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# Preferences over all random variables: Incompatibility of convexity and continuity\*

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## Abstract

We consider preferences over all random variables on a given nonatomic probability space. We show that non-trivial and complete preferences cannot simultaneously satisfy the two fundamental principles of convexity and continuity. As an implication of this incompatibility result there cannot exist any non-trivial continuous utility representations over all random variables that are either quasi-concave or quasi-convex. This rules out standard risk-averse (or seeking) utility representations for this large space of random variables.

*Keywords:* Large Spaces; Preference for Diversification; Utility Representations

*JEL Classification Numbers:* D81

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# 1 Introduction

Let us fix an arbitrary nonatomic probability space  $(\Omega, \Sigma, \mu)$ . The set of all random variables defined over this space, denoted  $L^0(\mu)$ , consists of all  $\Sigma$ -measurable functions  $X : \Omega \rightarrow \mathbb{R}$ . Most of the literature on preferences over random variables restricts attention to rather small subsets of random variables such as, e.g., random variables with finite support. Whenever larger classes of random variables are considered they typically belong to a technically convenient space  $L^p(\mu) \subset L^0(\mu)$ , with  $1 \leq p \leq \infty$ , such that  $X \in L^p(\mu)$  with  $p < \infty$  if, and only if, the integral

$$\int_{\Omega} |X|^p d\mu \quad (1)$$

exists. For example,  $L^1(\mu)$  collects all random variables with finite expected value;  $L^2(\mu)$  collects all random variables with finite variance; and  $L^\infty(\mu)$  denotes the set of all bounded random variables.

This paper takes the most general stand possible by considering preferences over ALL random variables.<sup>1</sup> As our topology of choice we endow  $L^0(\mu)$  with the metric topology of convergence in probability so that  $\mu$  becomes the reference measure which determines  $\mu$ -almost everywhere identity of random variables as well as our notions of continuous preferences and utility representations. To consider preferences over all random variables comes with a rather surprising insight: For non-trivial preferences that are complete on the large space  $L^0(\mu)$  (or on some  $L^p(\mu)$  space with  $0 < p < 1$ ) we obtain the incompatibility result that continuity and convexity cannot be simultaneously satisfied (Theorem 1). If we want to model non-trivial preferences over the random variables in  $L^0(\mu)$ , we must thus give up at least one of the three fundamental principles of continuity, convexity, or completeness, respectively. Under the additional assumption of transitivity, Theorem 2 establishes that continuity is neither compatible with quasi-concave nor with quasi-convex preferences. It is also not compatible with preference for diversification (Theorem 3).

Existing decision theoretic models defined for ‘small’ subsets of  $L^0(\mu)$  (e.g., for  $L^p(\mu)$  spaces with  $1 \leq p \leq \infty$ ) are subsumed under our analysis as special cases for which (complete) preferences exist on these respective subsets only. Our analysis demonstrates that standard decision theoretic modeling choices are limited to ‘small’ spaces as they become incompatible on large spaces. For example, continuous utility representations for  $L^p(\mu)$  spaces with  $1 \leq p \leq \infty$  cannot be extended to continuous utility representations for the large space  $L^0(\mu)$  for typical specifications of globally risk-averse decision

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<sup>1</sup>Our analytical findings can be analogously derived for the ‘smaller’  $L^p(\mu)$  spaces with  $0 < p < 1$  (cf. Remark 3).

makers. In particular, our findings imply the following limitations for standard utility representations of either global risk-aversion or global risk-seeking:

- Any non-trivial expected utility representation

$$\int_{\Omega} u(X) d\mu' \text{ for all } X \in L^0(\mu) \quad (2)$$

that is continuous on  $L^0(\mu)$  is neither compatible with a concave nor with a convex utility function  $u$  combined with an additive probability measure  $\mu'$  on  $(\Omega, \Sigma)$ .

- More generally, any non-trivial Choquet expected utility representation

$$\int_{\Omega}^C u(X) d\nu \text{ for all } X \in L^0(\mu) \quad (3)$$

that is continuous on  $L^0(\mu)$  is neither compatible with (i) a concave utility function  $u$  combined with any convex non-additive probability measure  $\nu$  on  $(\Omega, \Sigma)$  nor with (ii) a convex utility function  $u$  combined with any concave non-additive probability measure  $\nu$  on  $(\Omega, \Sigma)$ .<sup>2</sup>

One possible way of dealing with these incompatibility results is to give up on continuous utility representations altogether and consider complete preferences over all random variables that are convex but not continuous (cf. Examples 6 and 7 in Section 5). From an applicational point of view, however, the lack of a continuous utility representation is not very attractive because preference maximization problems become harder to analyze.

In case one wants to keep continuous utility representations, there are two alternative approaches for getting around the incompatibility between convexity and continuity. The first approach is to give up complete preferences on  $L^0(\mu)$  by assuming that not all  $X, Y \in L^0(\mu)$  can be compared by the reference relation. For example, one might consider a preference relation corresponding to a partial rather than a total order on all random variables in  $L^0(\mu)$  (cf. Example 2 in Section 5). Alternatively, one might restrict complete preferences to suitable subsets of random variables such that only the random variables within a given subset are comparable with one-another. A straightforward example for this approach would be to restrict preferences to the subset  $L^1(\mu) \subset L^0(\mu)$  only whereby these preferences are represented by the random variables' expected values (also see Example 3 in Section 5). These preferences are linear (i.e., weakly convex) and continuous as well as complete on  $L^1(\mu)$  because, by definition, every random variable in  $L^1(\mu)$  comes with an expected value. For an example of convex and continuous preferences that are complete for the non-negative random variables in  $L^1(\mu)$ , let us quote from Nielsen (1984, p.202):

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<sup>2</sup>For the formal definition of Choquet integration with respect to the non-additive probability measure  $\nu$  see Section 4.

“The conclusion of an exchange between Ryan (1974) and Arrow (1974) was that if  $u$  is a concave and increasing function on the non-negative real line, and if  $Z$  is a random variable on the non-negative real line with finite expected value, then the expected value of  $u(Z)$  is finite.”<sup>3</sup>

The second approach is to give up on convex preferences by restricting attention to utility functions  $u$  that are bounded and therefore neither concave nor convex (cf. Examples 4 and 5 in Section 5). Wakker (1993) already reflects on these two alternative approaches while exploring the role of bounded utility in Savage’s (1954) subjective expected utility theory:

“Ever since, the extension of Savage’s theorem to unbounded utility has been an open question, and with that the question "what is wrong with Savage’s axioms?". [...] I think that "what is wrong with Savage’s axioms", is primarily his requirement of completeness of the preference relation on the set of all (alternatives=) acts [...].” (p.448)

According to our incompatibility results this friction between complete preferences over the set of all real-valued Savage acts (i.e., random variables), on the one hand, and unbounded utility functions, on the other hand, is not specific to expected utility. Rather it applies to all continuous utility representations over random variables such as Choquet expected utility or max-min expected utility with multiple priors. More generally, the main insight from our analysis is that the conflict between the three principles of (i) continuity, (ii) convexity, and (iii) completeness is a fundamental one that affects any model of preferences over sufficiently large spaces of random variables.<sup>4</sup>

## Should an economist care?

Our analysis should be of interest to decision-theorists because it identifies limitations for modeling choices of preferences over large spaces of random variables that are in their generality, to the best of our knowledge, new to the literature. But are there any reasons why an economic modeler should care about our incompatibility results? At this point, we can only provide two brief answers.

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<sup>3</sup>The situation is more complicated for Choquet expected utility representations of preferences over the non-negative random variables in  $L^1(\mu)$ : even if  $u$  is concave such representation may fail to exist for non-convex capacities. For details see Rieger and Wang (2006).

<sup>4</sup>Another example for this conflict are *risk measures* from the mathematical finance literature. By our incompatibility result, there cannot exist risk measures defined over all random variables that are simultaneously convex and continuous (cf. Example 5 in Section 5).

First, the modeler does not need to care as long as he/she (i) either restricts attention to small spaces of random variables for which standard results for utility representations apply, or (ii) he/she uses some standard utility representation with a bounded utility function  $u$  for large spaces. In this sense, our analysis confirms ‘safe ground’ for economic modeling.

Second, our analysis raises awareness about the fact that the economic modeler might get into ‘non-anticipated trouble’ whenever both conditions, (i) and (ii), are violated. As one example consider Blavatsky (2005) who shows that, in contrast to expected utility theory, “conventional parameterizations of cumulative prospect theory do not explain the St. Petersburg paradox” (p.677). That is, for specifications of the unbounded utility (i.e., value) function for gains and of the capacity (i.e., probability weighting function) that are standard in the experimental prospect theory literature, preferences involving the lottery of the St. Petersburg paradox do not admit for a Choquet expected utility representation.

As another example for such non-anticipated trouble note that dynamic macro-economists have observed that ‘model uncertainty’ may easily lead to exploding moments of expected utility functions (or of the stochastic discount factor) for strictly concave period utility functions such as, e.g., CRRA utility that are standard in this literature (cf. Geweke 2001; Weitzman 2007). This insight culminated in Weitzman’s (2009) *Dismal Theorem* about modeling preferences over random consumption streams:

“Seemingly thin-tailed probability distributions (like the normal), which are actually only thin-tailed conditional on known structural parameters of the model (like the standard deviation), become tail-fattened (like the Student-t) after integrating out the structural-parameter uncertainty. This core issue is generic and cannot be eliminated in any clean way.” (p.9)

In the light of our analysis Weitzman’s Dismal Theorem is not surprising but rather an illustration of the general insight that expected utility representations might become impossible when concavity of the utility function is combined with random variables that belong to large spaces. In addition, our analysis implies that Weitzman’s Dismal Theorem cannot be avoided by replacing expected utility with alternative utility representations that are continuous.

We hope that our insights about preferences over large spaces of random variables will prove relevant to economic models that consider infinite streams of random payoffs or/and losses.

*The remainder of this paper is organized as follows.* Section 2 introduces our formal framework. Section 3 derives our main incompatibility results whose implications for

utility representations are discussed in Section 4. Section 5 presents several examples which illustrate our analytical findings. Finally, in Section 6 we argue in favor of our topological choice compared to alternative topologies whose definitions of continuity would be compatible with convexity. All formal proofs are relegated to the Appendix.

## 2 Our topological space of all random variables

Consider the additive probability space  $(\Omega, \Sigma, \mu)$ . We assume that  $\mu$  is *nonatomic*, i.e., there exists for every  $\epsilon > 0$  some finite partition  $\{\Omega_1, \dots, \Omega_n\} \subseteq \Sigma$  of  $\Omega$  such that  $\mu(\Omega_i) \leq \epsilon, i = 1, \dots, n$ .<sup>5</sup>

We endow the set of all random variables  $L^0(\mu)$  with the *topology of convergence in probability* (cf. Chapters 13.10 and 13.11 in Aliprantis and Border 2006). This topology is generated by the translation-invariant metric  $d_0 : L^0(\mu) \times L^0(\mu) \rightarrow [0, 1)$  such that

$$d_0(X, Y; \mu) = \int_{\Omega} \frac{|X - Y|}{1 + |X - Y|} d\mu \quad (4)$$

whereby we simply write  $d_0(X, Y)$  instead of  $d_0(X, Y; \mu)$  whenever it is well-understood that  $\mu$  is our reference measure.<sup>6</sup> That is, for any sequence of random variables  $\{X_n\}_{n=1}^{\infty}$  we have that

$$d_0(X_n, X) \rightarrow 0 \text{ iff } \forall \epsilon > 0, \mu(|X_n - X| > \epsilon) \rightarrow 0. \quad (5)$$

The distance between any two random variables is zero under this (essential) metric whenever both random variables coincide  $\mu$ -almost everywhere; that is, by fixing the reference measure  $\mu$  we distinguish between equivalence classes of  $\mu$ -measurable functions rather than between functions themselves.

