Structured Ambiguity and Model Misspecification*

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Abstract

A decision maker is averse to not knowing a prior over a set of restricted *structured* models (ambiguity) and suspects that each structured model is misspecified. The decision maker evaluates intertemporal plans under all of the structured models and, to recognize possible misspecifications, under *unstructured* alternatives that are statistically close to them. Likelihood ratio processes are used to represent unstructured alternative models, while relative entropy restricts a set of unstructured models. A set of structured models might be discrete or it might be indexed by a finite-dimensional vector of unknown parameters; parameters could vary over time in ways that a decision maker might not be able to describe probabilistically. We model such a decision maker with a dynamic version of variational preferences and revisit topics including dynamic consistency and admissibility.

Keywords— Ambiguity; misspecification; relative entropy; robustness; variational preferences; structured and unstructured models

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In what circumstances is a minimax solution reasonable? I suggest that it is reasonable if and only if the least favorable initial distribution is reasonable according to your body of beliefs. Irving J. Good (1952)

Now it would be very remarkable if any system existing in the real world could be exactly represented by any simple model. However, cunningly chosen parsimonious models often do provide remarkably useful approximations. George Box (1979)

1 Introduction

We describe a decision maker who expresses George Box's idea that models are approximations by constructing a set of probabilities in two steps, first by specifying a set of more or less tightly parameterized *structured* models with either fixed or time-varying parameters, then by adding statistically nearby *unstructured* models. Unstructured models can be described incompletely in the sense that they are required only to reside within a statistical neighborhood of the set of structured models, as measured by relative entropy.[1] We create a set of probability distributions for a cautious decision maker of a type described by Wald (1950) and axiomatized in different ways by Gilboa and Schmeidler (1989) and Maccheroni et al. (2006a,b) by starting with mixtures of structured models.[2] Alternative mixture weights are different Bayesian priors that the decision maker thinks are possible. We distinguish *ambiguity* about what weight to assign to the structured models from concerns about *misspecification* of the structured models that a decision maker manages by evaluating plans under statistically nearby unstructured alternatives.

We use the dynamic variational extension of max-min preferences created by Maccheroni et al. (2006a,b) to express aversions to two distinct components of ignorance – *ambiguity*

[1] Itzhak Gilboa suggested to us that there is a connection between our distinction between structured and unstructured models and the contrast that Gilboa and Schmeidler (2001) draw between rule-based and case-based reasoning. We find that possible connection intriguing but defer formalizing it to subsequent research. We suspect that our structured models could express Gilboa and Schmeidler's notion of rule-based reasoning, while our unstructured models resemble their case-based reasoning. But our approach here differs from theirs because we proceed by modifying an approach from robust control theory that seeks to acknowledge misspecifications of structured models while avoiding the flexible estimation methods that would be required to construct better statistical approximations that might be provided by unstructured models.

[2] Thus, by "structured" we don't mean what econometricians in the Cowles commission and rational expectations traditions call "structural" to distinguish them from "atheoretical" models.

about a prior over a set of structured models and *misspecification* fears about the structured models. In doing so, we substantially modify and extend Hansen and Sargent (2001) and Anderson et al. (2003). Hansen and Sargent (2019) provide applications of our new framework that bring new sources of variations in resource allocations and valuations in macro-finance models. In section 2, we describe a statistical decision theoretic concept called admissibility. We describe a characterization of admissible decision rules that allows us to implement a suggestion of Good that is often used as part of robust Bayesian analysis and is cited in the quote at the start of this paper. In section 2, we describe a tension that can exist between admissibility and dynamic consistency within the Gilboa and Schmeidler (1989) framework and a procedure of Epstein and Schneider (2003) that assures dynamic consistency by expanding a pre-specified set of models to create a "rectangular" set of models. We indicate how in our context their procedure sets up what is sometimes an irreconcilable tension with admissibility. We also argue that rectangularity gives unreasonable outcomes when used to entertain model misspecification and explain how that motivates us to use a version of dynamic variational preferences.

2 Decision theory components

Our model strikes a balance among three attractive but potentially incompatible preference properties, namely, (i) dynamic consistency, (ii) a statistical decision-theoretic concept called *admissibility*, and (iii) a capacity to express concerns that models are misspecified. Since we are interested in intertemporal decision problems, we like recursive preferences that automatically exhibit dynamic consistency. But our decision maker wants admissibility because he wants worst-case probabilities to be plausible possibilities. Within the confines of the max-min utility formulation of Gilboa and Schmeidler (1989), we describe (a) situations in which dynamic consistency and admissibility coexist;[3] and (b) other situations in which admissibility prevails but a decision maker's preferences are not dynamically consistent except in degenerate and uninteresting special cases. Type (b) situations include ones in which the decision maker is concerned about misspecifications that he describes in terms of relative entropy. Because we want to include type (b) situations, we use a version of the variational preferences of Maccheroni et al. (2006a,b) that reconcile dynamic consistency with admissibility. We now discuss reasoning that led us to adopt our version of variational preferences.

[3]These are also situations in which a decision maker has no concerns about model misspecification.

2.1 Dynamic consistency and admissibility can coexist

Let $\mathfrak{F} = \{\mathfrak{F}_t : t \geqslant 0\}$ be a filtration that describes information available at each $t \geqslant 0$. A decision maker evaluates *plans* or *decision processes* that are restricted to be progressively measurable with respect to $\mathfrak{F}$. A structured model indexed by parameters $\theta \in \Theta$ assigns probabilities to $\mathfrak{F}$, as do mixtures of structured models. Alternative mixing distributions can be interpreted as different possible priors over structured models. An admissible decision rule is one that cannot be weakly dominated by another decision rule for all $\theta \in \Theta$ while it is strictly dominated by that other decision rule for some $\theta \in \Theta$.

A Bayesian decision maker completes a probability specification by choosing a unique prior over a set of structured models.

Condition 2.1. *Suppose that for each possible probability specification over $\mathfrak{F}$ implied by a prior over the set of structured models, a decision problem has the following two properties:*

(i.) a unique plan solves a time 0 maximization problem, and

(ii.) for each $t > 0$, the time t continuation of that plan is the unique solution of a time t continuation maximization problem.

A plan with properties (i) and (ii) is said to be dynamically consistent. The plan typically depends on the prior over structured models.

A "robust Bayesian" evaluates plans under a nontrivial set of priors. By verifying applicability of the Minimax Theorem that justifies exchanging the order of maximization and minimization, a max-min expected utility plan that emerges from applying the max-min expected utility theory axiomatized by Gilboa and Schmeidler (1989) can be interpreted as an expected utility maximizing plan under a unique Bayesian prior, namely, the worst-case prior; this plan is therefore admissible.[4] Thus, after exchanging orders of extremization, the outcome of the outer minimization is a worst-case prior for which the max-min plan is "optimal" in a Bayesian sense. Computing and assessing the plausibility of a worst-case prior are important parts of a robust Bayesian analysis. Good (1952) referred to such a worst-case prior in the above quote. Admissibility and dynamic consistency under this worst-case prior follow because the assumptions of condition 2.1 hold.

[4]See Fan (1952).

2.2 Dynamic consistency and admissibility can conflict

But dynamic consistency under a worst-case prior does *not* imply that max-min expected utility preferences are dynamically consistent, for it can happen that if we replace "maximization problem" with "max-min problem" in item (i) in condition 2.1, then the counterpart of assertion (ii) can fail to hold. In this case, the extremizing time 0 plan is dynamically inconsistent. For many ways of specifying sets of probabilities, max-min expected utility preferences are dynamically inconsistent, an undesirable feature of preferences that Sarin and Wakker (1998) and Epstein and Schneider (2003) noted. Sarin and Wakker offered an enlightening example of restrictions on probabilities that restore dynamic consistency for max-min expected utility. Epstein and Schneider analyzed the problem in more generality and described a "rectangularity" restriction on a set of probabilities that suffices to assure this dynamic consistency.

To describe the rectangularity property, it is convenient temporarily to consider a discrete-time setting in which $\epsilon = \frac{1}{2^j}$ is the time increment. We will drive $j \rightarrow +\infty$ in our study of continuous-time approximations. Let p_t be a conditional probability measure for date $t + \epsilon$ events in $\mathfrak{F}_t$ conditioned on the date t sigma algebra $\mathfrak{F}_t$. By the product rule for joint distributions, date zero probabilities for events in $\mathfrak{F}_{t+\epsilon}$ can be represented by a "product" of conditional probabilities $p_0, p_\epsilon, ...p_t$. For a family of probabilities to be rectangular, it must have the following representation. For each t, let $\mathcal{P}_t$ be a pre-specified family of probability distributions p_t conditioned on $\mathfrak{F}_t$ over events in $\mathfrak{F}_{t+\epsilon}$. The rectangular set of probabilities $\mathcal{P}$ consists all of those that can be expressed as products $p_0, p_\epsilon, p_{2\epsilon}, ...$ where $p_t \in \mathcal{P}_t$ for each $t = 0, \epsilon, 2\epsilon, ...$ Such a family of probabilities is called rectangular because the restrictions are expressed in terms of the building block sets $\mathcal{P}_t, t = 0, \epsilon, 2\epsilon, \ldots$ of conditional probabilities.

A pre-specified family of probabilities $\mathcal{P}^o$ need not have a rectangular representation. For a simple example, suppose that there is a restricted family of date zero priors over a finite set of models where each model gives a distribution over future events in $\mathfrak{F}_t$ for all $t = \epsilon, 2\epsilon, ...$ Although for each prior we can construct a factorization via the product rule, we cannot expect to build the corresponding sets $\mathcal{P}_t$ that are required for a rectangular representation. The restrictions on the date zero prior do not, in general, translate into separate restrictions on $\mathcal{P}_t$ for each t. If, however, we allow all priors over models with a nonnegative probabilities that sum to one (a very large set), then this same restriction carries over to the implied family of posteriors and the resulting family of probabilities models will be rectangular.

2.3 Engineering dynamic consistency through set expansion

Since an initial subjectively specified family $\mathcal{P}^o$ of probabilities need not be rectangular, Epstein and Schneider (2003) show how to extend an original family of probabilities to a larger one that is rectangular. This delivers what they call a recursive multiple priors framework that satisfies a set of axioms that includes dynamic consistency. We briefly describe and discuss their construction.

For each member of the family of probabilities $\mathcal{P}^o$, construct the factorization $p_0, p_\epsilon, ...$ Let $\mathcal{P}_t$ be the set of all of the p_t's that are show up in these factorizations. Use this family of $\mathcal{P}_t$'s as the building blocks for an augmented family of probabilities that is rectangular. The idea is to make sure that each member of the rectangular set of augmented probabilities can be constructed as a product of p_t that belong to the set of conditionals for that date t associated with *some* member of the original set of probabilities $\mathcal{P}^o$, not necessarily the *same* member for all t. A rectangular set of probabilities constructed in this way can contain probability measures that are not in the original set $\mathcal{P}^o$. Epstein and Schneider's (2003) axioms lead them to use this larger set of probabilities to represent what they call recursive multiple prior preferences. In recommending this expanded set of probabilities for use with a max-min decision theory, Epstein and Schneider distinguish between an original subjectively specified original set of probabilities that we call $\mathcal{P}^o$, and that they call $\mathcal{P}rob$, and the expanded rectangular set of probabilities that they and we call $\mathcal{P}$. They make

> . . . an important conceptual distinction between the set of probability laws that the decision maker views as possible, such as $\mathcal{P}rob$, and the set of priors $\mathcal{P}$ that is part of the representation of preference.

