This paper describes links between the max-min expected utility theory of Itzhak Gilboa and David Schmeidler (1989) and the applications of robust-control theory proposed by Evan Anderson et al. (2000) and Paul Dupuis et al. (1998). The max-min expected-utility theory represents uncertainty aversion with preference orderings over decisions \( c \) and states \( x \), for example, of the form

\[
\inf_{Q} \mathbb{E}_{Q} \left[ \int_{0}^{\infty} \exp(-\delta t) U(c_{t}, x_{t}) dt \right]
\]

where \( Q \) is a set of measures over \( c \) and \( x \), and \( \delta \) is a discount rate. Gilboa and Schmeidler's theory leaves open how to specify the set \( Q \) in particular applications.

Criteria like (1) also appear as objective functions in robust-control theory. Robust-control theory specifies \( Q \) by taking a single “approximating model” and statistically perturbing it; \( Q \) is typically parameterized only implicitly, through a positive penalty variable \( \theta \). This paper describes how to transform that “penalty problem” into a closely related “constraint problem” like (1). These two formulations differ in subtle ways but are connected via the Lagrange multiplier theorem. The implicit preference orderings differ but imply the same decisions. Both preferences are recursive, and therefore both are time-consistent. However, time consistency for the constraint specification requires that we introduce a new endogenous state variable to restrict how probability distortions are reconsidered at future dates. To facilitate comparisons to Anderson et al. (2000) and Zengjing Chen and Larry G. Epstein (2000), we cast our discussion within continuous-time diffusion models.

I. A Benchmark Resource-Allocation Problem

We first pose a discounted, infinite-time, (optimal) resource-allocation problem without regard to robustness. Let \( \{B_{t}; t \geq 0\} \) denote a \( d \)-dimensional, standard Brownian motion on an underlying probability space \( (\Omega, \mathcal{F}, P) \). Let \( \{x_{t}; t \geq 0\} \) denote the completion of the filtration generated by this Brownian motion. The actions of the decision-maker form a stochastic process \( \{c_{t}; t \geq 0\} \) that is progressively measurable. Let \( U \) denote an instantaneous utility function, and write the discounted objective as

\[
\sup_{c \in C} \mathbb{E} \left[ \int_{0}^{\infty} \exp(-\delta t) U(c_{t}, x_{t}) dt \right]
\]

subject to

\[
dx_{t} = \mu(c_{t}, x_{t}) dt + \sigma(c_{t}, x_{t}) dB_{t},
\]

where \( x_{0} \) is a given initial condition and \( C \) is a set of admissible control processes. We use \( P \) to denote the stochastic process for \( x_{t} \) generated by (2). Equation (2) will be the “approximating model” of later sections, to which all other models in \( Q \) are perturbations.

We restrict \( \mu \) and \( \sigma \) so that any progressively measurable control \( c \) in \( C \) implies a progressively measurable state vector process \( x \). We assume throughout that the objective for the control problem without reference to robustness has a finite upper bound.

II. Model Misspecification

The decision-maker treats (2) as an approximation by taking into account a class of alternative models that are statistically difficult to distinguish from (2). To construct a perturbed model, we replace \( B_{t} \) in (2) by \( \tilde{B}_{t} + \int_{0}^{t} h ds \) where \( h \) is progressively measurable and \( \{\tilde{B}_{t}\} \) is a Brownian motion. Then we can
write the distorted stochastic evolution in continuous time as

\[ dx_t = \mu(c_t, x_t)dt + \sigma(c_t, x_t)(h_t dt + d\hat{B}_t) \]

under the Brownian-motion probability specification.

### A. Changes in Measure

The process \( h \) is used as a device to transform the probability distribution \( P \) on \( (\Omega, \mathcal{F}) \) into a new distribution \( Q \) that is absolutely continuous with respect to \( P \). An absolutely continuous change in measure for a stochastic process can be represented in terms of a nonnegative martingale. Let \( Q \) denote a probability distribution that is absolutely continuous with respect to \( P \). Associated with \( Q \) is a family of expectation operators applied to random variables that are \( \mathcal{F}_t \) measurable for each \( t \). Thus, we can write \( E_Q g_t = E_P g_t q_t \) for any bounded \( g_t \) that is \( \mathcal{F}_t \) measurable and some nonnegative random variable \( q_t \) that is \( \mathcal{F}_t \) measurable. The random variable \( q_t \) is called a Radon-Nikodym derivative. In our setting, we use the Girsanov Theorem to depict \( q_t \) as

\[ q_t = \exp \left[ \int_0^t h_s (d\hat{B}_s) - \int_0^t \frac{|h_s|^2}{2} \, ds \right]. \]

We use this representation to justify our use of \( h \) to parameterize absolutely continuous changes of measure.\(^2\) When \( h \) is zero we revert to the benchmark control problem.

### B. Relative Entropy of a Stochastic Process

Consider a scalar stochastic process \( \{g_t\} \) that is progressively measurable. This process is a random variable on a product space. Form \( \Omega^* = \Omega \times \mathbb{R}^+ \) where \( \mathbb{R}^+ \) is the nonnegative real line; form the corresponding sigma algebra \( \mathcal{F}^* \) as the smallest sigma algebra containing \( \mathcal{F}_t \otimes \mathcal{B}_t \) for any \( t \) where \( \mathcal{B}_t \) is the collection of Borel sets in \([0, t]\); and form \( P^* \) as the product measure \( P \times M \) where \( M \) is exponentially distributed with density \( \delta \exp(-\delta t) \). We let \( E^* \) denote the expectation operator on the product space. The \( E^* \) expectation of the stochastic process \( \{g_t\} \) is, by construction,

\[ E^*(g_t) = \delta \int_0^{\infty} \exp(-\delta t) E(g_t) \, dt. \]

We extend this construction by using the probability measure \( Q \). Form \( Q^* = Q \times M \). The process \( \{q_t\} \) is a Radon-Nikodym derivative for \( Q^* \) with respect to \( P^* \):

\[ E^*_Q(g_t) = \delta \int_0^{\infty} \exp(-\delta t) E_Q (q_t g_t) \, dt. \]

The \( Q^* \) values can be used to evaluate discounted expected utility under an absolutely continuous change in measure.