Note that  $L^0(\mu)$  is a vector space because the operations of addition and scalar multiplication for all its members are well defined. To state the obvious,  $Z = \lambda X + (1 - \lambda) Y$  means

$$Z(\omega) = \lambda X(\omega) + (1 - \lambda) Y(\omega), \mu\text{-a.e.} \quad (6)$$

so that the ‘mixture operation’ on  $L^0(\mu)$  is an ‘averaging’ of real-valued outcomes in a given state.<sup>7</sup>

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<sup>5</sup>For an additive probability space this definition is equivalent to the more common definition of a nonatomic  $\mu$  which states that there exists for every  $A \in \Sigma$  with  $\mu(A) > 0$  some  $B \in \Sigma$  such that  $0 < \mu(B) < \mu(A)$  (for a formal proof of this equivalence see, e.g., Lemma 7.6.22 in Corbae, Stinchcomb, and Zeman 2009).

<sup>6</sup>It is only in Remark 11 that we distinguish between two metrics  $d_0(X, Y; \mu)$  and  $d_0(X, Y; \mu')$  for  $\mu \neq \mu'$ .

<sup>7</sup>This mixture operation is different from the Anscombe-Aumann (1963) mixture operation which ‘averages’ in any given state over probability distributions defined as outcomes of Anscombe-Aumann acts thereby resulting in a new distribution instead of a new real number.

Recall that a subset of random variables  $L \subseteq L^0(\mu)$  is *convex* if, and only if,

$$Y_1, \dots, Y_n \in L \text{ implies } \lambda_1 Y_1 + \dots + \lambda_n Y_n \in L \text{ for all } \lambda_i \geq 0 \text{ s.t. } \sum_{i=1}^n \lambda_i = 1. \quad (7)$$

Next recall that the *interior* of a given subset of a topological space is the largest (in the sense of set-inclusion) open set included in this subset. The following proposition will be crucial for deriving our subsequent incompatibility results.

**Proposition 1.** *The only convex subset of  $L^0(\mu)$  with non-empty interior is the set  $L^0(\mu)$  itself.*

Although Proposition 1 seems to be known among experts on functional analysis, we could not find any direct proof thereof in the literature (cf. Remarks 2 and 3 below). For the sake of completeness, and for the reader's benefit, we therefore provide a formal proof in the Appendix.<sup>8</sup> The basic idea of the proof goes as follows. Consider any  $Y$  in the interior of some convex subset of  $L^0(\mu)$ , denoted  $L$ . For any nonatomic  $\mu$  and any  $X \in L^0(\mu)$ , one can then always find a sufficiently fine partition  $\{\Omega_1, \dots, \Omega_n\}$  of  $\Omega$  such that the distance  $d^0(Y_i, Y)$  becomes arbitrarily small for  $Y_i = Y + n(X - Y)1_{\Omega_i}$ ,  $i = 1, \dots, n$ . Assume now that  $d^0(Y_i, Y)$ ,  $i = 1, \dots, n$ , is sufficiently small for all  $Y_i$  to belong to  $L$ . Since, by construction,

$$X = \frac{1}{n}Y_1 + \dots + \frac{1}{n}Y_n, \quad (8)$$

convexity of  $L$  then implies  $X \in L$ . As  $X \in L^0(\mu)$  was chosen arbitrarily, we obtain the desired result that  $L = L^0(\mu)$  for any convex  $L \subseteq L^0(\mu)$  with non-empty interior.

**Remark 1.** The proof of Proposition 1 uses the whole space  $L^0(\mu)$  and it does not necessarily go through for some strict subset of  $L^0(\mu)$ . Consider for example the large subset of  $L^0(\mu)$  that only contains non-negative random variables

$$L_+^0(\mu) \equiv \{X \in L^0(\mu) \mid X(\omega) \geq 0, \mu\text{-a.e.}\} \quad (9)$$

endowed with (4). Denote by  $0 \in L_+^0(\mu)$  any random variable that gives zero  $\mu$ -a.e. In analogy to the proof of Proposition 1 it can be shown that any convex subset of  $L_+^0(\mu)$  with non-empty interior containing 0 must be  $L_+^0(\mu)$  itself (to see this, set  $Y = 0$  in the proof of Proposition 1).

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<sup>8</sup>We are grateful to an anonymous referee for pointing out to us that a space has no nontrivial open convex sets if, and only, if this space has a trivial dual. As a consequence, Proposition 1 also follows from Theorem 13.41 (3) in Aliprantis and Border (2006).



However, the argument of Proposition 1 does not go through for subsets of  $L_+^0(\mu)$  that do not contain 0 in their interior. Suppose that we could prove, in analogy to the proof of Proposition 1, that  $L = L_+^0(\mu)$  for any convex  $L \subseteq L_+^0(\mu)$  whenever there exists some  $Y \neq 0$  in the interior of  $L$ . Consider some  $X = aY$  such that  $0 \leq a < 1$  and observe that  $X \in L_+^0(\mu)$ . We claim that, in contrast to the proof of Proposition 1, we have no longer  $Y_i = Y + n(X - Y)1_{\Omega_i} \in L$  for all  $i = 1, \dots, n$  for arbitrarily fine partitions  $\{\Omega_1, \dots, \Omega_n\}$ . Note that

$$Y_i(\omega) = \begin{cases} Y(\omega) & \text{for } \omega \in \Omega \setminus \Omega_i \\ Y(\omega) - Y(\omega)n(1-a) & \text{for } \omega \in \Omega_i. \end{cases} \quad (10)$$

Next observe that there will always be  $L$ , with small enough *diameter*

$$\text{diam}(L) \equiv \sup \{d^0(Z, Z') \mid Z, Z' \in L\}, \quad (11)$$

for which we need a partition into  $n > \frac{1}{1-a}$  disjunct subsets of  $\Omega$  for the distance  $d^0(Y_i, Y)$  to become sufficiently small to allow for all  $Y_i \in L$ . But then

$$n > \frac{1}{1-a} \Leftrightarrow Y(\omega) - Y(\omega)n(1-a) < 0 \text{ for } \omega \in \Omega_i \quad (12)$$

so that we end up with the contradiction that some  $Y_i \notin L \subseteq L_+^0(\mu)$  because, for all  $i$ ,  $Y_i(\omega) < 0$  for  $\omega \in \Omega_i$ . In that case, convexity of  $L$  does no longer imply that  $X = \frac{1}{n}Y_1 + \dots + \frac{1}{n}Y_n \in L_+^0(\mu)$  belongs to  $L$ .

To be specific, pick  $Y = 1_\Omega$  as interior point and let  $a = 0$ , implying  $X = 0$  and  $Y_i(\omega) = 1 - n$  for  $\omega \in \Omega_i$ , so that

$$d^0(Y_i, Y) = \int_{\Omega \setminus \Omega_i} \frac{|Y - Y|}{1 + |Y - Y|} d\mu + \int_{\Omega_i} \frac{|-n|}{1 + |-n|} d\mu \quad (13)$$

$$= \frac{n}{1+n} \mu(\Omega_i). \quad (14)$$

Consider some  $L$  with diameter  $0 < \text{diam}(L) < \frac{1}{2}$ . If  $n = 1$ , then  $\Omega_1 = \Omega$  so that  $d^0(Y_1, Y) = \frac{1}{2}$ , implying  $Y_1 \notin L$ . If  $n \geq 2$ , consider a partition with  $\mu(\Omega_i) = \frac{1}{n}$  and note that we can always find  $n$  large enough such that

$$d^0(Y_i, Y) = \frac{1}{1+n} < \text{diam}(L), \quad (15)$$

which is a necessary condition for  $Y_i \in L$ . However, for  $n \geq 2$  we have  $Y_i(\omega) \leq -1$  for  $\omega \in \Omega_i$ , implying for any  $i$  with  $\mu(\Omega_i) > 0$  (which always exists) that  $Y_i \notin L$ . If  $0 \notin L$ ,  $L \subsetneq L_+^0(\mu)$  might thus be a convex set with non-empty interior.

As a consequence, our subsequent incompatibility results for preferences on  $L^0(\mu)$ , which are based on Proposition 1, will, e.g., not apply to preferences restricted to the non-negative random variables in  $L_+^0(\mu)$  (cf. Example 3 in Section 5).

**Remark 2.** Observe that Proposition 1 implies that  $L^0(\mu)$  is not *locally convex* (Example 8.47 (3) in Aliprantis and Border 2006). This implies in turn that, except for the trivial null-functional, there does not exist any continuous functional  $f : L^0(\mu) \rightarrow \mathbb{R}$  which is linear, i.e., that satisfies for all  $X, Y \in L^0(\mu)$ ,

$$f(\alpha X + \beta Y) = \alpha f(X) + \beta f(Y) \text{ for all } \alpha, \beta \in \mathbb{R}. \quad (16)$$

On the other hand, there exist non-zero continuous linear functionals which separate points from closed convex subsets for the locally convex spaces  $L^p(\mu)$  with  $1 \leq p \leq \infty$  (Corollary 5.80 in Aliprantis and Border 2006). Proposition 1 can thus not be extended to  $L^p(\mu)$  spaces with  $1 \leq p \leq \infty$ . As a consequence, our incompatibility results will not apply to these spaces.

**Remark 3.** Note that  $L^p(\mu)$  spaces with  $0 < p < 1$  endowed with the metric

$$d_p(X, Y) = \int_{\Omega} |X - Y|^p d\mu \quad (17)$$

are also locally non-convex spaces on which only the trivial null-functional exists as continuous linear functional (Theorem 1 in Day 1940). As a consequence, our subsequent incompatibility results obtained for  $L^0(\mu)$  can be analogously derived for  $L^p(\mu)$  spaces with  $0 < p < 1$ . As it is, our formal proof of Proposition 1 using the metric (4) employs the same line of argument as a proof in Rudin (1991, paragraph 1.47) for  $L^p(\mu)$  spaces with  $0 < p < 1$  endowed with (17).

## 3 Main results

### 3.1 Incompatibility of convexity and continuity

Consider a binary preference relation  $\preceq$  on  $L^0(\mu)$  whereby we treat random variables as identical objects if they coincide  $\mu$ -almost everywhere. The standard interpretations and notational conventions apply:  $X \preceq Y$  means that  $Y$  is at least as desirable as  $X$ ; an agent is indifferent between  $X$  and  $Y$ , denoted  $X \sim Y$ , iff  $X \preceq Y$  and  $Y \preceq X$ ; in addition, we have strict preference, i.e.,  $X \prec Y$ , whenever  $X \preceq Y$  holds whereas  $Y \preceq X$  does not. We assume that  $\prec$  is *asymmetric* (i.e., for all  $X, Y \in L^0(\mu)$ ,  $X \prec Y$  implies not  $Y \prec X$ ) and that  $\preceq$  is *reflexive* (i.e., for all  $X \in L^0(\mu)$ ,  $X \preceq X$ ). At this point, we neither assume *completeness* nor *transitivity* of  $\preceq$  on  $L^0(\mu)$  (see below).