Thus, regardless of whether they are subjectively or statistically plausible, Epstein and Schneider augment a decision maker's set of "possible" probabilities (i.e., their $\mathcal{P}rob$) with enough additional probabilities to create an enlarged set that is rectangular, $\mathcal{P}$. In this way, their recursive probability augmentation procedure constructs dynamically consistent preferences. But it does so by adding possibly implausible probabilities. That means that a max-min expected utility plan can be inadmissible with respect to the decision maker's original set of possible probabilities $\mathcal{P}^o$. Applying the Minimax Theorem to a rectangular embedding $\mathcal{P}$ of an original subjectively interesting set of probabilities $\mathcal{P}^o$ can yield a worst-case probability that the decision maker regards as implausible because it is not within his original set of probabilities.

These issues affect the enterprise in this paper in the following ways. If (a) a family of probabilities constructed from structured models is rectangular; or (b) it turns out that max-min decision rules under that set and an augmented rectangular set of probabilities are identical, then Good's plausibility criterion is available. Section 5 provides examples of such situations in which a max-min expected utility framework could work, but they exclude the concerns about misspecification that are a major focus for us in this paper. In settings that include concerns about misspecifications measured by relative entropy, worst-case probability will typically be in the expanded set $\mathcal{P}$ and not in the set of probabilities $\mathcal{P}^o$ that the decision maker thinks are possible, rendering Good's plausibility criterion violated and presenting us with an unreconcilable rivalry between dynamic consistency and admissibility. The more general variational preference framework provides us with a more attractive approach to confronting potential model misspecifications.

Our paper studies two classes of economic models that illustrate these issues. In one class, a rectangular specification is justified on subjective grounds by how it represents structured models that exhibit time variation in parameters. We do this in a continuous time setting that can be viewed as a limit of a discrete-time model attained by driving a time interval ϵ to zero. We draw on a representation provided by Chen and Epstein (2002) to verify rectangularity. In this class of models, admissibility and dynamic consistency coexist; but concerns about model misspecifications are excluded.

In our other class of models, including ones mainly of interest to us in this paper because they allow for concerns about model misspecification expressed in terms of relative entropy, rectangular embeddings lead to implausibly large sets of probabilities. In particular, we show that a procedure that first expands the set probabilities implied by the family of structured models to include relative entropy neighborhoods and then adds enough additional models to construct a rectangular set of probabilities requires adding a multitude of models that need satisfy only some very weak absolute continuity restrictions over finite intervals of time. The vastness of that set of models delivers max-min expected utility decision rules extremely and implausibly cautious. Because this point is so important, in subsection 8.1 we provide a simple discrete-time two-period demonstration of this "anything goes under rectangularity" proposition, while in subsection 8.2 we establish the appropriate counterpart in the continuous-time diffusion setting that is our main focus in this paper.

The remainder of this paper is organized as follows. In section 3, we describe how we use positive martingales to represent a decision maker's set of probability specifications. Working in continuous time and with Brownian motion information structures gives us a convenient way to represent positive martingales. In section 4, we describe how we use relative entropy to measure statistical discrepancies between probability distributions. In different ways, we use relative entropy measures of statistical neighborhoods to construct families of *structured* models in section 5 and sets of *unstructured* models in section 6. In section 5, we describe a *refinement*, i.e., a further restriction, of a relative entropy constraint that we use to construct a set of structured parametric models that expresses *ambiguity*. Because this set of structured models is rectangular, it could be used within a Gilboa and Schmeidler (1989) framework while reconciling dynamic consistency and admissibility. But because we want also to include fears that the structured models are all misspecified, in section 6 we use another relative entropy restriction to describe a set of unstructured models that the decision maker also wants to consider, this one being an "unrefined" relative entropy constraint that produces a set of unstructured models is not rectangular. To include the decision maker's ambiguity concerns about the set of structured models and his misspecification concerns about the set of unstructured models, we use the recursive representation of preferences described in section 7, an instance of dynamic variational preferences that reconcile dynamic consistency with admissibility as we want. Section 8 indicates in detail why a set of models that satisfies the section 6 (unrefined) relative entropy constraint that we use to circumscribe our set of unstructured models can't be expanded to be rectangular in a way that coexists with an admissibility plausibility check of the kind recommended by Good (1952). Section 9 concludes.

3 Model perturbations

This section describes nonnegative martingales that we use to perturb a baseline probability model. Section 4 then describes how we use a family of parametric alternatives to a baseline model to form a convex set of martingales representing unstructured models that we shall use to pose robust decision problems.

3.1 Mathematical framework

To fix ideas, we use a specific *baseline* model and in section 4 an associated family of alternatives that we call *structured* models. A decision maker cares about a stochastic process $X \doteq \{X_t : t \geqslant 0\}$ that she approximates with a baseline model[5]

$$dX_t = \widehat{\mu}(X_t)dt + \sigma(X_t)dW_t, \tag{1}$$

where W is a multivariate Brownian motion.[6] A *plan* is a $C = \{C_t : t \geqslant 0\}$ process that is progressively measurable with respect to the filtration $\mathfrak{F} = \{\mathfrak{F}_t : t \geqslant 0\}$ associated with the Brownian motion W augmented by information available at date zero. Progressively measurable means that the date t component C_t is measurable with respect to $\mathfrak{F}_t$. A decision maker cares about plans.

Because he does not fully trust baseline model (1), the decision maker explores utility consequences of other probability models that he obtains by multiplying probabilities associated with (1) by appropriate likelihood ratios. Following Hansen et al. (2006), we represent a likelihood ratio process by a positive martingale M^U with respect to the probability distribution induced by the baseline model (1). The martingale M^U satisfies[7]

$$dM_t^U = M_t^U U_t \cdot dW_t \tag{2}$$

or

$$d \log M_t^U = U_t \cdot dW_t - \frac{1}{2}|U_t|^2 dt, \tag{3}$$

where U is progressively measurable with respect to the filtration $\mathfrak{F}$. We adopt the convention that M_t^U is zero when $\int_0^t |U_\tau|^2 d\tau$ is infinite. In the event that

$$\int_0^t |U_\tau|^2 d\tau < \infty \tag{4}$$

with probability one, the stochastic integral $\int_0^t U_\tau \cdot dW_\tau$ is formally defined as a probability limit. Imposing the initial condition $M_0^U = 1$, we express the solution of stochastic

[5] We let X denote a stochastic process, X_t the process at time t, and x a realized value of the process.

[6] Although applications typically use one, a Markov formulation is not essential. It could be generalized to allow other stochastic processes that can be constructed as functions of a Brownian motion information structure.

[7] James (1992), Chen and Epstein (2002), and Hansen et al. (2006) used this representation.

differential equation (2) as the stochastic exponential[8]

$$M_t^U = \exp\left(\int_0^t U_\tau \cdot dW_\tau - \frac{1}{2}\int_0^t |U_\tau|^2 d\tau\right). \tag{5}$$

Definition 3.1. *$\mathcal{M}$ denotes the set of all martingales M^U that can be constructed as stochastic exponentials via representation* (5) *with a U that satisfies* (4) *and are progressively measurable with respect to $\mathfrak{F}$.*

Associated with U are probabilities defined by

$$E^U\left[B_t|\mathfrak{F}_0\right] = E\left[M_t^U B_t|\mathfrak{F}_0\right]$$

for any $t \geqslant 0$ and any bounded $\mathfrak{F}_t$-measurable random variable B_t; thus, the positive random variable M_t^U acts as a Radon-Nikodym derivative for the date t conditional expectation operator $E^U\left[\,\cdot\,|X_0\right]$. The martingale property of the process M^U ensures that successive conditional expectations operators E^U satisfy a Law of Iterated Expectations.

Under baseline model (1), W is a standard Brownian motion, but under the alternative U model, it has increments

$$dW_t = U_t dt + dW_t^U, \tag{6}$$

where W^U is now a standard Brownian motion. Furthermore, under the M^U probability measure, $\int_0^t |U_\tau|^2 d\tau$ is finite with probability one for each t. While (3) expresses the evolution of $\log M^U$ in terms of increment dW, its evolution in terms of dW^U is:

$$d\log M_t^U = U_t \cdot dW_t^U - \frac{1}{2}|U_t|^2 dt. \tag{7}$$

In light of (7), we write model (1) as:

$$dX_t = \widehat{\mu}(X_t)dt + \sigma(X_t)\cdot U_t dt + \sigma(X_t)dW_t^U.$$

[8] M_t^U specified as in (5) is a local martingale, but not necessarily a martingale. It is not convenient here to impose sufficient conditions for the stochastic exponential to be a martingale like Kazamaki's or Novikov's. Instead, we will verify that an extremum of a pertinent optimization problem does indeed result in a martingale.

4 Measuring statistical discrepancies

We use entropy relative to a baseline probability to restrict martingales that represent alternative probabilities.[9] We start with the likelihood ratio process M^U and from it construct ingredients of a notion of relative entropy for the process M^U. To begin, we note that the process $M^U \log M^U$ evolves as an Ito process with date t drift $\frac{1}{2} M_t^U |U_t|^2$ (also called a local mean). Write the conditional mean of $M^U \log M^U$ in terms of a history of local means as[10]

$$E\left[M_t^U \log M_t^U | \mathfrak{F}_0\right] = \frac{1}{2} E\left(\int_0^t M_\tau^U |U_\tau|^2 d\tau | \mathfrak{F}_0\right). \tag{8}$$

Also, let M^S be a martingale defined by a drift distortion process S that is measurable with respect to $\mathfrak{F}$. To construct entropy relative to a probability distribution affiliated with M^S instead of martingale M^U, we use a log likelihood ratio $\log M_t^U - \log M_t^S$ with respect to the M_t^S model to arrive at:

$$E\left[M_t^U \left(\log M_t^U - \log M_t^S\right) | \mathfrak{F}_0\right] = \frac{1}{2} E\left(\int_0^t M_\tau^U |U_\tau - S_\tau|^2 d\tau \Big| \mathfrak{F}_0\right).$$

A notion of relative entropy appropriate for stochastic processes is

$$\begin{aligned} \lim_{t\to\infty} \frac{1}{t} E\left[M_t^U \left(\log M_t^U - \log M_t^S\right) \Big| \mathfrak{F}_0\right] &= \lim_{t\to\infty} \frac{1}{2t} E\left(\int_0^t M_\tau^U |U_\tau - S_\tau|^2 d\tau \Big| \mathfrak{F}_0\right) \\ &= \lim_{\delta \downarrow 0} \frac{\delta}{2} E\left(\int_0^\infty \exp(-\delta\tau) M_\tau^U |U_\tau - S_\tau|^2 d\tau \Big| \mathfrak{F}_0\right), \end{aligned}$$

provided that these limits exist. The second line is the limit of Abel integral averages, where scaling by δ makes the weights $\delta \exp(-\delta\tau)$ integrate to one. Rather than using undiscounted relative entropy, we find it convenient sometimes to use Abel averages with a discount rate equal to the subjective rate that discounts an expected utility flow. With

[9]Entropy is widely used in the statistical and machine learning literatures to measure discrepancies between models. For example, see Amari (2016) and Nielsen (2014).

