- e.g.,

$\succcurlyeq^*$={(T,C),(T,CT),(T,NT),(C,CT),(C,NT),(NT,CT)}

- T $\succcurlyeq$ C ≡ (T,C) $\in \succcurlyeq$.
- $\succcurlyeq$ is complete iff $\forall$ x,y$\in$X,

  x$\succcurlyeq$y or y$\succcurlyeq$x.
- $\succcurlyeq$ is transitive iff $\forall$ x,y,z$\in$X,

  [x$\succcurlyeq$y and y$\succcurlyeq$z] $\Rightarrow$ x$\succcurlyeq$z.

Preference Relation

Definition: A relation is a preference relation iff it is complete and transitive.

Examples

Define a relation among the students in this class by

- x T y iff x is at least as tall as y;
- x M y iff x's final grade in 14.04 is at least as high as y's final grade;
- x H y iff x and y went to the same high school;
- x Y y iff x is strictly younger than y;
- x S y iff x is as old as y;

More relations

- Strict preference:

  $$x \succ y \Leftrightarrow [\, x \succcurlyeq y \text{ and } y \not\succcurlyeq x \,],$$

- Indifference:

  $$x \sim y \Leftrightarrow [\, x \succcurlyeq y \text{ and } y \succcurlyeq x \,].$$

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Ordinal representation

Definition: $\succcurlyeq$ represented by $u : X \to R$ iff

$$x \succcurlyeq y \Leftrightarrow u(x) \geq u(y) \quad \forall x,y \in X. \quad \text{(OR)}$$

Example

$\succcurlyeq^{**}$ =
{(T,C),(T,CT),(T,NT),(C,CT),(C,NT),(NT, CT),(C,C),(T,T),(CT,CT),(NT,NT)}

is represented by u^{**} where

$u^{**}(C) = 4$

$u^{**}(T) = 1500$

$u^{**}(CT) = 0$

$u^{**}(NT) = \pi$

Exercises

- Imagine a group of students sitting around a round table. Define a relation R, by writing x R y iff x sits to the right of y. Can you represent R by a utility function?
- Consider a relation $\succcurlyeq$ among positive real numbers represented by u with $u(x) = x^2$.

Can this relation be represented by $u^*(x) = x^{1/2}$?

What about $u^{**}(x) = 1/x$?

Theorem – Ordinal Representation

Let X be finite (or countable). A relation $\succcurlyeq$ can be represented by a utility function U in the sense of (OR) iff $\succcurlyeq$ is a preference relation.

If $U: X \rightarrow R$ represents $\succcurlyeq$, and if $f: R \rightarrow R$ is strictly increasing, then $f \circ U$ also represents $\succcurlyeq$.

Definition: $\succcurlyeq$ represented by $u : X \rightarrow R$ iff
$x \succcurlyeq y \Leftrightarrow u(x) \geq u(y) \quad \forall x,y \in X.$ (OR)

A Lottery

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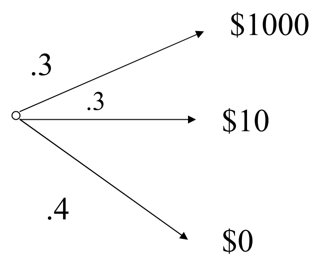
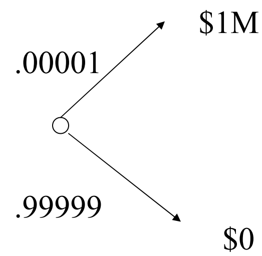
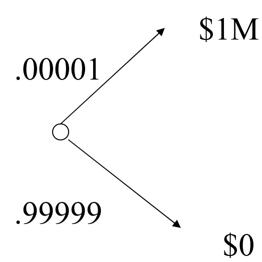
Two Lotteries





Cardinal representation – definitions

- Z = a finite set of consequences or prizes.
- A lottery is a probability distribution on Z.
- P = the set of all lotteries.
- A lottery:



Cardinal representation

- Von Neumann-Morgenstern representation:

A lottery (in P)

Expected value of u under p

$$p \succeq q \Leftrightarrow \underbrace{\sum_{z \in Z} u(z)p(z)}_{U(p)} \geq \underbrace{\sum_{z \in Z} u(z)q(z)}_{U(q)}$$