Let us introduce the *super-level* (=weakly better) set of  $X \in L^0(\mu)$  which contains all random variables that are at least as desirable as  $X$ :

$$S(X) \equiv \{Z \in L^0(\mu) \mid X \preceq Z\}. \quad (18)$$

Similarly, the *sub-level* (=weakly worse) set of  $X \in L^0(\mu)$  contains all random variables that are weakly less desirable than  $X$ :

$$s(X) \equiv \{Z \in L^0(\mu) \mid Z \preceq X\}. \quad (19)$$

Note that, by reflexivity of  $\preceq$ , both sets  $s(X)$  and  $S(X)$  are non-empty for all  $X \in L^0(\mu)$ .

Next consider the following definitions of possible properties that a preference relation  $\preceq$  on  $L^0(\mu)$  may or may not satisfy.

- *Non-triviality*:  $\exists X, Y, Z \in L^0(\mu)$  such that  $Y \prec X$  and  $X \prec Z$ .
- *Completeness*:  $\forall X, Y \in L^0(\mu)$ ,  $X \preceq Y$  or  $Y \preceq X$ .
- *$\mu$ -continuity*:  $\forall X \in L^0(\mu)$ , the super-level set  $S(X)$  and the sub-level set  $s(X)$  are *closed* sets with respect to the topology of convergence in probability.
- *$S$ -convexity*:  $\forall X \in L^0(\mu)$ , the super-level set  $S(X)$  is convex.
- *$s$ -convexity*:  $\forall X \in L^0(\mu)$ , the sub-level set  $s(X)$  is convex.

Without non-triviality the preference relation  $\preceq$  is not very interesting. By completeness, the decision maker is capable of making decisions in any situation. Although completeness might not always be plausible in empirical situations<sup>9</sup>, the whole point of this paper is to assume that a decision maker may have preferences over all random variables in  $L^0(\mu)$  and study the consequences of this assumption.

In behavioral terms continuity ensures that small changes, with respect to our chosen metric  $d_0$ , will not lead to abrupt changes in a decision maker's choice. More precisely,  $\mu$ -continuity ensures that whenever a sequence of random variables  $\{Y_k\}_{k \in \mathbb{N}}$  with  $X \prec Y_k$  for all  $k$  converges in probability to a random variable  $Y$ , then also  $X \preceq Y$ , i.e., preferences will not be reversed in the limit. From an applicational perspective,  $\mu$ -continuity is necessary for any representation of complete preferences on  $L^0(\mu)$  by some  $\mu$ -continuous utility function (see Section 4).

$S$ -convexity means that the decision maker likes to mix over the outcomes of random variables; a feature that is closely associated with behavioral concepts like risk- or/and uncertainty aversion as well as preference for diversification.  $s$ -convexity means the opposite and is associated with a risk- or/and uncertainty seeking and aversion against diversification.

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<sup>9</sup>In support of the empirical relevance of incomplete preferences see, e.g., Danan et al. (2015) and references therein.

To sum up: None of these five properties is behaviorally implausible (whereby  $S$ -convexity is empirically far more relevant than  $s$ -convexity). Nevertheless, convexity and continuity turn out to be incompatible with one another whenever preferences are non-trivial and complete.

**Theorem 1.** *Consider a binary preference relation  $\preceq$  on  $L^0(\mu)$  that is non-trivial and complete.*

- (a) *The preference relation  $\preceq$  cannot simultaneously satisfy  $\mu$ -continuity and  $S$ -convexity.*
- (b) *Neither can  $\preceq$  simultaneously satisfy  $\mu$ -continuity and  $s$ -convexity.*
- (c) *If non-triviality or completeness are dropped, then  $\preceq$  might simultaneously satisfy  $\mu$ -continuity and  $S$ -convexity (resp.  $s$ -convexity).*

Sketch of the proof (for details see the Appendix): Define the *strictly better* and *strictly worse* sets of  $X \in L^0(\mu)$  as follows

$$S^*(X) \equiv \{Z \in L^0(\mu) \mid X \prec Z\}, \quad (20)$$

$$s^*(X) \equiv \{Z \in L^0(\mu) \mid Z \prec X\}. \quad (21)$$

Completeness ensures that the topological structure of  $L^0(\mu)$  determines open, resp. closed, sets with respect to the preference relation  $\preceq$  so that Proposition 1 becomes applicable (cf. Remark 1). In particular, by completeness,  $\mu$ -continuity implies that the sets  $S^*(X)$  and  $s^*(X)$  must be open in the topology of convergence in probability. But by Proposition 1,  $S^*(X)$  and  $s^*(X)$  cannot be open if they are non-empty, convex, strict subsets of  $L^0(\mu)$ . Non-triviality ensures non-emptiness of  $S^*(X)$  and  $s^*(X)$  as well as  $S^*(X), s^*(X) \subsetneq L^0(\mu)$ .

### 3.2 Quasi-concave and quasi-convex preferences

Note that the incompatibility result of Theorem 1 does not require *transitivity* of  $\preceq$  which is defined as follows:

- *Transitivity:*  $\forall X, Y, Z \in L^0(\mu)$  if  $X \preceq Y$  and  $Y \preceq Z$ , then  $X \preceq Z$ .

Transitivity is a standard rationality requirement for economic agents that precludes the possibility of simple money pumps (cf. Cubitt and Sugden 2001). Next consider the following possible properties of preferences.

- *Quasi-concavity:*  $\forall X, Y \in L^0(\mu)$  if  $X \preceq Y$ , then  $X \preceq \alpha X + (1 - \alpha)Y$  for all  $\alpha \in [0, 1]$ .

- *Quasi-concavity:*  $\forall X, Y \in L^0(\mu)$  if  $X \preceq Y$ , then  $\alpha X + (1 - \alpha)Y \preceq Y$  for all  $\alpha \in [0, 1]$ .

The concept of quasi-concavity—formally defined as “uncertainty aversion” over acts in the Anscombe-Aumann (1963) framework—goes back to Gilboa and Schmeidler (1989, Axiom A.5) and Schmeidler (1989).<sup>10</sup> Because our formal definition of quasi-concavity applies to the outcomes of random variables, the meaning of our definition is different from the original one formulated for the Anscombe-Aumann framework.

Note that  $S$ -convexity implies quasi-concavity. Similarly,  $s$ -convexity implies quasi-convexity. In what follows we establish that these relationships also hold in the other direction whenever transitivity is satisfied.

**Proposition 2.** *Assume that  $\preceq$  on  $L^0(\mu)$  is complete and transitive.*

- (a) *Then quasi-concavity implies  $S$ -convexity.*
- (b) *Then quasi-convexity implies  $s$ -convexity.*

Combining Theorem 1 and Proposition 2 gives the following results.

**Theorem 2.** *Assume that  $\preceq$  is non-trivial, complete, transitive, and  $\mu$ -continuous.*

- (a) *Then  $\preceq$  must violate quasi-concavity.*
- (b) *Then  $\preceq$  must violate quasi-convexity.*

### 3.3 Preference for diversification

Dekel (1989) has introduced the following definition in the context of portfolio choices:<sup>11</sup>

- *Preference for diversification:*  $\forall X, Y \in L^0(\mu)$  if  $X \sim Y$ , then  $X \preceq \alpha X + (1 - \alpha)Y$  for all  $\alpha \in [0, 1]$ .

Quasi-concavity implies preference for diversification. The proof of the following result establishes that preference for diversification implies quasi-concavity under transitivity and  $\mu$ -continuity.

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<sup>10</sup>As motivation for his definition, Schmeidler (1989) writes: “Intuitively, uncertainty aversion means that “smoothing” or averaging utility distributions makes the decision maker better off. Another way is to say that substituting objective mixing for subjective mixing makes the decision maker better off.” (p.582) For an alternative approach to uncertainty aversion defined over random variables (i.e., Savage acts) rather than over Anscombe-Aumann acts see Epstein (1999).

<sup>11</sup>For extensions of Dekel’s (1989) approach see Chateauneuf and Lakhnati (2007) and Chateauneuf and Tallon (2002). For an excellent survey on this literature see De Giorgi and Mahmoud (2016).

**Theorem 3.** Assume that  $\preceq$  on  $L^0(\mu)$  is complete, transitive, and  $\mu$ -continuous. Then  $\preceq$  must violate preference for diversification.

**Remark 4.** One implication of the above analysis is that so-called *convex/coherent/sub-additive* risk measures defined over all  $L^0(\mu)$  cannot be continuous (see, e.g., Föllmer and Schied 2002; Delbaen 2002, 2009; Assa 2016). The next section discusses implications of our analytical findings for utility representations.

## 4 Implications for utility representations

Through the metric (4) the reference measure  $\mu$  pins down, firstly, what it means for random variables to be identical and, secondly, what it means for preferences to be continuous. We say that a utility functional  $U : L^0(\mu) \rightarrow \mathbb{R}$  is  $\mu$ -continuous iff  $d_0(Y_k, Y) \rightarrow 0$  implies  $\lim_k U(Y_k) = U(Y)$ . This section assumes that preferences on  $L^0(\mu)$  are represented by some  $\mu$ -continuous utility functional.

**Assumption 1.** Fix some non-trivial and complete preference relation  $\preceq$  on  $L^0(\mu)$  and suppose that there exists some  $\mu$ -continuous functional  $U : L^0(\mu) \rightarrow \mathbb{R}$  such that, for all  $X, Y \in L^0(\mu)$ ,

$$X \preceq Y \text{ iff } U(X) \leq U(Y). \quad (22)$$

For quasi-concave  $U$  it must hold that

$$\forall X, Y \in L^0(\mu), \alpha \in (0, 1), U(\alpha X + (1 - \alpha)Y) \geq \min\{U(X), U(Y)\} \quad (23)$$

whereas we have for quasi-convex  $U$  that

$$\forall X, Y \in L^0(\mu), \alpha \in (0, 1), \max\{U(X), U(Y)\} \geq U(\alpha X + (1 - \alpha)Y). \quad (24)$$

**Proposition 4.** Suppose that Assumption 1 holds. Then  $U$  can neither be quasi-concave nor quasi-convex.

Proposition 4 is fundamental in that it holds for any  $\mu$ -continuous utility representation on  $L^0(\mu)$ . In the remainder of this section we discuss implications for the two special cases of expected utility and Choquet expected utility representations, respectively.

## 4.1 Expected utility

Suppose that the utility representation (22) is of the expected utility (EU) form, i.e., for all  $X \in L^0(\mu)$ ,

$$U(X) \equiv E(u(X)) \quad (25)$$

$$= \int_{\Omega} u(X(\omega)) d\mu' \quad (26)$$

for some strictly increasing utility function  $u : \mathbb{R} \rightarrow \mathbb{R}$  and some additive probability measure  $\mu'$  on  $(\Omega, \Sigma)$ . Observe that quasi-concavity of EU preferences holds if  $u$  is concave thereby formally expressing risk-aversion of the EU decision maker. Conversely, quasi-convexity of EU preferences holds if  $u$  is convex thereby expressing risk-seeking. By Proposition 4, we thus obtain the following result.