[10]A variety of sufficient conditions justify equality (8). When we choose a probability distortion to minimize expected utility, we will use representation (8) without imposing that M^U is a martingale and then verify that the solution is indeed a martingale. Hansen et al. (2006) justify this approach. See their Claims 6.1 and 6.2.

that in mind, we define a discrepancy between two martingales M^U and M^S as:

$$\Delta\left(M^U; M^S|\mathfrak{F}_0\right) = \frac{\delta}{2}\int_0^\infty \exp(-\delta t) E\left(M_t^U \mid U_t - S_t\mid^2 \middle| \mathfrak{F}_0\right) dt.$$

Hansen and Sargent (2001) and Hansen et al. (2006) set $S_t \equiv 0$ to construct discounted relative entropy neighborhoods of a baseline model:

$$\Delta(M^U; 1|\mathfrak{F}_0) = \frac{\delta}{2}\int_0^\infty \exp(-\delta t) E\left(M_t^U |U_t|^2 \middle| \mathfrak{F}_0\right) dt \geqslant 0, \tag{9}$$

where baseline probabilities are represented here by the degenerate $S_t \equiv 0$ drift distortion that is affiliated with a martingale that is identically one. Formula (9) quantifies how a martingale M^U distorts baseline model probabilities.

5 Families of structured models

We use a formulation of Chen and Epstein (2002) to construct a family of structured probabilities by forming a set $\mathcal{M}^o$ of martingales M^S with respect to a baseline probability associated with model (1). Formally,

$$\mathcal{M}^o = \left\{M^S \in \mathcal{M} \text{ such that } S_t \in \Gamma_t \text{ for all } t \geqslant 0\right\} \tag{10}$$

where $\Gamma = \{\Gamma_t\}$ is a process of convex sets adapted to the filtration $\mathfrak{F}$.[11] We impose convexity to facilitate our subsequent application of the min-max theorem for the recursive problem.[12]

Hansen and Sargent (2001) and Hansen et al. (2006) started from a unique baseline model and then surrounded it with a relative entropy ball of unstructured models. In this paper, we instead start from a convex set $\mathcal{M}^o$ such that $M^S \in \mathcal{M}^o$ is a set of martingales with respect to a conveniently chosen and unique baseline model. The set $\mathcal{M}^o$ represents a set of *structured* models that in section 6 we shall surround with an entropy ball of unstructured models. This section contains several examples of sets of structured models formed according to particular versions of (10). Subsection 5.1 starts with a parametric

[11] Anderson et al. (1998) also explored consequences of a constraint like (10), but without state dependence in Γ. Allowing for state dependence is important in the applications featured in this paper.

[12] We have multiple models, so we create a convex set of priors over models. Restriction (10) imposes convexity conditioned on current period information, which follows from *ex ante* convexity of date 0 priors and a rectangular embedding. Section 5.1 elaborates within the context of some examples.

family; subsection 5.2 then adds time-varying parameters, while subsection 5.3 uses relative entropy to construct a set of structured models.

5.1 Finite number of underlying models

We present two examples that feature a finite number n of structured models of interest, with model j being represented by an S_t^j process that is a time-invariant function of the Markov state X_t for $j = 1, \ldots, n$. The examples differ in the processes of convex sets $\{\Gamma_t\}$ that define the set of martingales $\mathcal{M}^o$ in (10).

5.1.1 Time-invariant models

Each S^j process represents a probability assignment for all $t \geqslant 0$. Let Π_0 denote a convex set of probability vectors that reside in a subset of the probability simplex in $\mathbb{R}^n$. Alternative $\pi_0 \in \Pi_0$'s are potential initial period priors across models.

To update under a prior $\pi_0 \in \Pi_0$, we apply Bayes' rule to a finite collection of models characterized by S^j where M^{S^j} is in $\mathcal{M}^o$ for $j = 1, \ldots, n$. Let prior $\pi_0 \in \Pi_o$ assign probability $\pi_0^j \geqslant 0$ to model S^j, where $\sum_{j=1}^n \pi_0^j = 1$. A martingale

$$M = \sum_{j=1}^{n} \pi_0^j M^{S^j}$$

characterizes a mixture of S^j models. The mathematical expectation of M_t conditioned on date zero information equals unity for all $t \geqslant 0$. Martingale M evolves as

$$\begin{aligned} dM_t &= \sum_{j=1}^{n} \pi_0^j dM_t^{S^j} \\ &= \sum_{j=1}^{n} \pi_0^j M_t^{S^j} S_t^j \cdot dW_t \\ &= M_t \sum_{j=1}^{n} \left(\pi_t^j S_t^j \right) \cdot dW_t \end{aligned}$$

where the date t posterior π_t^j probability assigned to model S^j is

$$\pi_t^j = \frac{\pi_0^j M_t^{S^j}}{M_t}$$

and the associated drift distortion of martingale M is

$$S_t = \sum_{j=1}^{n} \pi_t^j S_t^j.$$

It is helpful to frame the potential conflict between admissibility and dynamic consistency in terms of a standard robust Bayesian formulation of a time 0 decision problem. A positive martingale generated by a process S implies a change in probability measure. Consider probability measures generated by the set

$$\Gamma = \left\{ S = \{S_t : t \geqslant 0\} : S_t = \sum_{j=1}^{n} \pi_t^j S_t^j, \; \pi_t^j = \frac{\pi_0^j M_t^{S^j}}{\sum_{\ell=1}^{n} \pi_0^\ell M_t^{S^\ell}}, \; \pi_0 \in \Pi_0 \right\}.$$

This family of probabilities indexed by an initial prior will in general not be rectangular so that max-min preferences with this set of probabilities violate the Epstein and Schneider (2003) dynamic consistency axiom. Nevertheless, think of a max-min utility decision maker who solves a date zero choice problem by minimizing over initial priors $\pi_0 \in \Pi_0$. Standard arguments that invoke the Minimax theorem to justify exchanging the order of maximization and minimization imply that the max-min utility worst-case model can be admissible and thus allow us to apply Good's plausibility test.

We can create a rectangular set of probabilities by adding other probabilities to the family of probabilities associated with the set of martingales Γ. To represent this rectangular set, let Π_t denote the associated set of date t posteriors and form the set:

$$\Gamma_t = \left\{ S_t = \sum_{j=1}^{n} \pi_t^j S_t^j, \; \pi_t \in \Pi_t \right\}.$$

Think of constructing alternative processes S by selecting alternative $S_t \in \Gamma_t$. Notice that here we index conditional probabilities by a process of potential posteriors π_t that no longer need be tied to a single prior $\pi_0 \in \Pi_0$. This means that more probabilities are entertained than were under the preceding robust Bayesian formulation that was based on a single worst-case time 0 prior $\pi_0 \in \Pi_0$. Now admissibility relative to the initial set of models does not necessarily follow because we have *expanded* the set of models to obtain rectangularity.

Thus, alternative sets of potential S processes generated by the set Γ, on one hand, and the sets Γ_t, on the other hand, illustrate the tension between admissibility and dynamic consistency within the Gilboa and Schmeidler (1989) max-min utility framework.

5.1.2 Pools of models

Geweke and Amisano (2011) propose a procedure that averages predictions from a finite pool of models. Their suspicion that all models within the pool are misspecified motivates Geweke and Amisano to choose weights over models in the pool that improve forecasting performance. These weights are not posterior probabilities over models in the pool and may not converge to limits that "select" a single model from the pool, in contrast to what often happens when weights over models are Bayesian posterior probabilities. Waggoner and Zha (2012) extend this approach by explicitly modeling time variation in the weights according to a well behaved stochastic process.

In contrast to this approach, our decision maker expresses his specification concerns formally in terms of a set of structured models. An agnostic expression of the decision maker's weighting over models can be represented in terms of the set

$$\Gamma_t = \left\{ S_t = \sum_{j=1}^{n} \pi_t^j S_t^j, \ \pi_t \in \overline{\Pi} \right\},$$

where $\overline{\Pi}$ is a time invariant set of possible model weights that can be taken to be the set of all potential nonnegative weights across models that sum to one. A decision problem can be posed that determines weights that vary over time in ways designed to manage concerns about model misspecification. To employ Good's 1952 criterion, the decision maker must view a weighted average of models as a plausible specification.[13]

In the next subsection, we shall consider other ways to construct a set $\mathcal{M}^o$ of martingales that determine structured models that allow time variation in parameters.

5.2 Time-varying parameter models

Suppose that S_t^j is a time invariant function of the Markov state X_t for each $j = 1, \ldots, n$. Linear combinations of S_t^j's generate the following set of time-invariant parameter models:

$$\left\{ M^S \in \mathcal{M} : S_t = \sum_{j=1}^{n} \theta^j S_t^j, \theta \in \Theta \text{ for all } t \geqslant 0 \right\}. \tag{11}$$

[13]For some of the examples of Waggoner and Zha that take the form of mixtures of rational expectations models, this requirement could be problematic because mixtures of rational expectations models are not rational expectations models.

Here the unknown parameter vector is $\theta = \begin{bmatrix} \theta^1 & \theta^2 & \dots & \theta^n \end{bmatrix}' \in \Theta$, a closed convex subset of $\mathbb{R}^n$. We can include time-varying parameter models by changing (11) to:

$$\left\{ M^S \in \mathcal{M} : S_t = \sum_{j=1}^{n} \theta_t^j S_t^j, \theta_t \in \Theta \text{ for all } t \geqslant 0 \right\}, \tag{12}$$

where the time-varying parameter vector $\theta_t = \begin{bmatrix} \theta_t^1 & \theta_t^2 & \dots & \theta_t^n \end{bmatrix}'$ has realizations confined to Θ, the same convex subset of $\mathbb{R}^n$ that appears in (11). The decision maker has an incentive to compute the mathematical expectation of θ_t conditional on date t information, which we denote $\bar{\theta}_t$. Since the realizations of θ_t are restricted to be in Θ, conditional expectations $\bar{\theta}_t$ of θ_t also belong to Θ, so what now plays the role of Γ in (10) becomes

$$\Gamma_t = \left\{ S_t = \sum_{j=1}^{n} \bar{\theta}_t^j S_t^j, \ \bar{\theta}_t \in \Theta, \ \bar{\theta}_t \text{ is } \mathcal{F}_t \text{ measurable} \right\}. \tag{13}$$

5.3 Structured models restricted by relative entropy

We can construct a set of martingales $\mathcal{M}^o$ by imposing a constraint on entropy relative to a baseline model that restricts drift distortions as functions of the Markov state. This method has proved useful in applications.

Section 4 defined discounted relative entropy for a stochastic process generated by martingale M^S as

$$\Delta(M^S; 1, \delta | \mathfrak{F}_0) = \frac{\delta}{2} \int_0^\infty \exp(-\delta t) E \left(M_t^S |S_t|^2 \middle| \mathfrak{F}_0 \right) dt \geqslant 0$$

where we have now explicitly noted the dependence of Δ on δ. We begin by studying a discounted relative entropy measure for a martingale generated by $S_t = \eta(X_t)$.

