Answers to reading check #3

True or false: one of the most lucrative investments of many Americans over the past century has been their own home.

Quite contrary to almost everything you hear in the news and from your parents, *false*. For most of the last century, home values have been among the worst investments of all: a house bought for $10,000 in 1896 was worth, on average, $10,600 in 1996 after adjusting for inflation. (!!)

What's the difference between uncertainty and risk?

Risk is the possibility of a bad outcome whose likelihood you can quantify: say, the probability that an investment won't pan out and you'll lose all your money. If a company you're buying stock in has a 20% chance of going bankrupt, we say the investment's risk is 20%.

Uncertainty is when you don't even know what the number is.

Suppose there are five different borrowers, each of whom has an estimated 10% chance of defaulting on their loan. The probability of *all five* borrowers defaulting, therefore, is an astonishingly low $.10^5 = .00001$.

Or is it? What underlying assumption have we made in this analysis, which if it turns out *not* to hold, would dramatically increase the chances of *everybody* defaulting?

Our assumption was that all 5 are independent: whether loan #1 defaults is unrelated to whether loan #2 defaults, and so forth. But if they're highly dependent, statistically, the probability of a massive default could be as high as .1, not .00001!

What two emotional factors does Larry Summers think need to be balanced in order for the economy to stay stable? Which one, in his view, did people have way too much of, and which one did people have way too little of, in the lead-up to the financial crisis?

Too much *greed*, too little *fear*.