**Corollary 1.** *Suppose that Assumption 1 holds such that  $U$  is of the EU form (25). Then the utility function  $u$  can neither be concave nor convex.*

By Corollary 1, an EU representation over all random variables can thus neither express global risk-aversion nor global risk-seeking. We will come back to this point in our Examples 3 and 4 in Section 5.

**Remark 5.** The quintessence of Corollary 1 already appears in the EU literature in the form of existence conditions for the integral (26) (cf. Nielsen 1984; Wakker 1993; Delbaen, Drapeau and Kupper 2011 and references therein). A main insight from this literature is that boundedness of  $u$  is required for any EU representation defined over all random variables: for unbounded  $u$  we can always find random variables for which the integral (26) does not exist.<sup>12</sup> To see the connection between this literature and our Corollary 1, observe that any (non-constant) concave  $u$  is unbounded from below whereas any (non-constant) convex  $u$  is unbounded from above.

**Remark 6.** Note that the measure  $\mu'$  which appears in the EU representation (26) does not have to be the reference measure  $\mu$ . However, for  $\mu' \neq \mu$  Assumption 1 requires that

$$\int_{\Omega} u(X(\omega)) d\mu' = \int_{\Omega} u(Y(\omega)) d\mu' \text{ for all } X = Y, \mu\text{-a.e.}, \quad (27)$$

otherwise (26) cannot be a utility representation on  $L^0(\mu)$  as it would assign different utilities to  $\mu$ -a.e. identical random variables. Equation (27) is satisfied if  $\mu'$  is absolutely

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<sup>12</sup>Cf. Wakker (1993, p.448): “The underlying problem was already observed by Menger (1934). As soon as utility is unbounded, there exist acts with unbounded expected utility[...].”

continuous with respect to  $\mu$  (i.e., for all  $A \in \Sigma$ ,  $\mu'(A) = 0$  if  $\mu(A) = 0$ ). As a consequence, any  $\mu'$  in the EU representation (26) must also be nonatomic.<sup>13</sup> At this point, one might ask why the reference measure  $\mu$  is used to define continuity for a EU representation w.r.t.  $\mu' \neq \mu$ . If both measures are equivalent (i.e., for all  $A \in \Sigma$ ,  $\mu'(A) = 0$  iff  $\mu(A) = 0$ ), it is natural to use  $\mu$  as reference measure. If both measures are not equivalent, however, one might instead want to consider the space  $(\Omega, \Sigma, \mu')$ . Obviously, if  $(\Omega, \Sigma, \mu')$  is nonatomic, the analysis of this paper equivalently applies to  $(\Omega, \Sigma, \mu')$  such that  $\mu'$  instead of  $\mu$  becomes the reference measure.

## 4.2 Choquet expected utility

Denote by  $\nu : \Sigma \rightarrow [0, 1]$  a *not necessarily additive probability measure* satisfying:

- (i) Normalization:  $\nu(\emptyset) = 0$  and  $\nu(\Omega) = 1$ ;
- (ii) Monotonicity:  $A \subset B$  implies  $\nu(A) \leq \nu(B)$ .

Suppose now that the utility representation (48) is of the Choquet expected utility (CEU) form, i.e., for all  $X \in L^0(\mu)$ ,

$$U(X) = \int_{\Omega}^C u(X(\omega)) d\nu \quad (28)$$

where the integral in (28) is the Choquet integral with respect to some  $\nu$ . The Choquet integral is formally defined as

$$\int_{\Omega}^C u(X(\omega)) d\nu \equiv \int_0^{\infty} \nu(u(X(\omega)) \geq x) dx - \int_{-\infty}^0 (1 - \nu(u(X(\omega)) \geq x)) dx \quad (29)$$

(for details on Choquet integration and properties of the Choquet integral see Schmeidler 1986 for bounded  $u$  and, more generally, Wakker 1993). CEU has been axiomatized within the Savage (1954) framework—relevant to our model of preferences over random variables (i.e., Savage acts)—by Gilboa (1987).

We follow the literature and call  $\nu$  *convex* iff, for all  $A, B \in \Sigma$ ,

$$\nu(A \cup B) + \nu(A \cap B) \geq \nu(A) + \nu(B). \quad (30)$$

$\nu$  is called *concave* iff the inequality in (30) is reversed. For the EU representation (25) quasi-concavity (resp. quasi-convexity) of  $U$  is simply implied by concavity (resp. convexity) of  $u$ . The case is more complicated for the CEU representation (28) for which we must additionally consider properties of  $\nu$ . In the Appendix we prove the following result.

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<sup>13</sup>A formal proof of this fact, which uses the Radon-Nikodym Theorem, is available upon request from the authors.



**Corollary 2.** *Suppose that Assumption 1 holds such that  $U$  is of the CEU form (28). Then we can neither have (i) concavity of the utility function  $u$  combined with convexity of the capacity  $\nu$  nor (ii) convexity of the utility function  $u$  combined with concavity of the capacity  $\nu$ .*

The analysis in Chew, Karni, and Saffra (1985) implies that CEU preferences express *strong* risk-aversion—defined as aversion to mean-preserving spreads—if, and only if,  $u$  is concave and  $\nu$  is convex. Consequently, Corollary 2 rules out that a CEU representation over all random variables in  $L^0(\mu)$  could express strong risk-aversion. In addition to strong risk-aversion, Chateauneuf, Cohen, and Meilijson (2005) consider the concepts of *monotone* and *weak* risk-aversion. While all three risk-aversion concepts are equivalent for EU preferences, Chateauneuf et al. (2005) show that monotone and weakly risk-averse CEU representations do not necessarily require concavity of  $u$  combined with convexity of  $\nu$ . Corollary 2 does thus not apply to these weaker concepts of risk aversion.<sup>14</sup>

**Remark 7.** If Assumption 1 holds for some CEU representation we must have that

$$\int_{\Omega}^C u(X(\omega)) d\nu = \int_{\Omega}^C u(Y(\omega)) d\nu \text{ for all } X = Y, \mu\text{-a.e.} \quad (31)$$

As for an additive measure (cf. Remark 6), this excludes any  $\nu$  with some atom  $\Omega^* \in \Sigma$  such that  $\nu(\Omega^*) = \epsilon > 0$  whereas  $\nu(A) = 0$  for all  $A \subset \Omega^*$ . To see this directly for  $L^0(\mu)$ , suppose that there is some atom such that  $\nu(\Omega^*) = \epsilon > 0$  whereas  $\nu(A) = 0$  for all  $A \subset \Omega^*$ . Consider the two random variables  $X, Y \in L^0(\mu)$  and some  $\omega^* \in \Omega^*$  such that

$$\begin{aligned} X(\omega) &= Y(\omega) = 1 \text{ for all } \omega \in \Omega^* \setminus \{\omega^*\}, \\ X(\omega^*) &= 0 \text{ and } Y(\omega^*) = 1 \text{ for } \omega^* \in \Omega^*, \\ X(\omega) &= 0 \text{ and } Y(\omega) = 0 \text{ for all } \omega \in \Omega/\Omega^*. \end{aligned}$$

Suppose now that Assumption 1 holds for an CEU representation w.r.t.  $\nu$ . Then

$$\begin{aligned} U(X) &= \int_{\Omega}^C u(X(\omega)) d\nu = u(0) \\ &< \epsilon u(1) + (1 - \epsilon) u(0) = \int_{\Omega}^C u(Y(\omega)) d\nu \\ &= U(Y) \end{aligned} \quad (32)$$

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<sup>14</sup>The analysis in Chew et al. (1985) and in Chateauneuf et al. (2005) is formulated for *rank dependent utility under risk* (see Remark 8).

as well as

$$X = Y, \mu\text{-a.e.} \Leftrightarrow U(X) = U(Y), \quad (33)$$

a contradiction.

**Remark 8.** As in the case of an EU representation w.r.t.  $\mu' \neq \mu$ , one might ask why is the additive reference measure  $\mu$  used to define continuity for a CEU representation w.r.t. a non-additive  $\nu \neq \mu$  (also see Remark 9 below) One class of CEU representations for which the choice of an additive reference measure arises naturally is the class of *rank dependent utility under risk* (=RDU) representations originally introduced by Quiggin (1981; 1982). For an RDU representation the non-additive probability measure  $\nu$  results from the application of an increasing probability weighting/perception function  $f : [0, 1] \rightarrow [0, 1]$  with  $f(0) = 0$  and  $f(1) = 1$  to objective probabilities. For any CEU (i.e., RDU) representation satisfying  $\nu(A) = f(\mu(A))$ ,  $A \in \Sigma$ , the objective measure  $\mu$  becomes the natural reference measure of choice.

**Remark 9.** At this point it is natural to ask whether our analysis could be extended to a non-additive probability space  $(\Omega, \Sigma, \nu)$  such that  $\nu$  instead of  $\mu$  becomes the reference measure. While we have to leave the details of such analysis for future research, let us briefly sketch the basic question. Suppose that  $\nu$  is *nonatomic* in the sense that there exists for every  $\epsilon > 0$  some finite partition  $\{\Omega_1, \dots, \Omega_n\} \subset \Sigma$  of  $\Omega$  such that  $\nu(\Omega_i) \leq \epsilon, i = 1, \dots, n$ . Also suppose that the new metric

$$d_0^C(X, Y) = \int_{\Omega}^C \frac{|X - Y|}{1 + |X - Y|} d\nu \quad (34)$$

is well defined to give us the space  $L^0(\nu)$ . We then conjecture that, in analogy to Proposition 1, *The only convex subset of  $L^0(\nu)$  with non-empty interior is the set  $L^0(\nu)$  itself.* If is the case, the incompatibility results of this paper would simply follow. But the open question is under which conditions (34) is well-defined.<sup>15</sup>

**Remark 10.** The proof of Corollary 2(i) for concave  $u$  and convex  $\nu$  uses exactly three properties of the Choquet expectations operator: (i) monotonicity, (ii) homogeneity of degree one, and (iii) super-additivity for convex  $\nu$ ; (an analogous proof for Corollary 2(ii) with convex  $u$  would use the fact that the Choquet integral is sub-additive

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<sup>15</sup>The details of this issue are far from obvious to us. For starters, the notion of  $\nu$ -a.e. identical random variables seems to require restrictions on admissible  $\nu$  to ensure that  $X = Y, \nu$ -a.e. and  $Y = Z, \nu$ -a.e. implies  $X = Z, \nu$ -a.e. That is, without further restrictions on  $\nu$  (which ones?) we cannot be sure that  $d_0^C(X, Z) = 0$  whenever  $d_0^C(X, Y) = 0$  and  $d_0^C(Y, Z) = 0$ .

for concave  $\nu$ ). Suppose that Assumption 1 holds for a *max-min MEU* (=multiple priors expected utility) representation of preferences on  $L^0(\mu)$  such that for all  $X \in L^0(\mu)$

$$U(X) = \min_{\mu' \in \mathcal{P}} \int_{\Omega} u(X(\omega)) d\mu' \quad (35)$$

where  $\mathcal{P}$  denotes some set of probability measures (=priors) on  $(\Omega, \Sigma)$ . Then the minimal expectations operators on the right side of (35) is also monotone, homogenous of degree one, and super-additive (cf. Lemmas 3.4 and 3.5 in Gilboa and Schmeidler 1989). By the same formal argument as for Corollary 2(i), we thus have that there cannot exist any  $\mu$ -continuous max-min MEU representation of preferences on  $L^0(\mu)$  such that  $u$  is concave; (nor can there exist any  $\mu$ -continuous max-max MEU representation, i.e.,  $U(X) = \max_{\mu' \in \mathcal{P}} \int_{\Omega} u(X(\omega)) d\mu'$ , for convex  $u$ ). Similar to the case of an EU representation w.r.t.  $\mu' \neq \mu$  (cf. Remark 6), the choice of  $\mu$  as reference measure for the max-min MEU utility representation (35) is natural whenever all priors in  $\mathcal{P}$  are equivalent to  $\mu$ .<sup>16</sup>

## 5 Examples

This section illustrates our analytical results through examples that relax different assumptions of Theorem 1 in order to ensure existence of preferences and/or their utility representations.