We want the decision maker's set of structured models to be rectangular in the sense that it satisfies an instant-by-instant constraint $S_t \in \Gamma_t$ for all $t \geqslant 0$ in (10) for a collection of $\mathfrak{F}_t$-measurable convex sets $\{\Gamma_t : t \geqslant 0\}$. To construct such a rectangular set we can't simply specify an upper bound on relative entropy discounted relative entropy, $\Delta(M^S; 1, \delta \mid \mathfrak{F}_0)$, or on its undiscounted counterpart, and then find all drift distortion S processes for which relative entropy is less than or equal to this upper bound. Doing that would produce a family of probabilities that fails to satisfy an instant-by-instant rectangularity constraint of the form (10) that we want. Furthermore, enlarging such a set to make it rectangular as

Epstein and Schneider recommend would yield a set of probabilities that is much too large for max-min preferences, as we describe in detail in section 8.2. Therefore, we impose a more stringent restriction cast in terms of a refinement of relative entropy. It is a refinement in the sense that it excludes many of those other section 8.2 models that also satisfy the relative entropy constraint. We refine the constraint by also restricting the time derivative of the conditional expectation of relative entropy.[14] We accomplish this by restricting the drift (i.e, the local mean) of relative entropy via a Feynman-Kac relation, as we now explain.

To explain how we refine the relative entropy constraint, we start by providing a functional equation for discounted relative entropy ρ as a function of the Markov state that involves an instantaneous counterpart $\mathcal{A}$ to a discrete-time one-period transition distribution for a Markov process in the form of an infinitesimal generator that describes how conditional expectations of the Markov state evolve locally. A *generator* $\mathcal{A}$ can be derived informally by differentiating a family of conditional expectation operators with respect to the gap of elapsed time. A stationary distribution Q for a continuous-time Markov process with generator $\mathcal{A}$ satisfies

$$\int \mathcal{A}\rho dQ = 0. \tag{14}$$

Restriction (14) follows from an application of the Law of Iterated Expectations to a small time increment.

For a diffusion like baseline model (1), the infinitesimal generator of transitions under the M^S probability associated with $S = \eta(X)$ is the second-order differential operator $\mathcal{A}^\eta$ defined by

$$\mathcal{A}^\eta \rho = \frac{\partial \rho}{\partial x} \cdot (\widehat{\mu} + \sigma\eta) + \frac{1}{2}\text{trace}\left(\sigma' \frac{\partial^2 \rho}{\partial x \partial x'}\sigma\right), \tag{15}$$

where the test function ρ resides in an appropriately defined domain of the generator $\mathcal{A}^\eta$. Relative entropy is then $\delta\rho$, where ρ solves a Feynman-Kac equation:

$$\frac{\eta \cdot \eta}{2} - \delta\rho + \mathcal{A}^\eta \rho = 0 \tag{16}$$

where the first term captures the instantaneous contribution to relative entropy and the second term captures discounting. It follows from (16) that

$$\frac{1}{2}\int \eta \cdot \eta dQ^\eta = \delta \int \rho dQ^\eta. \tag{17}$$

[14] Restricting a derivative of a function at every instant is in general substantially more constraining than restricting the magnitude of a function itself.

Later we shall discuss a version of (16) as $\delta \to 0$.

Imposing an upper bound $\overline{\rho}$ on the function ρ would not produce a rectangular set of probabilities. So instead we proceed by constraining ρ locally and, inspired by Feynman-Kac equation (16) to impose

$$\frac{\eta \cdot \eta}{2} \leqslant \delta\overline{\rho} - \mathcal{A}^{\eta}\overline{\rho} \tag{18}$$

for a prespecified function $\overline{\rho}$ that might be designed to represent alternative Markov models. By constraining the local evolution of relative entropy in this way we construct a rectangular set of alternative probability models. The "local" inequality (18) implies that

$$\rho(x) \leqslant \overline{\rho}(x) \text{ for all } x,$$

but the converse is not necessarily true, so (18) strengthens a constraint on relative entropy itself by bounding time derivatives of conditional expectations under alternative models.

Notice that (18) is quadratic in the function η and thus determines a sphere for each value of x. The state-dependent center of this sphere is $-\sigma' \frac{\partial \overline{\rho}}{\partial x}$ and the radius is $\delta\overline{\rho} - \mathcal{A}^0\rho + \left|\sigma' \frac{\partial \overline{\rho}}{\partial x}\right|^2$. To construct the convex set for restricting S_t of interest to the decision maker, we fill this sphere:

$$\Gamma_t = \left\{ s : \frac{|s|^2}{2} + s \cdot \left[\sigma(X_t)' \frac{\partial \overline{\rho}}{\partial x}(X_t) \right] \leqslant \delta\overline{\rho}(X_t) - \mathcal{A}^0\overline{\rho}(X_t) \right\}. \tag{19}$$

By using a candidate $\overline{\eta}$ that delivers relative entropy $\overline{\rho}$, we can ensure that the set Γ_t is not empty.

To implement instant-by-instant constraint (19), we restrain what is essentially a time derivative of relative entropy.[15] By bounding the time derivative of relative entropy, we strengthen the constraint on the set of structured models enough to make it rectangular.

5.3.1 Small discount rate limit

It is enlightening to study the subsection 5.3 way of creating a rectangular set of alternative models as $\delta \to 0$. We do this for two reasons. First, it helps us to assess statistical implications of our specification of $\overline{\rho}$ when δ is small. Second, it provides an alternative way to construct Γ_t when $\delta = 0$ that is of interest in its own right.

[15]The logic here is very similar to that employed in deriving Feynman-Kac equations.

A small δ limiting version quantifies relative entropy as:

$$\begin{aligned}\varepsilon(M^S) &= \lim_{\delta \downarrow 0} \Delta(M^S; 1, \delta \mid \mathfrak{F}_0) \\ &= \lim_{t \to \infty} \frac{1}{2t} \int_0^t E\left(M^S_\tau |S_\tau|^2 \middle| \mathfrak{F}_0 \right) d\tau, \end{aligned} \tag{20}$$

which equates the limit of an exponentially weighted average to the limit of an unweighted average. Evidently $\varepsilon(M^S)$ is the limit as $t \to +\infty$ of a process of mathematical expectations of time series averages

$$\frac{1}{2t} \int_0^t |S_\tau|^2 d\tau$$

under the probability measure implied by martingale M^S.

Suppose again that M^S is defined by drift distortion $S = \eta(X)$ process, where X is an ergodic Markov process with transition probabilities that converge to a well-defined and unique stationary distribution Q^η under the M^S probability. In this case, we can compute relative entropy from

$$\varepsilon(M^S) = \frac{1}{2} \int |\eta|^2 dQ^\eta. \tag{21}$$

In what follows, we parameterize relative entropy by $\frac{\mathsf{q}^2}{2}$, where q measures the magnitude of the drift distortion using a mean-square norm.

To motivate an HJB equation, we start with a low frequency refinement of relative entropy. For $S_t = \eta(X_t)$, consider the log-likelihood-ratio process

$$\begin{aligned} L_t &= \int_0^t \eta(X_\tau) \cdot dW_\tau - \frac{1}{2} \int_0^t \eta(X_\tau) \cdot \eta(X_\tau) d\tau \\ &= \int_0^t \eta(X_\tau) \cdot dW^S_\tau + \frac{1}{2} \int_0^t |\eta(X_\tau)|^2 d\tau. \end{aligned} \tag{22}$$

From (20), relative entropy is the long-horizon limiting average of the expectation of L_t under M^S probability. To refine a characterization of its limiting behavior, we note that a log-likelihood process has an additive structure that admits the decomposition

$$L_t = \frac{\mathsf{q}^2}{2} t + D_t + \lambda(X_0) - \lambda(X_t) \tag{23}$$

where D is a martingale under the M^S probability measure, so that

$$E\left[\left(\frac{M^S_{t+\tau}}{M^S_t}\right)(D_{t+\tau} - D_t) \mid X_t\right] = 0 \text{ for all } t, \tau \geqslant 0.$$

Decomposition (23) asserts that the log-likehood ratio process L has three components: a time trend, a martingale, and a third component described by a function ρ. See Hansen (2012, Sec. 3). The coefficient $\frac{\mathsf{q}^2}{2}$ on the trend term in decomposition (23) is relative entropy, an outcome that could be anticipated from the definition of relative entropy as a long-run average. Subtracting the time trend and taking date zero conditional expectations under the probability measure induced by M^S gives

$$\begin{aligned}\lim_{t\to\infty}\left[E\left(M^S_t L_t | X_0 = x\right) - \frac{\mathsf{q}^2}{2}t\right] &= \lim_{t\to\infty} E\left(M^S_t[D_t - \lambda(X_t)] \mid X_0 = x\right) + \lambda(x)\\ &= \lambda(x) - \int \lambda dQ^\eta,\end{aligned}$$

a valid limit because X is stochastically stable under the S implied probability. Thus, $\lambda - \int \lambda dQ^\eta$ provides a long-horizon first-order refinement of relative entropy.

Using the two representations (22) and (23) of the log-likelihood ratio process L, we can equate corresponding derivatives of conditional expectations under the M^S probability measure to get

$$\frac{\mathsf{q}^2}{2} - \mathcal{A}^\eta \lambda = \frac{1}{2}\eta \cdot \eta.$$

Rearranging this equation, gives:

$$\frac{1}{2}\eta \cdot \eta - \frac{\mathsf{q}^2}{2} + \mathcal{A}^\eta \lambda = 0, \tag{24}$$

which can be recognized as a limiting version of Fynman-Kac equation (16), where

$$\frac{\mathsf{q}^2}{2} = \lim_{\delta \downarrow 0} \delta \rho(x),$$

and the function ρ depends implicitly on δ. The need to scale ρ by δ is no surprise in light of formula (17). Evidently, state dependence of $\delta\rho$ vanishes in a small δ limit. Netting out this “level term” gives

$$\lambda - \int \lambda dQ^\eta = \lim_{\delta \downarrow 0}\left(\rho - \int \rho dQ^\eta\right).$$

In fact, the limiting Feynman-Kac equation (24) determines λ only up to a translation because the Feynman-Kac equation depends only on first and second derivatives of λ. Thus, we can use this equation to solve for a pair (λ, q) in which λ is determined only up to translation by a constant. By integrating (24) with respect to Q^η and substituting from equation (14), we can verify that $\frac{\mathsf{q}^2}{2}$ is relative entropy.[16]

Proceeding much as we did when we were discounting, we can use $(\overline{\lambda}, \mathsf{q})$ to restrict η by constructing the sequence of $\mathfrak{F}_t$-measurable convex sets

$$\Gamma_t = \left\{ s : \frac{|s|^2}{2} + s \cdot \left[\sigma(X_t)' \frac{\partial \overline{\lambda}}{\partial x}(X_t) \right] \leqslant \frac{\mathsf{q}^2}{2} - \mathcal{A}^0 \overline{\lambda}(X_t) \right\}.$$

Remark 5.1. *We could instead have imposed the restriction*

$$\frac{|S_t|^2}{2} \leqslant \frac{\mathsf{q}^2}{2}$$

that would also impose a quadratic refinement of relative entropy that is tractable to implement. However, for some interesting examples that are motivated by unknown coefficients, S_t's are not bounded independently of the Markov state.