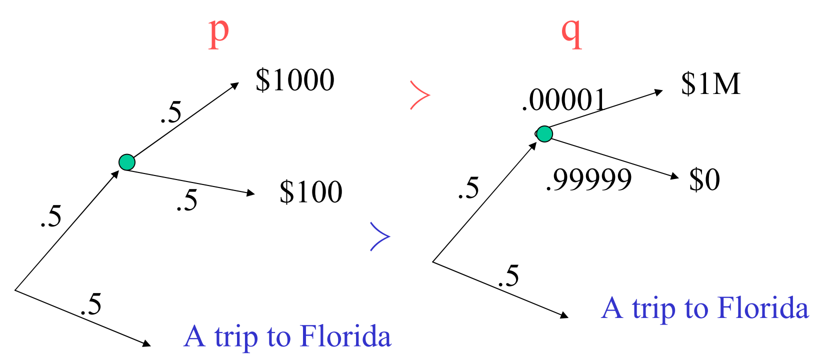
VNM Axioms

Axiom A1: $\succcurlyeq$ is complete and transitive.

VNM Axioms

Axiom A2 (*Independence*): For any p,q,r∈P, and any $a \in (0,1]$,

$$ap + (1-a)r \succ aq + (1-a)r \Leftrightarrow p \succ q.$$



VNM Axioms

Axiom A3 (*Continuity*): For any p,q,r∈P, if $p \succ q \succ r$, then there exist $a,b \in (0,1)$ such that

$$ap + (1-a)r \succ q \succ bp + (1-b) r.$$

Theorem – VNM-representation

A relation $\succcurlyeq$ on P can be represented by a VNM utility function $u : Z \to R$ iff $\succcurlyeq$ satisfies Axioms A1-A3.

u and v represent $\succcurlyeq$ iff $v = a u + b$ for some $a > 0$ and $b \in R$.

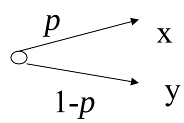
Exercise

- Consider a relation $\succcurlyeq$ among positive real numbers represented by VNM utility function u with $u(x) = x^2$.

  Can this relation be represented by VNM utility function $u^*(x) = x^{1/2}$?

  What about $u^{**}(x) = 1/x$?

Attitudes towards Risk

- A fair gamble: 

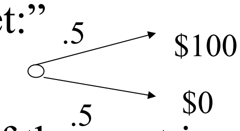
$px+(1-p)y = 0.$

- An agent is *risk neutral* iff
  he is indifferent towards all fair gambles.
- He is *(strictly) risk averse* iff
  he never wants to take any fair gamble.
- He is (strictly) *risk seeking* iff
  he always wants to take fair gambles.

- An agent is risk-neutral iff his utility function is linear, i.e., $u(x) = ax + b$.
- An agent is risk-averse iff his utility function is concave.
- An agent is risk-seeking iff his utility function is convex.

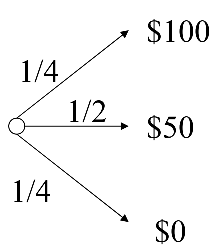
Risk Sharing

- Two agents, each having a utility function *u* with $u(x) = \sqrt{x}$ and an "asset:"



- For each agent, the value of the asset is 5.
- Assume that the value of assets are independently distributed.

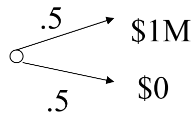
- If they form a mutual fund so that each agent owns half of each asset, each gets



•The Value of the mutual fund for an agent is $(1/4)(100)^{1/2} + (1/2)(50)^{1/2} + (1/4)(0)^{1/2}$
$\approx 10/4 + 7/2 = 6$

Insurance

- We have an agent with $u(x) = x^{1/2}$ and



- And a risk-neutral insurance company with lots of money, selling full insurance for "premium" P.

Insurance –continued

- The agent is willing to pay premium P_A where

$$(1M-P_A)^{1/2} \geq (1/2)(1M)^{1/2} + (1/2)(0)^{1/2}$$
$$= 500$$

i.e.,

$$P_A \leq \$1M - \$250K = \$750K.$$

- The company is willing to accept premium

$$P_I \geq (1/2)(1M) = \$500K.$$

Quiz Problem

- Without discussing with anyone, each student is to write down a real number x_i between 0 and 100 on a paper and submit it to a TA.
- The TAs will then compute the average

$$\bar{x} = \frac{x_1 + x_2 + \cdots + x_n}{n}.$$

- The grade is $100 - |x_i - 2\bar{x}/3|$ where x_i is the number student bids.