**Example 1.** [Relaxing non-triviality]. Just consider a degenerate preference relation such that  $\forall X, Y \in L^0(\mu), X \sim Y$ . This preference relation is (trivially) complete,  $\mu$ -continuous as well as  $S$ -convex (resp.  $s$ -convex). Moreover, it can be represented by any constant functional  $U : L^0(\mu) \rightarrow \mathbb{R}$ .  $\square$

**Example 2.** [Relaxing completeness: Monotonicity]. We say that  $Y$  *dominates* ( $\mu$ -a.e.)  $X$ , denoted  $X \preceq Y$ , iff

$$X(\omega) \leq Y(\omega), \mu\text{-a.e.} \quad (36)$$

Let  $\forall X, Y \in L^0(\mu), X \preceq Y$  iff  $X \leq Y$  and observe that  $\mu$ -continuity and convexity hold for these incomplete preferences.  $\square$

Example 2 relaxes completeness by considering a partial rather than a total preference relation on  $L^0(\mu)$ . Alternatively, we can relax completeness of preferences on  $L^0(\mu)$  by

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<sup>16</sup>An interesting question for future research, related to Footnote 15, is which reference measure should be chosen for defining continuity of MEU presentations if not all priors are equivalent to  $\mu$ .

considering ‘complete’ preferences that are defined for some strict subset of  $L^0(\mu)$  only. Such preferences are incomplete on  $L^0(\mu)$  because we assume that only random variables within the given subset are comparable with each other. The following example shows how continuity and convexity can be reconciled for a suitably chosen subset.

**Example 3.** [Relaxing completeness: Risk-averse expected utility for non-negative random variables]. Suppose that  $\preceq$  is only defined on the set of non-negative random variables

$$L_+^0(\mu) \equiv \{X \in L^0(\mu) \mid X(\omega) \geq 0, \mu\text{-a.e.}\} \quad (37)$$

and consider an expected utility decision maker with the following utility function

$$u(x) = \frac{x}{1+x}, \text{ for } x \geq 0. \quad (38)$$

The expected utility of any  $X \in L_+^0(\mu)$  with respect to  $\mu$  is given as the distance (4) of  $X$  from the constantly zero random variable:

$$\int_{\Omega} u(X(\omega)) d\mu = \int_{\Omega} \frac{|X(\omega) - 0|}{1 + |X(\omega) - 0|} d\mu \quad (39)$$

$$= d_0(X, 0) \in [0, 1]. \quad (40)$$

This decision maker’s preferences on  $L_+^0(\mu)$  are  $\mu$ -continuous and, by strict concavity of  $u$  on  $\mathbb{R}_+$ , they are also  $S$ -convex on  $L_+^0(\mu)$ .  $\square$

On the one hand, Example 3 shows that continuity and convexity can be easily reconciled if we restrict attention to preferences that are only complete on a suitable subset of  $L^0(\mu)$  like  $L_+^0(\mu)$  (cf. Remark 1). On the other hand, however, this example also demonstrates the interpretational shortcomings of such restriction: Why should the decision maker not be able to compare random variables in  $L_+^0(\mu)$  with random variables that have losses (negative  $x$ ) in their support? The following example shows how we could naturally extend the preferences on  $L_+^0(\mu)$  from Example 3 to preferences that are complete on the whole domain  $L^0(\mu)$ . However, by establishing completeness on  $L^0(\mu)$  either  $\mu$ -continuity or convexity has to give (which will be convexity in Example 4).

**Example 4.** [Relaxing convexity: Expected utility with a reference point at zero]. Recall the preferences from Example 3 but assume now a complete preference ordering on the whole domain  $L^0(\mu)$ . To this purpose define the following (once-differentiable) utility function:

$$u(x) = \begin{cases} \frac{x}{1+x} & \text{if } x \geq 0 \\ \frac{x}{1-x} & \text{if } x \leq 0 \end{cases} \quad (41)$$

resulting in an EU representation of  $\mu$ -continuous preferences  $\preceq$  on  $L^0(\mu)$ . As under Example 3, the expected utility of any  $\mu$ -a.e. positive  $X$  is its distance  $d_0(X, 0)$  from the constant zero random variable. For an  $\mu$ -a.e. negative  $Y$  we have

$$\int_{\Omega} u(Y(\omega)) d\mu = \int_{\Omega} \frac{(-)|Y(\omega) - 0|}{1 + |Y(\omega) - 0|} d\mu = -d_0(Y, 0); \quad (42)$$

that is, the expected utility of the negative  $Y$  is the negative of its distance from this zero random variable. Consequently,  $U(X) \in (-1, 1)$  for any  $X \in L^0(\mu)$ .

Observe that  $u$  is strictly concave for all  $x > 0$  and strictly convex for all  $x < 0$  so that the EU decision maker is risk-averse for positive and risk-seeking for negative outcomes. From Corollary 1 we know that an EU representation of a  $\mu$ -continuous preference relation  $\preceq$  on  $L^0(\mu)$  is impossible for an utility function that is concave (or convex) on the whole domain  $\mathbb{R}$ . This example shows that we can have an  $\mu$ -continuous EU representation on  $L^0(\mu)$  when we are prepared to give up  $S$ -convexity (corresponding to a concave  $u$ , i.e., risk-aversion) as well as  $s$ -convexity (corresponding to a convex  $u$ , i.e., risk-seeking) as global properties.

Finally, let us interpret  $u$  as a value function from *prospect theory* (cf. Wakker 2010) such that positive  $x$  correspond to gains with respect to the reference point zero whereas negative  $x$  stand for losses. Under this interpretation giving up on  $S$ - and  $s$ -convexity for the above preferences is nothing else than the standard assumption of prospect theory according to which the bounded value function for gains is (strictly) concave whereas it is (strictly) convex for losses (cf. Vendrik and Woltjer 2007 and references therein).  $\square$

**Example 5.** [Relaxing convexity: Value-at-Risk]. Recall the definition of *Value at Risk* ( $\text{VaR}$ ) as a popular risk measure in financial applications which is not sub-additive:

$$\text{VaR}_{\alpha}(X) = -\sup \{x \in \mathbb{R} | P(X \geq x) \geq \alpha\} \quad (43)$$

for a fixed confidence level  $1 - \alpha \in (0, 1)$ . Let  $\forall X, Y \in L, X \preceq Y$  iff  $\text{VaR}_{\alpha}(X) \geq \text{VaR}_{\alpha}(Y)$ . It is easy to see that (the complete and non-trivial)  $\preceq$  is  $\mu$ -continuous because  $\mu$ -continuity implies convergence in distribution. The following example taken from Embrechts et al. (2002) shows that  $S$ -convexity is violated. Let  $X, Y$  be two independent Pareto distributed random variables with  $F_X(x) = F_Y(x) = 1 - x^{-1/2}, x \geq 1$  and 0, otherwise. Then it is easy to see that  $P(X + Y \leq z) = 1 - \frac{2\sqrt{z-1}}{z} < P(2X \leq z)$ , for  $z \geq 2$ . Consequently,  $\text{VaR}_{\alpha}(\frac{X+Y}{2}) > \text{VaR}_{\alpha}(X) = \frac{\text{VaR}_{\alpha}(X) + \text{VaR}_{\alpha}(Y)}{2}$ . That is, we have  $X, Y \in S(X)$  but not  $\frac{X+Y}{2} \in S(X)$  so that  $S$ -convexity fails.

As the basis for the Basel II and III capital requirement formula, the  $\text{VaR}$  criterion has been heavily criticized in the mathematical finance literature because it does not satisfy preference for diversification (cf. Artzner et al. 1997, 1999). On the other

hand, VaR has the nice feature to ensure continuity of preferences on  $L^0(\mu)$ , which is impossible for convex/coherent/subadditive risk measures (see Remark 4).  $\square$

**Example 6.** [Relaxing continuity: Lexicographic preferences]. Define (*strict*) *dominance on an event*  $E \in \Sigma$  as follows:  $\forall X, Y \in L^0(\mu)$

$$X \leq_E Y \text{ iff } X(\omega) \leq Y(\omega), \mu\text{-a.e. on } E;$$

$$X <_E Y \text{ iff } X \leq_E Y \text{ and } X(\omega) < Y(\omega) \text{ on some } E' \subseteq E \text{ with } \mu(E) > 0.$$

Fix a collection  $\Omega_1, \Omega_2, \dots$  of nested events in  $\Sigma$  such that  $\Omega_{i+1} \subset \Omega_i$ ,  $\mu(\Omega_1) = 1$  and  $\mu(\Omega_i) > \mu(\Omega_{i+1}) > 0$  for all  $i$ . Define the following lexicographic preferences:

$$\text{if } X <_{\Omega_1} Y \text{ then } X \prec Y,$$

$$\text{if neither } Y <_{\Omega_i} X \text{ nor } X <_{\Omega_i} Y \text{ for any } i < j \text{ but } X <_{\Omega_j} Y, \text{ then } X \prec Y,$$

$$X \sim Y, \text{ else.}$$

First, let us show that the (complete and non-trivial) preference relation  $\preceq$  is  $S$ -convex. If not, then  $X \preceq Y$  but  $\lambda Y + (1 - \lambda) X \prec X$  for some  $\lambda$ . Focus on the strict case  $X \prec Y$ . Then there exists some  $i \geq 1$  and  $X, Y$  such that  $X <_{\Omega_i} Y$  but neither  $Y <_{\Omega_j} X$  nor  $X <_{\Omega_j} Y$  for  $j < i$ . Note that  $X <_{\Omega_i} Y$  implies  $X <_{\Omega_i} \lambda Y + (1 - \lambda) X$ . Similarly, neither  $Y <_{\Omega_j} X$  nor  $X <_{\Omega_j} Y$  implies neither  $Y <_{\Omega_j} \lambda Y + (1 - \lambda) X$  nor  $X <_{\Omega_j} \lambda Y + (1 - \lambda) X$  for  $j < i$ . Consequently,  $X \prec \lambda Y + (1 - \lambda) X$ , a contradiction. Now focus on  $X \sim Y$  so that, by the same argument, neither  $Y <_{\Omega_j} \lambda Y + (1 - \lambda) X$  nor  $X <_{\Omega_j} \lambda Y + (1 - \lambda) X$  for any  $j$ , implying  $\lambda Y + (1 - \lambda) X \sim X$ .