Remark 5.2. *As another alternative, we could impose a state-dependent restriction*

$$\frac{|S_t|^2}{2} \leqslant \frac{|\overline{\eta}(X_t)|^2}{2}$$

where $\overline{\eta}(X_t)$ is constructed with a particular model in mind, perhaps motivated by uncertain parameters. While this approach would be tractable and could have interesting applications, its connection to relative entropy is less evident. For instance, even if this restriction is satisfied, the relative entropy of the S model could exceed that of the $\{\eta(X_t) : t \geqslant 0\}$ model because the appropriate relative entropies are computed by taking expectations under different probability specifications.

In summary, we have shown how to use a refinement of relative entropy to construct a family of structured models. By constraining the local evolution of an entropy-bounding function $\overline{\rho}$, when the decision maker wants to discount the future, or a small discount rate limit captured by the pair $(\overline{\lambda}, \mathsf{q}^2/2)$, we restrict a set of structured models to be rectangular. If we had instead specified only $\overline{\rho}$ and relative entropy $\mathsf{q}^2/2$ and not the function implied

[16]This approach to computing relative entropy has direct extensions to Markov jump processes and mixed jump diffusion processes.

evolution $\overline{\rho}$ or $\overline{\lambda}$ too, the set of models would cease to be rectangular, as we discuss in detail in subsections 8.1 and 8.2.

If we were modeling a decision maker who is interested only in a set of models defined by (10), we could stop here and use a dynamic version of the max-min preferences of Gilboa and Schmeidler (1989). That way of proceeding is worth pursuing in its own right could lead to interesting applications. But because he distrusts all of those models, the decision maker who is the subject of this paper also wants to investigate the utility consequences of models not in the set defined by (10). This will lead us to an approach in section 6 that uses a continuous-time version of the variational preferences that extend max-min preferences. Before doing that, we describe an example of a set of structured models that naturally occur in an application of interest to us.

5.4 Illustration

In this subsection, we offer an example of a set $\mathcal{M}^o$ for structured models that can be constructed by the approach of subsection 5.3. We start with a baseline parametric model for a representative investor's consumption process Y, then form a family of parametric structured probability models. We deduce the pertinent version of the second-order differential equation (16) to be solved for ρ. The baseline model for consumption is

$$\begin{aligned} dY_t &= .01\left(\widehat{\alpha}_y + \widehat{\beta}_y Z_t\right) dt + .01\sigma_y \cdot dW_t \\ dZ_t &= \left(\widehat{\alpha}_z - \widehat{\beta}_z Z_t\right) dt + \sigma_z \cdot dW_t. \end{aligned} \tag{25}$$

We scale by .01 because we want to work with growth rates and Y is typically expressed in logarithms. The mean of Z in the implied stationary distribution is $\bar{z} = \widehat{\alpha}_z/\widehat{\beta}_z$.

Let

$$X = \begin{bmatrix} Y \\ Z \end{bmatrix}.$$

The decision maker focuses on the following collection of alternative structured parametric models:

$$\begin{aligned} dY_t &= .01\left(\alpha_y + \beta_y Z_t\right) dt + .01\sigma_y \cdot dW_t^S \\ dZ_t &= \left(\alpha_z - \beta_z Z_t\right) dt + \sigma_z \cdot dW_t^S, \end{aligned} \tag{26}$$

where W^S is a Brownian motion and (6) continues to describe the relationship between the processes W and W^S. Collection (26) nests the baseline model (25). Here $(\alpha_y, \beta_y, \alpha_z, \beta_z)$ are parameters that distinguish structured models (26) from the baseline model, and (σ_y, σ_z) are parameters common to models (25) and (26).

We represent members of the parametric class defined by (26) in terms of our section 3.1 structure with drift distortions S of the form

$$S_t = \eta(X_t) = \eta^o(Z_t) \equiv \eta_0 + \eta_1(Z_t - \bar{z}),$$

then use (1), (6), and (26) to deduce the following restrictions on η_1:

$$\sigma\eta_1 = \begin{bmatrix} \beta_y - \widehat{\beta}_y \\ \widehat{\beta}_z - \beta_z \end{bmatrix} \tag{27}$$

where

$$\sigma = \begin{bmatrix} (\sigma_y)' \\ (\sigma_z)' \end{bmatrix}.$$

Given an η that satisfies these restrictions, we compute a function ρ that is quadratic and depend only on z so that $\rho(x) = \rho^o(z)$. Relative entropy $\frac{\mathsf{q}^2}{2}$ emerges as part of the solution to the following relevant instance of differential equation (16):

$$\frac{|\eta^o(z)|^2}{2} + \frac{d\rho^o}{dz}(z)[\widehat{\beta}_z(\bar{z} - z) + \sigma_z \cdot \eta(z)] + \frac{|\sigma_z|^2}{2}\frac{d^2\rho^o}{dz^2}(z) - \frac{\mathsf{q}^2}{2} = 0.$$

Under parametric alternatives (26), the solution for ρ is quadratic in $z - \bar{z}$. Write:

$$\rho^o(z) = \rho_1(z - \bar{z}) + \frac{1}{2}\rho_2(z - \bar{z})^2.$$

As described in Appendix A, we compute ρ_1 and ρ_2 by matching coefficients on terms $(z - \bar{z})$ and $(z - \bar{z})^2$, respectively. Matching constant terms then pins down $\frac{\mathsf{q}^2}{2}$. To restrict the structured models, we impose:

$$\frac{|S_t|^2}{2} + [\rho_1 + \rho_2(Z_t - \bar{z})]\, \sigma_z \cdot S_t \leqslant \frac{|\sigma_z|^2}{2}\rho_2 - \frac{\mathsf{q}^2}{2} - [\rho_1 + \rho_2(Z_t - \bar{z})]\, \widehat{\beta}_z(\bar{z} - Z_t)$$

Figure 1 portrays an example in which $\rho_1 = 0$ and ρ_2 satisfies:

$$\rho_2 = \frac{\mathsf{q}^2}{|\sigma_z|^2}.$$

When $S_t = \eta(Z_t)$ is restricted to be $\eta_1(Z_t - \bar{z})$, a given value of q imposes a restriction on η_1 and, through equation (27), implicitly on (β_y, β_z). Figure 1 plots the $\mathsf{q} = .05$ iso-entropy contour as the boundary of a convex set for (β_y, β_z).[17]

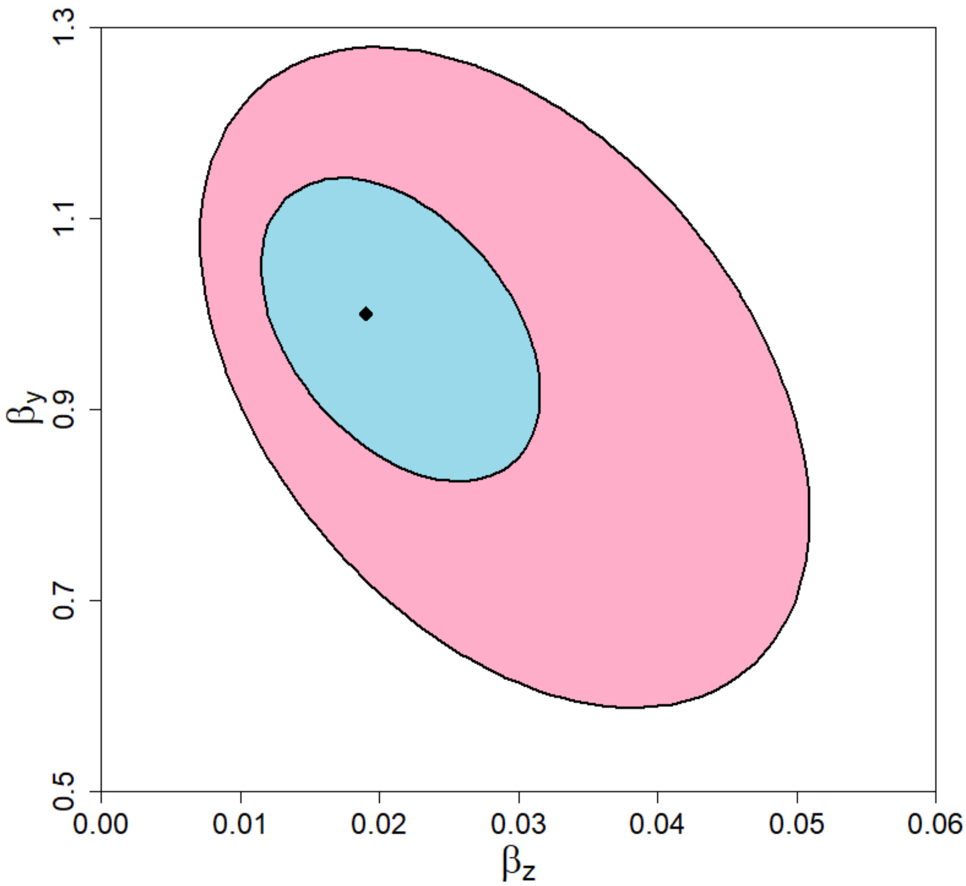

Figure 1: Parameter contours for (β_y, β_z) holding relative entropy and σ_z fixed. The outer curve depicts $\mathsf{q} = .1$ and the inner curve $\mathsf{q} = .05$. The small diamond depicts the baseline model.

[17]This figure was constructed using the parameter values:

$$\begin{aligned} \widehat{\alpha}_y &= .484 & \widehat{\beta}_y &= 1 \\ \widehat{\alpha}_z &= 0 & \widehat{\beta}_z &= .014 \end{aligned}$$
$$(\sigma_y)' = \begin{bmatrix} .477 & 0 \end{bmatrix}$$
$$(\sigma_z)' = \begin{bmatrix} .011 & .025 \end{bmatrix}$$

taken from Hansen and Sargent (2019).

While Figure 1 displays contours of time-invariant parameters with the same relative entropies as the boundary of convex region, our restriction allows parameters(β_y, β_z) to vary over time provided that they remain within the plotted region. Indeed, we use (10) as a convenient way to build a set of structured models that includes ones with time varying parameters that lack probabilistic descriptions of how parameters vary.

If we were to stop here and endow a max-min decision maker with the set of probabilities determined by the set of martingales $\mathcal{M}^o$, we could study max-min preferences associated with this set of probabilities. Restriction (10) on the set of $\mathcal{M}^o$ martingales guarantees that the set of probabilities is rectangular and that therefore these preferences satisfy the dynamic consistency axiom of Epstein and Schneider (2003) that justifies dynamic programming. However, as we emphasize in section 6, our decision maker expands the set of models because he wants to evaluate outcomes under probability models inside relative entropy neighborhoods of structured models. This expanded set is not rectangular and for reasons stated formally in subsection 8.2 can't be made rectangular by following Epstein and Schneider's expansion procedure and still yield a set of models that will interest a decision maker who like ours wants to apply Good's plausibility criterion. That motivates us to penalize relative entropies from the family of structured models in $\mathcal{M}^o$ in order to describe additional potential misspecifications taking the form of unstructured models that reside within a vast collection of models that fit nearly as well as the structured models in $\mathcal{M}^o$. We describe details in section 6. But first we briefly describe approaches suggested by other authors.

5.5 Other approaches

In our example so far, we have assumed that the structured model probabilities can be represented as martingales with respect to a baseline model. A different approach, invented by Peng (2004), uses a theory of stochastic backward differential equations under a notion of ambiguity that is rich enough to allow for uncertainty about conditional volatilities of Brownian increments.[18] Because alternative probability specifications fail to be absolutely continuous (over finite time intervals), standard likelihood ratio analysis does not apply. This approach would push us outside the Chen and Epstein (2002) formulation but would still let us construct a rectangular embedding that we could use to construct structured

[18]See Chen et al. (2005) for a further discussion of Peng's characterizations of a class of nonlinear expectations to Choquet integration used in decision theory in both economics and statistics.

models.[19]

6 Including unstructured alternatives

In section 5.1, we described how the decision maker forms a set $\mathcal{M}^o$ of structured models that are parametric alternatives to the baseline model. To represent the unstructured models that also concern the decision maker, we proceed as follows. After constructing $\mathcal{M}^o$, for scalar $\xi > 0$, we define a scaled discrepancy of martingale M^U from a set of martingales $\mathcal{M}^o$ as

$$\begin{aligned} \Xi(M^U|\mathfrak{F}_0) &= \xi \inf_{M^S \in \mathcal{M}^o} \Delta\left(M^U; M^S|\mathcal{F}_0\right) \\ &= \frac{\xi\delta}{2}\int_0^\infty \exp(-\delta t) E\left[M_t^U \gamma_t(U_t)\Big|\mathfrak{F}_0\right] dt. \end{aligned} \tag{28}$$

where

$$\gamma_t(U_t) = \inf_{S_t \in \Gamma_t} |U_t - S_t|^2. \tag{29}$$

Scaled discrepancy $\Xi(M^U|\mathfrak{F}_0)$ equals zero for M^U in $\mathcal{M}^o$ and is positive for M^U not in $\mathcal{M}^o$. We use discrepancy $\Xi(M^U|\mathfrak{F}_0)$ to define a set of unstructured models near $\mathcal{M}^o$ whose utility consequences a decision maker wants to know. When we pose a max-min decision problem, we use the scaling parameter ξ to measure how the expected utility minimizer is penalized for choosing unstructured models that are statistically farther from the structured models in $\mathcal{M}^o$.

The decision maker doesn't stop with the set of structured models generated by martingales in $\mathcal{M}^o$ because he wants to evaluate the utility consequences not just of the structured models in $\mathcal{M}^o$ but also of unstructured models that statistically are difficult to distinguish from them. For that purpose, he employs the scaled statistical discrepancy measure $\Xi(M^U|\mathfrak{F}_0)$ defined in (28).[20]

[19]See Epstein and Ji (2014) for an application of the Peng analysis to asset pricing.

[20]Watson and Holmes (2016) and Hansen and Marinacci (2016) discuss misspecification challenges confronted by statisticians and economists.

7 Recursive Representation of Preferences

The decision maker uses relative entropy implied by the scaling parameter ξ to restrain the statistical discrepancy between unstructured models and the set of structured models. In particular, the decision maker solves a minimization problem in which ξ serves as a penalty parameter that effectively excludes unstructured probabilities that are statistically too far from the set $\mathcal{M}^o$ of structured models. That minimization problem induces a special case of the dynamic variational preference ordering that Maccheroni et al. (2006b) showed is dynamically consistent.

7.1 Continuation values

The decision maker ranks alternative consumption plans with a scalar continuation value stochastic process. Date t continuation values tell a decision maker's date t ranking. Continuation value processes have a recursive structure that makes preferences be dynamically consistent. Thus, for Markovian plans, a Hamilton-Jacobi-Bellman (HJB) equation restricts the evolution of continuation values. In particular, for a consumption plan $\{C_t\}$, a continuation value process $\{V_t\}_{t=0}^{\infty}$ is defined by

$$V_t = \min_{\{U_\tau : t \leqslant \tau < \infty\}} E\left(\int_0^\infty \exp(-\delta\tau) \left(\frac{M_{t+\tau}^U}{M_t^U} \right) \left[\psi(C_{t+\tau}) + \left(\frac{\xi\delta}{2} \right) \gamma_{t+\tau}(U_{t+\tau}) \right] d\tau \mid \mathfrak{F}_t \right) \tag{30}$$

where ψ is an instantaneous utility function. We can use (30) to derive an inequality that describes a sense in which a minimizing process $\{U_\tau : t \leqslant \tau < \infty\}$ isolates a statistical model that is robust. After deriving and discussing this inequality and the associated robustness bound, we shall use (30) to provide a recursive representation of preferences.

Turning to the derived bound, we proceed by applying an inequality familiar from optimization problems subject to penalties. Let U^o be the minimizer for problem (30) and let $S^o = S(U^o)$ be the minimizing S implied by equation (29). The process affiliated with the pair (U^o, S^o) gives a lower bound on discounted expected utility that can be represented in the following way.

Bound 7.1. *If (U, S) satisfies:*

$$\frac{\delta}{2} E\left(\int_0^\infty \exp(-\delta\tau) \left(\frac{M_{t+\tau}^U}{M_t^U} \right) |S_{t+\tau} - U_{t+\tau}|^2 d\tau \mid \mathfrak{F}_t \right)$$

$$\leqslant \frac{\delta}{2} E\left(\int_0^\infty \exp(-\delta\tau)\left(\frac{M_{t+\tau}^{U^o}}{M_t^{U^o}}\right)|S_{t+\tau}^o - U_{t+\tau}^o|^2 d\tau \mid \mathfrak{F}_t\right) \tag{31}$$

then

$$E\left(\int_0^\infty \exp(-\delta\tau)\left(\frac{M_{t+\tau}^{U}}{M_t^{U}}\right)\psi(C_{t+\tau})d\tau \mid \mathfrak{F}_t\right)$$
$$\geqslant E\left(\int_0^\infty \exp(-\delta\tau)\left(\frac{M_{t+\tau}^{U^o}}{M_t^{U^o}}\right)\psi(C_{t+\tau})d\tau \mid \mathfrak{F}_t\right) \tag{32}$$

for all $t \geqslant 0$.

Inequality (32) is a direct implication of minimization problem (30). It gives probability specifications that have date t discounted expected utilities that are at least as large as the one parameterized by U^o. The structured models all satisfy this bound; so do unstructured models that are statistically close to them as measured by the date t conditional counterpart to our discrepancy measure.

Turning next to a recursive representation of preferences, note that equation (30) implies that

$$V_t = \min_{\{U_\tau : t \leqslant \tau < t+\epsilon\}} \Bigg\{ E\left[\int_0^\epsilon \exp(-\delta\tau)\left(\frac{M_{t+\tau}^{U}}{M_t^{U}}\right)\left[\psi(C_{t+\tau}) + \left(\frac{\xi\delta}{2}\right)\gamma_{t+\tau}(U_{t+\tau})\right] d\tau \mid \mathfrak{F}_t\right]$$
$$+ \exp(-\delta\epsilon) E\left[\left(\frac{M_{t+\epsilon}^{U}}{M_t^{U}}\right) V_{t+\epsilon} \mid \mathfrak{F}_t\right]\Bigg\} \tag{33}$$

for $\epsilon > 0$. Heuristically, we can "differentiate" the right-hand side of (33) with respect to ϵ to obtain an instantaneous counterpart to a Bellman equation. Viewing the continuation value process $\{V_t\}$ as an Ito process, write:

$$dV_t = \nu_t dt + \varsigma_t \cdot dW_t.$$

A local counterpart to (33) is then

$$0 = \min_{U_t}\left[\psi(C_t) - \frac{\xi\delta}{2}\gamma_t(U_t) - \delta V_t + U_t \cdot \varsigma_t + \nu_t\right]$$
$$= \min_{S_t \in \Gamma_t} \min_{U_t}\left[\psi(C_t) + \frac{\xi\delta}{2}|U_t - S_t|^2 - \delta V_t + U_t \cdot \varsigma_t + \nu_t\right]$$
$$= \min_{S_t \in \Gamma_t}\left[\psi(C_t) - \frac{1}{2\xi\delta}\varsigma_t \cdot \varsigma_t - \delta V_t + S_t \cdot \varsigma_t + \nu_t\right] \tag{34}$$

where the minimizing U_t expressed as a function of S_t satisfies

$$U_t = S_t - \frac{1}{\delta\xi}\varsigma_t$$

The term $U_t \cdot \varsigma_t$ on the right side of (34) comes from an Ito adjustment to the local covariance between $\frac{dM_t^U}{M_t^U}$ and dV_t. Equivalently, $U_t \cdot \varsigma_t$ is an adjustment to the drift ν_t of dV_t that is induced by using martingale M^U to change the probability measure. For a continuous-time Markov decision problem, (34) gives rise to an HJB equation for a corresponding value function expressed as a function of a Markov state.

Remark 7.2. *With preferences described by* (34)*, we can still discuss admissibility relative to a set of structured models using the representation on the third line of* (34)*. Recall that the S process parameterizes a structured model. For a given decision process C, solve*

$$0 = \psi(C_t) - \frac{1}{2\xi\delta}\tilde{\varsigma}_t \cdot \tilde{\varsigma}_t - \delta\tilde{V}_t + S_t \cdot \tilde{\varsigma}_t + \tilde{\nu}_t$$

where

$$d\widetilde{V} = \tilde{\nu}_t dt + \tilde{\varsigma}_t \cdot dW_t.$$

Solving this equation backwards for alternative C processes gives a ranking of them for a given S probability. By posing a Markov decision problem, we can study admissibility by applying a Minimax theorem along with a Bellman-Isaacs condition for a dynamic two-person game. See, for instance, Fleming and Souganidis (1989). If we can exchange orders of maximization and minimization, then the implied worst-case structured model process S^* can be used in the fashion recommended by Good (1952) in the quote with which we began this paper.

By extending Bound 7.1, the implied adjustment U^* for misspecification of the structured models is also enlightening. Specifically, we can use (U^*, S^*) in place of (U^o, S^o) in inequality (31) *and conclude that a counterpart to inequality* (32) *holds in which we maximize both the right and left sides by choice of a C plan subject to the constraints imposed on the decision problem. Thus, the entropy of U^* relative to S^* tells us over what probabilities we can bound discounted expected utilities.*

Remark 7.3. *It is useful to compare roles of the baseline model here and in the robust decision model based on the multiplier preferences of Hansen and Sargent (2001) and Hansen* *et al. (2006), another continuous time version of variational preferences.*[21] *Their baseline model is a unique structured model, distrust of which motivates a decision maker to compute a worst-case unstructured model to guide evaluations and decisions. In the present paper, the baseline model is just one of a set of structured models that the decision maker maintains. The baseline model here merely anchors specifications of other members of the set of structured models. The decision maker in this paper distrusts all models in the set of structured models associated with martingales in* $\mathcal{M}^o$.

8 Relative entropy versus rectangularity

This section is dedicated to showing how using relative entropy (without our refinement) to constrain a set of alternative models can result in an extremely large rectangular embedding that contains very implausible models. Subsection 8.1 uses a simple two-period model to display the basic idea while section 8.2 employs the continuous-time Brownian information structure that we use throughout the rest of this paper.