Next observe that  $\preceq$  is not  $\mu$ -continuous. To see this, let  $\Omega_1 = E_1 \cup E_2$ ,  $\Omega_2 = E_1$  and consider the following random variables:

	$E_1$	$E_2$
$X$	1	0
$Y_k$	$1 - \frac{1}{k}$	1
$Y$	1	1

Note that  $Y_k \prec X$  for all  $k$  but  $X \prec Y$  whereby  $d_0(Y_k, Y) \rightarrow 0$ .  $\square$

**Example 7.** [Relaxing continuity: Preferences generated by a linear functional]. An anonymous referee pointed out to us that it is a standard result in functional analysis “that every vector space admits nontrivial linear functionals”. For the reader’s benefit we sketch the formal argument within our framework. Suppose that there exists a non-zero linear functional  $f$  on  $L^0(\mu)$ . Then we can use  $f$  to construct a non-trivial, complete, and convex preference relation as follows:

$$X \preceq_f Y \text{ iff } f(X) \leq f(Y). \quad (44)$$

This preference relation is non-trivial since  $f$  is non-zero (and by linearity thus non-constant). It is complete since for all  $X, Y \in L^0(\mu)$  we have either  $f(X) \leq f(Y)$  or  $f(Y) \leq f(X)$ . It is convex since, for all  $X, Y, Z \in L^0(\mu)$ , if  $f(Z) \leq f(X)$  and  $f(Z) \leq f(Y)$  then

$$f(Z) = \lambda f(X) + (1 - \lambda)f(Y) \quad (45)$$

$$\leq \lambda f(X) + (1 - \lambda)f(Y) = f(\lambda X + (1 - \lambda)Y). \quad (46)$$

Recall from our Remark 2 that there does not exist any (non-zero) continuous linear functional on  $L^0(\mu)$ . However, that does not mean that there does not exist any linear functional on this space at all. In what follows, we prove the existence of a linear function on  $L^0(\mu)$  whereby we use Zorn's lemma (cf. pp.65-66 in Komj  th and Totik 2006):

**Zorn's Lemma.** *Suppose that a non-empty partially ordered set  $(\mathcal{Z}, R)$  has the property that every chain has an upper bound, i.e., for any totally ordered set  $\mathcal{C} \subseteq \mathcal{Z}$  there exists  $\mathcal{M}_{\mathcal{C}}$  such that  $\mathcal{X} R \mathcal{M}_{\mathcal{C}}$  for all  $\mathcal{X} \in \mathcal{C}$ . Then the set  $\mathcal{Z}$  contains at least one maximal element  $\mathcal{M}$ , i.e., there is no  $\mathcal{X} \in \mathcal{Z}$  with  $\mathcal{M} R \mathcal{X}$  and  $\neg \mathcal{X} R \mathcal{M}$ .*

Let  $\mathcal{O}$  be the set of all linearly independent subsets of  $L^0(\mu)$  that contains the constant random variable 1. Because of  $\{1\} \in \mathcal{O}$ ,  $\mathcal{O}$  is non-empty. In Zorn's lemma let  $\mathcal{Z} = \mathcal{O}$  and  $R = \subseteq$ . Since  $\mathcal{O}$  is a set of subsets of  $L^0(\mu)$ ,  $(\mathcal{O}, \subseteq)$  is partially ordered. On the other hand, for any chain  $\mathcal{C}$  one can see that  $\mathcal{M}_{\mathcal{C}} = \cup_{A \in \mathcal{C}} A$  is an upper bound. By Zorn's lemma, there must thus exist a maximal set  $\mathcal{M}$  of linearly independent members in  $L^0(\mu)$  that also contains 1. We claim that  $\mathcal{M}$  is a basis for  $L^0(\mu)$ . If not, there exists some  $X \in L^0(\mu)$  such that  $X$  cannot be written as linear combination of members in  $\mathcal{M}$ . That means  $X$  is linearly independent from members of  $\mathcal{M}$ . But if we introduce  $\mathcal{X}' = \mathcal{M} \cup \{X\}$ , then  $\mathcal{M} \subsetneq \mathcal{X}'$ , which contradicts the maximality of  $\mathcal{M}$ .

Now let us construct a linear functional  $f_1$  as follows: for every  $X \in L^0(\mu)$ , there are real numbers  $\{x_m\}_{m \in \mathcal{M}}$  such that  $X = \sum_{m \in \mathcal{M}} x_m m$ . Let  $f_1(X) := x_1$ . Since  $\mathcal{M}$  is a basis, the representation  $X = \sum_{m \in \mathcal{M}} x_m m$  is unique, and as a result  $f_1$  is well defined and linear.  $\square$

## 6 Discussion: Our topology of choice

Mathematical continuity is a relative concept that is determined by the topology we impose on  $L^0(\mu)$ . We will show in a moment that it is easy to come up with topologies

on  $L^0(\mu)$  that can reconcile convexity with mathematical continuity with respect to these topologies. This raises the question why we have chosen the topology of convergence in probability.

The remainder of this section presents three arguments in favor of the  $d_0$ -metric as our topology of choice. These arguments can be summarized as follows:

1. A utility representation over the distributions of random variables is continuous if, and only if,  $\mu$ -continuity holds.
2. The  $d_0$ -metric is behaviorally plausible and it translates the standard convergence behavior of random variables from familiar  $L^p(\mu)$  spaces into the larger  $L^0(\mu)$  space.
3. Any alternative topologies we can think of that reconcile convexity with mathematical continuity require behaviorally implausible notions of convergence.

## 6.1 Continuous utility representation over distributions

Let us assume that a non-trivial and complete preference relation on  $L^0(\mu)$  can be represented by some utility function defined over the distributions of all random variables in  $L^0(\mu)$ .<sup>17</sup> Recall that the *distribution*  $F_Z$  of any  $Z \in L^0(\mu)$  is a probability measure on the Borel subsets of the real line satisfying

$$F_Z(A) \equiv \mu(\{\omega \in \Omega \mid Z(\omega) \in A\}). \quad (47)$$

**Assumption 2.** *Fix some non-trivial and complete preference relation  $\preceq$  on  $L^0(\mu)$  and suppose that there exists some real-valued  $U$  such that, for all  $X, Y \in L^0(\mu)$ ,*

$$X \preceq Y \text{ iff } U(F_X) \leq U(F_Y). \quad (48)$$

For a sequence of random variables  $\{Y_k\}_{k \in \mathbb{N}}$  we write  $F_{Y_k} \Rightarrow F_Y$  whenever the  $Y_k$  *converge in distribution* to  $Y$ , i.e., whenever the cumulative distribution functions (=cdf)

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<sup>17</sup>The majority of utility representations reduces preferences over random variables to preferences over distributions. Notable exceptions are *state-dependent utility models*. For a good textbook treatment of state-dependent expected utility see Chapter 6.E in Mas-Collel et al. (1995). For a recent overview on objective and subjective models with state-dependent utility see Karni and Schmeidler (2016) and references therein.



of the  $Y_k$  converge weakly to the cdf of  $Y$ .<sup>18</sup> We say that  $U$  is continuous in distribution if  $F_{Y_k} \Rightarrow F_Y$  implies  $\lim_k U(F_{Y_k}) = U(F_Y)$ .

**Proposition 5.** *Suppose that Assumption 2 holds.  $U$  is continuous in distribution if, and only if,  $\preceq$  is  $\mu$ -continuous.*

Most decision-theoretic applications are concerned with the maximization of utility functions over distributions whereby—mainly out of analytical convenience—these utility functions are supposed to be continuous. By Proposition 5, such analytical convenience would not be at hand without  $\mu$ -continuity.

## 6.2 $L^p(\mu)$ spaces and the $d_0$ -metric

Beyond the mere mathematical definition of continuity there is also a behavioral interpretation of what it means that a decision maker has ‘continuous preferences’. According to this behavioral interpretation of continuity, preferences should not abruptly switch in the limit of converging random variables. A good behavioral concept of continuity should therefore be based on a behaviorally plausible concept of convergence that closely captures what real-life decision makers may perceive as convergence of random variables.

Let us consider the familiar  $L^p(\mu)$  spaces with  $1 \leq p \leq \infty$  which only contain random variables that come with an expected value.<sup>19</sup> The standard topology imposed on these spaces is generated by the  $L_p$ -norm

$$\|X\|_p = \begin{cases} [\int_{\Omega} |X|^p d\mu]^{\frac{1}{p}} & \text{for } 1 \leq p < \infty \\ \inf \{\alpha \in [0, \infty) \mid \mu(\{\omega \in \Omega \mid |X(\omega)| > \alpha\}) = 0\} & \text{for } p = \infty \end{cases} \quad (49)$$

with corresponding metric

$$d_p(X, Y) = \|X - Y\|_p \text{ for all } X, Y \in L^p(\mu). \quad (50)$$

Arguably, most decision-theorists would agree that convergence in the  $d_p$ -metric is a behaviorally plausible notion for the convergence behavior of random variables in  $L^p(\mu)$ .

When we move from an  $L^p(\mu)$  space to the large  $L^0(\mu)$  space, where the metric  $d_p$  is no longer available in general, it would be desirable to have a metric for  $L^0(\mu)$

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<sup>18</sup>Denote by  $CDF_Z$  the cdf of  $Z$ , formally defined as

$$CDF_Z(x) \equiv F_Z(-\infty, x] \text{ for all } x \in \mathbb{R}.$$

The  $CDF_{Y_k}$  converge weakly to the  $CDF_Y$  iff  $CDF_{Y_k}(x) \rightarrow CDF_Y(x)$  for all  $x$  such that  $\mu(Y = x) = 0$ ; (for more details see Chapter 14 in Billingsley 1995).

<sup>19</sup>For properties of  $L^p(\mu)$  spaces with  $1 \leq p \leq \infty$  see Section 19 in Billingsley (1995).

that guarantees for any sequence  $\{Y_k\}_{k \in \mathbb{N}} \subset L^p(\mu)$  the same convergence behavior in  $L^0(\mu)$  as under the  $d_p$ -metric. The following proposition shows that the  $d_0$ -metric is accomplishing this task.

**Proposition 6.** *Fix some  $L^p(\mu)$  space with  $1 \leq p \leq \infty$ . Convergence in the  $d_p$ -metric implies convergence in the  $d_0$ -metric, i.e.,*

$$d_p(Y_k, Y) \rightarrow 0 \text{ implies } d_0(Y_k, Y) \rightarrow 0. \quad (51)$$

### 6.3 Alternative topologies that establish compatibility between convexity and continuity

To see that it is actually trivial to ensure compatibility of convexity with some notion of mathematical continuity, let us first consider the *discrete topology* on  $L^0(\mu)$  generated by the discrete metric  $d^D : L^0(\mu) \times L^0(\mu) \rightarrow [0, 1]$  such that

$$d^D(X, Y) = \begin{cases} 0 & X = Y, \mu\text{-a.e.} \\ 1 & \text{else.} \end{cases} \quad (52)$$

In this topology all subsets of  $L^0(\mu)$  are closed to the effect that convexity and  $d^D$ -continuity are compatible. To impose  $d^D$ -continuity, however, comes with the drawback that the corresponding notion of convergence is behaviorally not very plausible.