8.1 Anything goes: take 1

In this subsection, time takes values $0, 1, 2$. At time $t = 2$, one of J states can be realized that we denote $j = 1, ..., J$. We represent information available at date $t = 1$ by a size $I \leqslant J$ partition $\Lambda_i, i = 1, 2, ..., I$ of the collection of the J states. Every state j is contained in exactly one Λ_i.

Let $\hat{\pi}_i > 0$ denote the baseline probability of Λ_i, and let $\hat{\pi}_i \widehat{P}_{i,j} > 0$ denote the baseline probability assigned to j in Λ_i. Thus, $\widehat{P}_{i,j}$ is the baseline conditional probability of state j given partition i. Similarly, we use $\pi_i P_{i,j}$ to represent alternative probabilities assigned to Λ_i. From the point of view of time 0, the entropy of an alternative probability relative to

[21]Our way of formulating preferences differs from how equation (17) of Maccheroni et al. (2006b) describes Hansen and Sargent (2001) and Hansen et al. (2006)'s "multiplier preferences". The disparity reflects what we regard as a minor blemish in Maccheroni et al. (2006b). The term $\frac{\xi\delta}{2}\gamma_t$ in our analysis is γ_t in Maccheroni et al. (2006b) and our equation (34) is a continuous time counterpart to equation (12) in their paper. In Hansen and Sargent (2001) and Hansen et al. (2006), $\gamma_t = |U_t|^2$ as we define γ_t. We point out this minor error here only because the analysis in the present paper generalizes our earlier work by now measuring discrepancy from a non-singleton set $\mathcal{M}^o$ of structured models rather than from a single structured model.

the baseline probability is

$$
\begin{aligned}
\epsilon_0 &\doteq \sum_{i=1}^{I} \sum_{j \in \Lambda_i} \pi_i P_{i,j} \left(\log P_{i,j} + \log \pi_i - \log \widehat{P}_{i,j} - \log \hat{\pi}_i \right) \\
&= \sum_{i=1}^{I} \pi_i \left(\epsilon_{1,i} + \log \pi_i - \log \hat{\pi}_i \right). \qquad (35)
\end{aligned}
$$

where

$$
\epsilon_{1,i} = \sum_{j \in \Lambda_i} P_{i,j} \left(\log P_{i,j} - \log \widehat{P}_{i,j} \right)
$$

Expression (35) represents joint entropy ϵ_0 in terms of a sum of an expected value of "continuation conditional relative entropies" $\epsilon_{1,i}$ of the time $t = 2$ possible outcomes and the unconditional relative entropy $\sum_{i=1}^{I} \pi_i (\log \pi_i - \log \hat{\pi}_i)$ of the marginal distribution of the time $t = 1$. This is an example of what is sometimes called a "chain rule of relative entropy."

To relate this structure to positive martingales with mathematical expectations equal to 1 that are used throughout this paper, let M_2 denote a random variable that is equal to the probability ratio $\frac{\pi_i P_{ij}}{\hat{\pi}_i \hat{P}_{ij}}$ in state j and let M_1 equal the probability ratio $\frac{\pi_i}{\hat{\pi}_i}$ when $j \in \Lambda_i$. It can be verified under the baseline probability that the expectation M_2 equals M_1 conditional on information at $t = 1$ and that the unconditional mathematical expectation of M_1 equals 1. Written in terms of M_2 and M_1, time 0 entropy is

$$
\begin{aligned}
\epsilon_0 &= E \left[M_2 \left(\log M_2 - \log M_1 \right) \right] + E \left(M_1 \log M_1 \right) \\
&= E \left[M_1 \left(\epsilon_1 + \log M_1 \right) \right] \qquad (36)
\end{aligned}
$$

where

$$
\epsilon_1 = E \left[\left(\frac{M_2}{M_1} \right) \left(\log M_2 - \log M_1 \right) \mid \mathfrak{F}_1 \right]
$$

and $\mathfrak{F}_1$ denotes the date one sigma algebra constructed from the partition. Versions of formula (36) that are cast in terms of a mean 1 positive martingale $\{M_t\}$ extend to more general probability specifications and to more time periods. In later sections of this paper, we use a continuous-time limiting version of formula (36) that we modify to incorporate discounting the future at a fixed discount rate.

We now show that a rectangular embedding of the baseline model imposes extremely weak restrictions on the continuation entropies $\epsilon_{1,i}$. Represent relative entropy ϵ_0 as

$$\epsilon_0 = \mathbb{H}(\pi, \epsilon_1) = \sum_{i=1}^{I} \pi_i \left(\epsilon_{1,i} + \log \pi_i - \log \hat{\pi}_i\right). \tag{37}$$

We use the $\mathbb{H}$ notation to make explicit the dependence of ϵ_0 on the vector π of probabilities and the vector ϵ_1 date $t = 1$ continuation entropies. We impose the following restriction on date 0 entropy

$$\mathbb{H}(\pi, \epsilon_1) \leqslant \bar{\epsilon} \tag{38}$$

where $\bar{\epsilon} > 0$. Inequality (38) is an *ex ante* constraint that jointly restricts (π, ϵ_1) as determinants of time 0 relative entropy.

We want a set of probabilities surrounding the baseline probability that is *rectangular* in the sense of Epstein and Schneider (2003), i.e., we want a "rectangular embedding of a set of probabilities that is not rectangular." To construct a rectangular embedding, we shall seek the weakest restriction that (37) and (38) impose on $\epsilon_{1,\ell}$ for a given ℓ as we search over alternative vectors π of probabilities and vectors ϵ_1 of continuation entropies.

We begin by deducing a bound under the restriction $\pi = \hat{\pi}$, so that there are no distortions of time $t = 1$ probabilities. To obtain the *weakest* bound under this restriction, we set $\epsilon_{1,i} = 0$ for all i except for state ℓ. Then

$$\mathbb{H}(\hat{\pi}, \epsilon_1) = \hat{\pi}_\ell \epsilon_{1,\ell}$$

and constraint (38) implies that

$$\epsilon_{1,\ell} \leqslant \frac{\bar{\epsilon}}{\hat{\pi}_\ell}. \tag{39}$$

Repeating this calculation for each $\ell = 1, ..., I$ gives us a restricted set of continuation entropies ϵ_1 and is an example of a "rectangular restriction" on the date $t = 2$ conditional probabilities expressed in terms continuation entropies. Suppose that we now set each of these continuation entropies at its upper bound. Then entropy ϵ_0 is

$$\sum_{\ell=1}^{I} \hat{\pi}_\ell \epsilon_{1,\ell} = \bar{\epsilon} I,$$

verifying that we have substantially expanded the set of admissible continuation entropies. For a fixed $\bar{\epsilon}$, constraint (39) for each ℓ becomes weaker and weaker as we reduce probability π_ℓ assigned to partition component Λ_ℓ.

We can loosen restriction (39) further by allowing $\pi_i \neq \hat{\pi}_i$ and in particular by setting $\pi_\ell < \hat{\pi}_\ell$. It is convenient to proceed in two steps. First, for a given $(\epsilon_{1,\ell}, \pi_\ell)$, minimize $\mathbb{H}(\pi, \epsilon_1)$ by choosing $(\epsilon_{1,i}, \pi_i)$ for $i \neq \ell$. Evidently, the minimizers are $\epsilon_{1,i} = 0$ for $i \neq \ell$. It is straightforward to show that the minimizing π_i's are proportional to the corresponding $\hat{\pi}_i$'s and hence that for $i \neq \ell$,

$$\pi_i = \frac{(1-\pi_\ell)\hat{\pi}_i}{1-\hat{\pi}_\ell}.$$

Notice that the proportionality coefficients $\frac{1-\pi_\ell}{1-\hat{\pi}_\ell}$ guarantee that the altered probabilities sum to 1:

$$\sum_{i=1}^{I} \pi_i = \pi_\ell + (1-\pi_\ell) = 1.$$

Imposing these minimizing choices gives

$$\begin{aligned}
\mathbb{H}^*(\pi, \epsilon_{1,\ell}) &= \sum_{i=1}^{I} \pi_i \left(\epsilon_{1,i} + \log \pi_i - \log \hat{\pi}_i\right) \\
&= \pi_\ell(\epsilon_{1,\ell} + \log \pi_\ell - \log \hat{\pi}_\ell) + \left(\frac{1-\pi_\ell}{1-\hat{\pi}_\ell}\right) \left[\log(1-\pi_\ell) - \log(1-\hat{\pi}_\ell)\right] \sum_{i \neq \ell} \hat{\pi}_i \\
&= \pi_\ell(\epsilon_{1,\ell} + \log \pi_\ell - \log \hat{\pi}_\ell) + (1-\pi_\ell) \left[\log(1-\pi_\ell) - \log(1-\hat{\pi}_\ell)\right]
\end{aligned}$$

At these minimizing choices, entropy constraint (36) becomes

$$\pi_\ell \epsilon_{1,\ell} + \pi_\ell(\log \pi_\ell - \log \hat{\pi}_\ell) + (1-\pi_\ell) \left[\log(1-\pi_\ell) - \log(1-\hat{\pi}_\ell)\right] \leqslant \bar{\epsilon}.$$

It follows that

Claim 8.1. *The rectangular embedding is described by:*

$$\epsilon_{1,\ell} \leqslant \sup_{0<\pi_\ell \leqslant 1} \frac{\bar{\epsilon} - (1-\pi_\ell)\left[\log(1-\pi_\ell) - \log(1-\hat{\pi}_\ell)\right] - \pi_\ell \left(\log \pi_\ell - \log \hat{\pi}_\ell\right)}{\pi_\ell}. \tag{40}$$

for $\ell = 1, 2, ...I$.

Sometimes the right-hand side of (40) can be made arbitrarily large by letting π_ℓ decrease to zero. To discover when, note that

$$\lim_{\pi_\ell \downarrow 0} \pi_\ell(\log \pi_\ell - \log \hat{\pi}_\ell) = 0$$

$$\lim_{\pi_\ell \downarrow 0} (1-\pi_\ell) \left[\log(1-\pi_\ell) - \log(1-\hat{\pi}_\ell)\right] = -\log(1-\hat{\pi}_\ell)$$

Therefore, as $\pi_\ell \to 0$ the numerator of the right-hand side of inequality (40) approaches

$$\bar{\epsilon} + \log(1 - \hat{\pi}_\ell)$$

It is convenient to construct the threshold

$$\tilde{\pi} \doteq 1 - \exp(-\bar{\epsilon})$$

that satisfies

$$\bar{\epsilon} + \log(1 - \tilde{\pi}) = 0.$$

If $\hat{\pi}_\ell < \tilde{\pi}$, the numerator of the right side of inequality (40) remains strictly positive as π_ℓ converges to zero. But the denominator of the right side of inequality (40) converges to zero as π_ℓ converges to zero, implying that the ratio diverges to plus infinity.

Corollary 8.2. *If $\hat{\pi}_\ell < \tilde{\pi}$, then the rectangular embedding does not restrict ϵ_ℓ. Furthermore, if $\hat{\pi}_\ell < \tilde{\pi}$ for all ℓ, the rectangular embedding does not restrict* any $\epsilon_{1,\ell}$.

Figure 2 plots the right-hand side of inequality (40) as a function of π_ℓ for two cases, one in which $\hat{\pi}_\ell > \tilde{\pi}$ and a second in which $\hat{\pi}_\ell < \tilde{\pi}$. In the first large $\hat{\pi}_\ell$ case, an interior maximum occurs to the left of $\hat{\pi}$. In the second small $\hat{\pi}_\ell$ case, the function is unbounded as π_ℓ tends to zero. In the second low-baseline-probability case, by adopting a rectangular embedding, we relax – indeed we completely eliminate – an upper bound on each continuation entropy $\epsilon_{1,\ell}$.

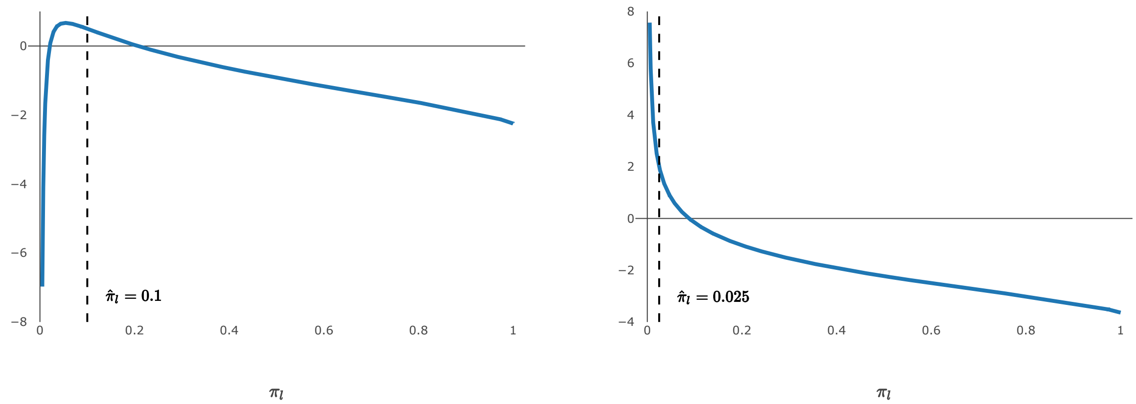

Figure 2: Entropy bounds implied by a rectangular embedding as described by the right-hand side of inequality (40) as a function of π_ℓ for two cases. The maxima equal the induced bounds on continuation entropies. When $\eta = 0.05$, the threshold is $\tilde{\pi} = 0.049$. The left panel imposes $\hat{\pi}_\ell = 0.1$, and the right panel assumes $\hat{\pi}_\ell = 0.025$. Vertical lines depict $\pi_\ell = \hat{\pi}_\ell$.

8.2 Anything goes: take 2

In this subsection, we show that if a decision maker starts with a set of unstructured models constrained by relative entropy to be close to the set of structured models, enlarging that set to make it rectangular results in the set of all unstructured models that are absolutely continuous to a structured model over finite intervals. Most of those are statistically very implausible and not ones that the decision maker is concerned about.

Our decision maker starts with a set of structured probability models that we have constructed to be rectangular in the sense of Epstein and Schneider. But our decision maker's suspicion that all of these structured models are misspecified motivates him to explore the utility consequences of a larger set that includes unstructured probability models. This larger set is not rectangular, even though as measured by relative entropy, all of the unstructured models are statistically close to models in the rectangular set formed by the structured models.

An alternative to formulating the decision maker's problems with the dynamic variational preferences of Maccheroni et al. (2006b) would have been first to construct a set that includes relative entropy neighborhoods of all martingales in $\mathcal{M}^o$. For instance, for $\epsilon > 0$,

Ξ given by (28), and $\xi = 1$, we could have started with a set

$$\overline{\mathcal{M}} = \left\{ M^U \in \mathcal{M} : \Xi(M^U|\mathfrak{F}_0) < \epsilon \right\}. \tag{41}$$

The set of implied probabilities is not rectangular. At this point, why not follow Epstein and Schneider's (2003) recommendation and add just enough martingales to attain a rectangular set of probability measures? A compelling practical reason not to do so is that doing so would include all martingales in $\mathcal{M}$ defined in definition 3.1 – implying a set much too large for an interesting max-min decision analysis.

To show this, it suffices to look at relative entropy neighborhoods of the baseline model.[22] To construct a rectangular set of models that includes the baseline model, for a fixed date τ, consider a random vector $\overline{U}_\tau$ that is observable at τ and that satisfies

$$E\left(|\overline{U}_\tau|^2 \mid \mathfrak{F}_0\right) < \infty.$$

Form a stochastic process

$$U_t^h = \begin{cases} 0, & 0 \leqslant t < \tau \\ \overline{U}_\tau, & \tau \leqslant t < \tau + h \\ 0, & t \geqslant \tau + h. \end{cases}$$

The martingale M^{U^h} associated with U^h equals one both before time τ, and $M_t^{U^h}/M_{h+\tau}^{U^h}$ equals one after time $h + \tau$. Compute relative entropy:

$$\begin{aligned} \Delta(M^{U^h}|\mathfrak{F}_0) &= \left(\frac{1}{2}\right) \int_\tau^{\tau+h} \exp(-\delta t) E\left[M_t^{U^h} |\overline{U}_\tau|^2 dt \middle| \mathfrak{F}_0 \right] dt \\ &= \left[\frac{1 - \exp(-\delta h)}{2\delta} \right] \exp(-\delta \tau) E\left(|\overline{U}_\tau|^2 \mid \mathfrak{F}_0\right). \end{aligned}$$

Evidently, relative entropy $\Delta(M^{U^h}|\mathfrak{F}_0)$ can be made arbitrarily small by shrinking h to zero. This means that any rectangular set that contains $\overline{\mathcal{M}}$ must allow for a drift distortion $\overline{U}_\tau$ at date τ. This argument implies the following proposition:

Proposition 8.3. *Any rectangular set of probabilities that contains the probabilities induced by martingales in $\overline{\mathcal{M}}$ must also contain the probabilities induced by any martingale in $\mathcal{M}$.*

This rectangular set of martingales allows too much freedom in setting date τ and random vector $\overline{U}_\tau$: all martingales in the set $\mathcal{M}$ isolated in definition 3.1 are included in

[22] Including additional structured models would only make the set of martingales larger.

the smallest rectangular set that embeds the set described by (41). That set is too big to pose a max-min problem for a decision maker who wants to apply the plausibility check recommended by Good (1952).

9 Conclusion

While important aspects of our analysis apply in more general settings, we have added inessential auxiliary assumptions that we find enlightening and that set the stage for concrete applications. Extensions of the framework presented here would relax the Brownian information structure and would not use relative entropy to constrain a family of structured models. Our continuous-time formulation (34) exploits mathematically convenient properties of a Brownian information structure. A discrete-time version starts from a baseline model cast in terms of a nonlinear stochastic difference equation. Counterparts to structured and unstructured models play the same roles that they do in the continuous time formulation described in this paper. In the discrete time formulation, preference orderings defined in terms of recursions on continuation values are dynamically consistent.

In both continuous time and discrete time settings, there are compelling reasons for a decision maker to think that a rectangular set of structured probability models does not describe the set of probabilities that concerns him. The set of structured models is *too small* because it excludes interesting statistically nearby unstructured models. But a rectangular embedding of unstructured probabilities of concern to the decision maker models is *too large* because it includes models that are statistically very implausible in the sense of Good (1952). Therefore, the decision maker uses the framework of the present paper to include concerns about unstructured models that satisfy a penalty on entropy relative to the set of structured models, the same type of statistical neighborhood routinely applied to construct probability approximations in computational information geometry.[23]

A purpose of this paper is to provide a framework for analyzing the consequences of long-term variations in macroeconomic growth coming from rates of technological progress, climate change, and demographics that concertn private and public decision makers in situations that naturally involve both ambiguity and misspecification fears as we have formalized those concepts here.

While we do not explore the issue here, we suspect that the tension between admissibility and dynamic consistency described in this paper is also present in other approaches to

[23]See Amari (2016) and Nielsen (2014).

ambiguity and misspecification, including ones proposed by Hansen and Sargent (2007) and Hansen and Miao (2018).

A Computing relative entropy

We show how to compute relative entropies for parametric models of the form (26). Recall that relative entropy $\frac{\mathsf{q}^2}{2}$ emerges as part of the solution to the second-order differential equation (16) appropriately specialized to become:

$$\frac{|\eta^o(z)|^2}{2} + \frac{d\rho^o}{dz}(z)[-\widehat{\beta}_z(z-\bar{z}) + \sigma_z \cdot \eta(z)] + \frac{|\sigma_z|^2}{2}\frac{d^2\rho^0}{dz^2}(z) - \frac{\mathsf{q}^2}{2} = 0.$$

where $\bar{z} = \frac{\widehat{\alpha}_z}{\widehat{\beta}_z}$ and

$$\eta^o(z) = \eta_0 + \eta_1(z-\bar{z}).$$

Under our parametric alternatives, the solution for ρ^o is quadratic in $z-\bar{z}$:

$$\rho^o(z) = \rho_1(z-\bar{z}) + \frac{1}{2}\rho_2(z-\bar{z})^2.$$

Compute ρ_2 by targeting only terms that involve $(z-\bar{z})^2$:

$$\frac{\eta_1 \cdot \eta_1}{2} + \rho_2\left[-\widehat{\beta}_z + \sigma_z \cdot \eta_1\right] = 0.$$

Thus,

$$\rho_2 = \frac{\eta_1 \cdot \eta_1}{2\left(\widehat{\beta}_z - \sigma_z \cdot \eta_1\right)}.$$

Given ρ_2, compute ρ_1 by targeting only the terms in $(z-\bar{z})$:

$$\eta_0 \cdot \eta_1 + \rho_2\left(\sigma_z \cdot \eta_0\right) + \rho_1\left(-\widehat{\beta}_z + \sigma_z \cdot \eta_1\right) = 0.$$

Thus,

$$\rho_1 = \frac{\eta_0 \cdot \eta_1}{\widehat{\beta}_z - \sigma_z \cdot \eta_1} + \frac{(\eta_1 \cdot \eta_1)\left(\sigma_z \cdot \eta_0\right)}{2\left(\widehat{\beta}_z - \sigma_z \cdot \eta_1\right)^2}.$$

Finally, calculate q by targeting the remaining constant terms:

$$\frac{\eta_0 \cdot \eta_0}{2} + \rho_1\left(\sigma_z \cdot \eta_0\right) + \rho_2\frac{|\sigma_z|^2}{2} - \frac{\mathsf{q}^2}{2} = 0.$$

Thus,[24]

$$\frac{\mathsf{q}^2}{2} = \frac{\eta_0 \cdot \eta_0}{2} + \frac{\eta_0 \cdot \eta_1 \left(\sigma_z \cdot \eta_0\right)}{\widehat{\beta}_z - \sigma_z \cdot \eta_1} + \frac{\eta_1 \cdot \eta_1 \left(\sigma_z \cdot \eta_0\right)^2}{2\left(\widehat{\beta}_z - \sigma_z \cdot \eta_1\right)^2} + \frac{\eta_1 \cdot \eta_1 |\sigma_z|^2}{4\left(\widehat{\beta}_z - \sigma_z \cdot \eta_1\right)}.$$

[24] We could also have derived this same formula by computing the expectation of $\frac{|\tilde{\eta}(Z_t)|^2}{2}$ under the perturbed distribution.

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