**Example 8.** [Convergence under  $d^D$ -continuity]. Let us revisit the lexicographic preferences of Example 6 which satisfy convexity but violate  $\mu$ -continuity. These (like any other) preferences trivially satisfy  $d^D$ -continuity because only (eventually) constant sequences of random variables converge under the discrete topology. For the random variables

	$E_1$	$E_2$
$Y_k$	$1 - \frac{1}{k}$	1
$Y$	1	1

we can thus have under  $d^D$ -continuity that  $Y_k \prec X$  for all  $k$  as well as  $X \prec Y$  because the  $Y_k$  no longer converge to  $Y$ , i.e.,

$$\lim_{k \rightarrow \infty} d^D(Y_k, Y) = 1. \quad (53)$$

Arguably, most real-life decision makers would judge that (or: behave as if) the  $Y_k$  were increasingly resembling  $Y$  for larger  $k$  whereby the difference between the  $Y_k$  and  $Y$

becomes negligible in the limit. But then any behaviorally relevant concept of continuity should be based on the notion that the  $Y_k$  are indeed converging to  $Y$ , which is not the case under  $d^D$ -continuity.  $\square$

The discrete topology stands for the largest topology under which any given convex preference relation over equivalence classes of random variables becomes continuous. Alternatively, we might consider the smallest topology under which a given convex preference relation becomes continuous. More precisely, fix some convex preference relation  $\preceq$  and introduce the smallest topology whose closed sets consist of a basis given by super- and sub-level sets  $s(X), S(X), \forall X \in L^0(\mu)$ . Indeed, this topology is the smallest topology under which  $\preceq$  is continuous and it is also included in any such topology. However, the same criticism as under Example 8 applies: Making the (convex) lexicographic preferences of Example 6 continuous is incompatible with any topology in which  $Y$  belongs to some closed set containing all  $Y_k$ . As in the case of the discrete topology, the notion of convergence required to make the preferences of Example 6 continuous is therefore not plausible from a behavioral perspective.

So far we have considered topologies that treat random variables which coincide  $\mu$ -almost everywhere as identical objects. If we are prepared to give up this notion of equivalence classes of random variables, preference relations on  $L^0(\mu)$  become possible that can combine convexity with mathematical continuity.

**Example 9.** [Abandoning equivalence classes of  $\mu$ -a.e. random variables]. Let  $\Omega = [0, 1)$  and consider the (non-metrizable) topology of pointwise convergence:

$$\text{for any net } X_\lambda \rightarrow X \text{ iff } X_\lambda(\omega) \rightarrow X(\omega), \forall \omega \in [0, 1). \quad (54)$$

For any  $\omega \in [0, 1)$ ,  $f_\omega(X) = X(\omega)$  is a continuous functional in this topology. Consequently, for any fixed  $\omega \in [0, 1)$ , the complete preference relation  $\preceq$  defined by

$$X \prec Y \text{ iff } X(\omega) < Y(\omega) \quad (55)$$

is continuous with respect to pointwise convergence. Obviously, this preference relation is also convex.  $\square$

Under our assumption of a nonatomic  $\mu$ , the preferences described under Example 9 belong to a decision maker who cares about probability zero events. One possible view is that such preferences are problematic as a decision maker should treat random variables as identical objects in case they are identical almost everywhere. However, the opposite view is also viable. An anonymous referee writes: “A good deal of the theory of

decision making under ambiguity relies on the fact that a "measure-zero event", e.g., a catastrophic event, may matter for the decision maker." The following example describes a continuous and linear utility representation for a decision maker who cares about a catastrophic (measure zero) event.

**Example 10.** [Catastrophic event]. As before we consider a nonatomic probability space  $(\Omega, \Sigma, \mu)$  whereby we now assume that  $\{0\} \subset \Omega$  is the catastrophic event. Endow the set of all  $\Sigma$ -measurable random variables with the new metric

$$d_\lambda(X, Y) = (1 - \lambda) d_0(X, Y) + \lambda \frac{|X(0) - Y(0)|}{1 + |X(0) - Y(0)|} \quad (56)$$

for a fixed  $\lambda \in (0, 1)$ . We denote this metric space by  $L_c^0(\mu)$ . In contrast to the space  $L^0(\mu)$ —where  $X, Y \in L^0(\mu)$  are identical iff  $X = Y$ ,  $\mu$ -a.e.— $X, Y \in L_c^0(\mu)$  are identical iff  $X(0) = Y(0)$  and  $X = Y$ ,  $\mu$ -a.e. on  $\Omega \setminus \{0\}$ . Consider now any complete preferences on  $L_c^0(\mu)$  that satisfy, for all  $X, Y \in L_c^0(\mu)$ ,

$$X(0) < Y(0) \text{ and } X = Y, \mu\text{-a.e. on } \Omega \setminus \{0\} \text{ implies } X \prec Y. \quad (57)$$

That is, although the event  $\{0\}$  has measure zero the decision maker cares about the outcomes in this event.

We claim that any existing  $d_\lambda$ -continuous linear utility representation of complete preferences on  $L_c^0(\mu)$  satisfying (57) must be of the form  $U(Y) = cY(0)$  where  $c > 0$ . The argument is as follows. Suppose that there exists some  $d_\lambda$ -continuous linear functional  $\delta$  on  $L_c^0(\mu)$ . Fix  $\delta$  and introduce  $\gamma : L^0(\mu) \rightarrow \mathbb{R}$  such that  $\gamma(Y) = \delta(Y - 1_{\{0\}}Y(0))$ . Observe that  $\gamma$  is linear as well as  $\mu$ -continuous on  $L^0(\mu)$ . But then  $\gamma(Y) = 0$  for all  $Y$  as  $\gamma$  must be the null-functional (cf. Remark 2). Consequently, we have for any  $Y$  that  $\delta(Y - 1_{\{0\}}Y(0)) = 0$  so that, by assumed linearity of  $\delta$ ,

$$\delta(Y) = \delta(1_{\{0\}})Y(0). \quad (58)$$

First note that  $\delta$  given by (58) is indeed  $d_\lambda$ -continuous and linear on  $L_c^0(\mu)$  so that there exists a  $d_\lambda$ -continuous and linear functional on  $L_c^0(\mu)$  whenever it is of the form (58). Moreover, because the  $d_\lambda$ -continuous linear functional  $\delta$  was chosen arbitrarily any existing  $d_\lambda$ -continuous and linear functional on  $L_c^0(\mu)$  must be of the form (58). In other words, there exists a  $d_\lambda$ -continuous and linear functional  $\delta$  on  $L_c^0(\mu)$  if, and only if,  $\delta$  is of the form (58). Next, by setting  $U = \delta$  and  $c \equiv \delta(1_{\{0\}})$  in (58) we obtain

$$U(Y) = cY(0). \quad (59)$$

Observe that if  $U$  represents preferences satisfying (57), we must have that  $c > 0$ . Consequently, if there exists any  $d_\lambda$ -continuous and linear utility representation  $U$  of

complete preferences on  $L_c^0(\mu)$  satisfying (57), we must equivalently have that

$$X \prec Y \text{ iff } X(0) < Y(0). \quad (60)$$

Complete preferences on  $L_c^0(\mu)$  satisfying (57) can thus only be represented by some  $d_\lambda$ -continuous and linear utility functional if nothing else but the payoff in the catastrophic event matters.  $\square$

**Remark 11.** Examples 9 and 10 also demonstrate why the assumption of a nonatomic measure space is crucial to our incompatibility results. Suppose, e.g., that we have in Example 10  $\mu'$  instead of  $\mu$  such that  $\mu'$  has exactly one atom at  $\{0\}$  with  $\mu'(0) > 0$  whereas, for all  $A \in \Sigma$  with  $A \subseteq \Omega \setminus \{0\}$ ,  $\mu'(A) = (1 - \mu'(0))\mu(A)$ . Then the preferences of Example 10 represented by (59) are linear (i.e., weakly convex) as well as  $\mu'$ -continuous on  $L_0(\mu')$  because the metric (4) becomes for  $\mu'$

$$d_0(X, Y; \mu') = \int_{\Omega \setminus \{0\}} \frac{|X - Y|}{1 + |X - Y|} d\mu' + \frac{|X(0) - Y(0)|}{1 + |X(0) - Y(0)|} \mu'(0) \quad (61)$$

$$= (1 - \mu'(0)) d_0(X, Y; \mu) + \mu'(0) \frac{|X(0) - Y(0)|}{1 + |X(0) - Y(0)|}, \quad (62)$$

which coincides for  $\lambda = \mu'(0)$  with the metric (56) on  $L_c^0(\mu)$  so that  $d_\lambda$ -continuity on  $L_c^0(\mu)$  in Example 10 is equivalent to  $\mu'$ -continuity on  $L_0(\mu')$ .

## Appendix: Formal proofs

**Proof of Proposition 1.** Let  $L$  be a convex subset of  $L^0(\mu)$  with non-empty interior and suppose that  $Y \in L^0(\mu)$  belongs to the interior of  $L$ . Fix some  $\epsilon > 0$  such that  $Y' \in L$  requires  $d_0(Y, Y') \leq \epsilon$ . Pick some partition  $\{\Omega_1, \dots, \Omega_n\} \subset \Sigma$  of  $\Omega$  such that  $\mu(\Omega_i) \leq \epsilon, i = 1, \dots, n$ , which always exists for nonatomic  $\mu$ .

Choose  $X \in L^0(\mu)$  arbitrarily and introduce  $Y_i = Y + n(X - Y)1_{\Omega_i}$  where  $1_{\Omega_i}$  denotes the indicator function on  $\Omega_i$ . For any  $i = 1, \dots, n$  we have

$$d_0(Y, Y_i) = \int_{\Omega} \frac{|Y - Y_i|}{1 + |Y - Y_i|} d\mu = \int_{\Omega} \frac{|n(X - Y)1_{\Omega_i}|}{1 + |n(X - Y)1_{\Omega_i}|} d\mu \quad (63)$$

$$= \int_{\Omega} \frac{|n(X - Y)|}{1 + |n(X - Y)|} 1_{\Omega_i} d\mu \quad (64)$$

$$< \int_{\Omega} 1_{\Omega_i} d\mu = \mu(\Omega_i) \leq \epsilon. \quad (65)$$

As a consequence, we can now assume that  $Y_i \in L$  for all  $i = 1, \dots, n$ .

Next note that

$$\frac{1}{n} \sum_{i=1}^n Y_i = Y + \sum_{i=1}^n (X - Y)1_{\Omega_i} \quad (66)$$

$$= Y + X - Y. \quad (67)$$

By convexity of  $L$ , we thus have

$$X = \frac{1}{n}Y_1 + \dots + \frac{1}{n}Y_n \in L. \quad (68)$$

Since  $X \in L^0(\mu)$  was chosen arbitrarily, we obtain  $L = L^0(\mu)$ . This also justifies our assumption that  $Y_i \in L$  for all  $i = 1, \dots, n$ , which proves the Proposition.  $\square\square$

**Proof of Theorem 1.** Ad part (a).

**Step 1.** Suppose that  $S(X)$  is convex for some  $X$  such that  $Y \prec X$  and  $X \prec Z$ , which exists by non-triviality. Because of  $Y \prec X$ , we have  $Y \notin S(X)$  which implies  $S(X) \neq L^0(\mu)$ . By Proposition 1,  $S(X)$  must thus have an empty interior with respect to the topology of convergence in probability on  $L^0(\mu)$ .

**Step 2.** By non-triviality, we also have that the set

$$S^*(X) \equiv \{X' \in L^0(\mu) \mid X \prec X'\} \subset S(X) \quad (69)$$

is non-empty because of  $Z \in S^*(X)$ .

**Step 3.** Combining Step 1 and Step 2 establishes that  $S^*(X)$  cannot be an open set in the topology of convergence in probability. However, by completeness,

$$s(X) = L^0(\mu) \setminus S^*(X) \quad (70)$$

so that  $s(X)$  cannot be a closed set, which contradicts  $\mu$ -continuity.  $\square$

Ad part (b). Just observe that non-triviality implies (i), by  $s(X) \neq L^0(\mu)$  and Proposition 1, that  $s(X)$  has an empty interior as well as (ii) non-emptiness of

$$s^*(X) \equiv \{X' \in L^0(\mu) \mid X' \prec X\} \subset s(X). \quad (71)$$

By an analogue argument as under Step 3, the set

$$S(X) = L^0(\mu) \setminus s^*(X) \quad (72)$$

is thus not closed.  $\square$

Ad part (c). The validness of this statement is demonstrated through the examples in Section 5.  $\square\square$

**Proof of Proposition 2.** We prove part (a). If  $S(X) = \{X\}$  there is nothing to prove so let us assume that  $Y, Z \in S(X)$  with  $Y \neq Z$ . Without loss of generality, suppose that, by completeness,  $Y \preceq Z$ . If quasi-concavity holds, we have  $Y \preceq \alpha Z + (1 - \alpha)Y$ . Finally, since  $X \preceq Y$ , transitivity implies  $X \preceq \alpha Z + (1 - \alpha)Y$ .  $\square\square$

**Proof of Theorem 3.** By Theorem 2 it is sufficient to show that quasi-concave preferences follow from preference for diversification under the assumptions of Theorem 3.

**Step 1.** Without loss of generality, suppose that  $X \preceq Y$  with  $X \neq Y$  (again: if  $S(X) = \{X\}$ , we don't have anything to prove). We have to show that preference for diversification implies

$$X \preceq \alpha X + (1 - \alpha)Y \quad (73)$$

for  $\alpha \in [0, 1]$ . If  $X \sim Y$ , we immediately obtain (73). So, let us assume  $X \prec Y$ .

**Step 2.** Because any metric is continuous (3.16 Theorem in Aliprantis and Border 2006), we obtain:

**Lemma 1.** *Fix some  $\epsilon \geq 0$ . For any  $X, Y \in L^0(\mu)$ , there exists some  $\delta > 0$  such that*

$$d_0(q'X + (1 - q')Y, qX + (1 - q)Y) \leq \epsilon \quad (74)$$

*for all  $|q' - q| \leq \delta$ .*

**Step 3.** Introduce

$$q^* = \max \{q \in [0, 1] \mid X \preceq \alpha X + (1 - \alpha)Y, \forall \alpha \in [0, q]\}. \quad (75)$$

By transitivity, we have

$$X \preceq \alpha X + (1 - \alpha) Y \quad (76)$$

iff  $\alpha \in [0, q^*]$ . If  $q^* = 1$ , we have the desired result (73). Suppose now  $0 \leq q^* < 1$ . By  $X \prec Y$ ,  $d_0$ -continuity and completeness implies that the set

$$S^*(X) \equiv \{Z \in L^0(\mu) \mid X \prec Z\} \quad (77)$$

is open. Consequently, there exists some number  $\epsilon > 0$  such that  $d_0(Y, Z) \leq \epsilon$  implies  $X \prec Z$ , i.e.,  $Z \in S^*(X)$ . By Lemma 1, there exists some  $\delta > 0$  such that  $d_0(Y, \alpha X + (1 - \alpha) Y) \leq \epsilon$  for all  $\alpha \leq \delta$ . Consequently, for all  $\alpha \leq \delta$ ,  $X \prec \alpha X + (1 - \alpha) Y$  implying  $q^* \geq \delta > 0$ . That is, we can henceforth assume that  $0 < q^* < 1$ .

**Step 4.** We claim that  $q^* < 1$  implies  $X \sim q^* X + (1 - q^*) Y$ . We prove this claim by way of contradiction. First, suppose that  $X \prec q^* X + (1 - q^*) Y$ . By Lemma 1 and openness of the set  $S^*(X)$ , there exists some  $\delta > 0$  such that

$$d_0\left(q' X + (1 - q') Y, q^* X + (1 - q^*) Y\right) \leq \epsilon \quad (78)$$

for all  $|q' - q^*| \leq \delta$ . Let  $q' = \min\{1, q^* + \frac{1}{2}\delta\}$  and observe that  $q' > q^*$  as well as  $X \prec q' X + (1 - q') Y$ . But this contradicts the definition of  $q^*$ .

Next, suppose that  $X \succ q^* X + (1 - q^*) Y$ . An analogous argument as above results in some  $q'$  such that  $q' < q^*$  as well as  $q' X + (1 - q') Y \prec X$ . Again, a contradiction to the definition of  $q^*$ .

**Step 5.** In Step 4 we have proven that  $X \sim q^* X + (1 - q^*) Y$  whenever  $q^* < 1$ . By preference for diversification, we thus obtain

$$X \preceq \beta X + (1 - \beta) (q^* X + (1 - q^*) Y) \quad (79)$$

$$\Leftrightarrow$$

$$X \preceq (\beta + (1 - \beta) q^*) X + (1 - \beta) (1 - q^*) Y \quad (80)$$

for all  $\beta \in [0, 1]$ . By definition of  $q^*$ ,

$$\beta + (1 - \beta) q^* \leq q^* \quad (81)$$

for all  $\beta \in [0, 1]$ , which only holds for  $q^* = 1$ . But this contradicts  $q^* < 1$  and gives us the desired result (73).  $\square\square$

**Proof of Proposition 4.**  $\mu$ -continuity of preferences is violated if, and only if, there exists some sequence of random variables  $\{Y_k\}_{k \in \mathbb{N}}$  with  $d_0(Y_k, Y) \rightarrow 0$  such that  $X \preceq Y_k$  for all  $k$  but  $Y \prec X$ . By Assumption 1, we then have that  $U(X) \leq U(Y_k)$  for all  $k$  and  $U(Y) < U(X)$ , which violates  $\mu$ -continuity of  $U$ . Consequently,  $\mu$ -continuity



of  $U$  requires  $\mu$ -continuity of preferences. Moreover, by Assumption 1, quasi-concave (resp. quasi-convex) preferences require a quasi-concave (resp. quasi-convex)  $U$ . The proposition then follows from Theorem 2.  $\square\square$

**Proof of Corollary 2.** Suppose that  $\nu$  is convex and  $u$  is concave. By Proposition 3 (iii) in Schmeidler (1986), convexity of  $\nu$  implies super-additivity of the Choquet integral, i.e., we have

$$E^C(b + c) \geq E^C(b) + E^C(c) \quad (82)$$

for real-valued functions  $b$  and  $c$  whenever these Choquet integrals exist. Applied to an CEU representation convexity of  $\nu$  thus implies, for any  $\lambda \in [0, 1]$  and all  $X, Y \in L^0(\mu)$ ,

$$E^C(\lambda u(X) + (1 - \lambda)u(Y)) \geq E^C(\lambda u(X)) + E^C((1 - \lambda)u(Y)) \quad (83)$$

$$= \lambda E^C(u(X)) + (1 - \lambda) E^C(u(Y)) \quad (84)$$

whereby the last equality follows because the Choquet integral is homogeneous of degree one. By concavity of  $u$ , for all  $\omega$ ,

$$u(\lambda X(\omega) + (1 - \lambda)Y(\omega)) \geq \lambda u(X(\omega)) + (1 - \lambda)u(Y(\omega)) \quad (85)$$

so that monotonicity of the Choquet integral implies

$$E^C(u(\lambda X + (1 - \lambda)Y)) \geq E^C(\lambda u(X) + (1 - \lambda)u(Y)). \quad (86)$$

Combining the above inequalities gives

$$E^C(u(\lambda X + (1 - \lambda)Y)) \geq \lambda E^C(u(X)) + (1 - \lambda) E^C(u(Y)) \text{ for all } X, Y \in L^0(\mu). \quad (87)$$

For all  $X, Y \in L^0(\mu)$  such that  $E^C(u(X)) \geq E^C(u(Y))$ , we obtain from (87) that

$$E^C(u(\lambda X + (1 - \lambda)Y)) \geq E^C(u(Y)), \quad (88)$$

which is the definition of a quasi-concave  $E^C(u(\cdot))$ . Collecting the above arguments gives Corollary 2 (the argument for quasi-convexity proceeds analogously).  $\square\square$

**Proof of Proposition 5.** The ‘if’-part is easy since convergence in the  $d_0$ -metric implies convergence in distribution; that is,  $d_0(Y_k, Y) \rightarrow 0$  implies  $F_{Y_k} \Rightarrow F_Y$  (cf., e.g., Theorem 25.2 in Billingsley 1995).

The ‘only if’ part is less obvious as convergence in distribution on the same probability space does not necessarily imply convergence in the  $d_0$ -metric. Suppose that  $F_{Y_k} \Rightarrow F_Y$ . Then  $F_{Y_k}^{-1}$  converges point-wise to  $F_Y^{-1}$  where, for any  $Z$ ,  $F_Z^{-1}$  denotes the left

inverse of  $CDF_Z$ . Let us fix a uniform random variable  $V$  on  $(0, 1)$  which exists because the probability space is nonatomic. By construction, the random variable  $F_Z^{-1}(V)$  has the same distribution as the random variable  $Z$ , implying, by (48),  $F_{Y_k}^{-1}(V) \sim Y_k$  and  $F_Y^{-1}(V) \sim Y$ . Since the  $F_{Y_k}^{-1}(V)$  converge point-wise to  $F_Y^{-1}(V)$ , they also converge in probability (i.e., in  $d_0$ ). By law-invariance of  $U$ , we thus have

$$\lim_k U(Y_k) = \lim_k U(F_{Y_k}^{-1}(V)) = U(F_Y^{-1}(V)) = U(Y). \quad (89)$$

□□

**Proof of Proposition 6.** Suppose that  $f \in L^p(\mu)$  and  $g \in L^q(\mu)$  with either  $\frac{1}{p} + \frac{1}{q} = 1$  or  $p = \infty, q = 1$ . By Hölder's inequality, we have that

$$\int_{\Omega} |f \cdot g| d\mu \leq \|f\|_p \cdot \|g\|_q. \quad (90)$$

For any  $X, Y \in L^p(\mu)$ , let

$$f \equiv |X - Y|, \quad (91)$$

$$g \equiv \frac{1}{1 + |X - Y|} \quad (92)$$

so that (90) becomes

$$d_0(X, Y) \leq d_p(X, Y) \cdot \|g\|_q. \quad (93)$$

Since  $\|g\|_q \leq 1$ , convergence in  $d_p$  implies convergence in  $d_0$  on  $L^p(\mu)$ . □□

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