We measure the discrepancy between the distributions of \( P \) and \( Q \) as the relative entropy between \( Q^* \) and \( P^* \):

\[ R(Q) = \delta \int_0^{\infty} \exp(-\delta t) E_Q (\log q_t) \, dt = \int_0^{\infty} \exp(-\delta \tau) E_Q \left( \frac{|h_\tau|^2}{2} \right) \, d\tau. \]

Relative entropy is convex in the measure \( Q^* \) (see e.g., Dupuis and Richard S. Ellis, 1997). Relative entropy is nonnegative and zero only when the probability distributions \( P^* \) and \( Q^* \) agree. This is true only when the process \( h \) is zero.

### III. Two Robust Control Problems

We study the relationship between two robust-control problems. Let \( E_Q \) denote the mathematical expectation taken with respect to the stochastic process \( \{B_t: t \geq 0\} \) where

\^2\ Perturbations that are not absolutely continuous are easy to detect statistically, which is the reason why Anderson et al. (2000) impose absolute continuity on the perturbations.
\( dB_t = d\bar{B}_t + h_t dt \) and \( \{\bar{B}_t; \; t \geq 0\} \) is a Brownian motion under both \( P \) and \( Q \). Thus we parameterize \( Q \) by the choice of drift distortion \( \{h_t\} \) and use the state evolution equation:

\[
(3) \quad dx_t = \mu(c_t, x_t) dt + \sigma(c_t, x_t) dB_t.
\]

We define two control problems. A multiplier robust-control problem is

\[
\sup_{c \in \mathcal{C}} \inf_{Q} E_Q \left[ \int_0^\infty \exp(-\delta t) U(c_t, x_t) dt \right] + \theta R(Q)
\]

subject to (3). A constraint robust control problem is \( \sup_{c \in \mathcal{C}} \inf_{Q} E_Q \left[ \int_0^\infty \exp(-\delta t) U(c_t, x_t) dt \right] \) subject to (3) and \( R(Q) \leq \eta \). Note that \( R(Q) \leq \eta \) is a single intertemporal constraint on the entire path of distortions \( h \).

These two problems are closely related. We can interpret the robustness parameter \( \theta \) in the first problem as an implied Lagrange multiplier on the specification-error constraint \( R(Q) \leq \eta \). Use \( \theta \) to index a family of multiplier robust-control problems and \( \eta \) to index a family of constraint robust-control problems. Because not all values of \( \theta \) are admissible, we consider only nonnegative values of \( \theta \) for which it is feasible to make the objective function greater than \(-\infty\). Call the closure of this set \( \Theta \). In Hansen et al. (2001) we provide assumptions and a proof for the following.

**PROPOSITION 1:** Suppose that for \( \eta = \eta^* \), \( c^* \) and \( Q^* \) solve the constraint robust control problem. There exists a \( \theta^* \in \Theta \) such that the multiplier and constraint robust-control problems have the same solution.

To construct the multiplier, let \( J(c, \eta) \) satisfy

\[
J(c, \eta) = \inf_Q E_Q \left[ \int_0^\infty \exp(-\delta t) U(c_t, x_t) dt \right]
\]

subject to \( R(Q) \leq \eta \) and \( J^*(\eta) = \sup_{c \in \mathcal{C}} J(c, \eta) \). As argued by David G. Luenberger (1969), \( J(c, \eta) \) is decreasing and convex in \( \eta \). These same properties carry over to the optimized (over \( c \)) function \( J^* \). Given \( \eta^* \), we let \( \theta^* \) be the negative of the slope of the subgradient of \( J^* \) at \( \eta^* \), (i.e., \( \theta^* \) is the absolute value of the slope of a line tangent to \( J^* \) at \( \eta^* \)).

Hansen et al. (2001) also establish the following.

**PROPOSITION 2:** Suppose \( J^* \) is strictly decreasing, \( \theta^* \) is in the interior of \( \Theta \), and that there exists a solution \( c^* \) and \( Q^* \) to the multiplier robust-control problem. Then, that \( c^* \) also solves the constraint robust-control problem for \( \eta = \eta^* = R(Q^*) \).

Propositions 1 and 2 are observational equivalence results because they describe how the multiplier and constraint robust-control problems give rise to the same decisions. By adapting arguments in Hansen and Sargent (1995) and Anderson et al. (2000), it can be shown that the multiplier robust-control problem has the same solution as a recursive risk-sensitive control problem, where \(-\theta^{-1}\) is the risk-sensitivity parameter. Propositions 1 and 2 thus link a risk-sensitive control problem to the constraint robust-control problem.

**IV. Recursivity of the Multiplier Formulation**

The multiplier robust-control problem can be represented as

\[
\sup_{c} \inf_{\eta} \hat{E} \int_0^\infty \exp(-\delta t) \left( U(c_t, x_t) + \frac{\theta}{2} (h_t \cdot h_t) \right) dt
\]

subject to

\[
3 This connection has been explored informally in Hansen et al. (1999) and formally in Hansen and Sargent (2001) in the context of a linear-quadratic control problem. We mimic arguments in I. R. Peterson et al. (2000) and David G. Luenberger (1969).

4 Risk-sensitive control theory makes decision rules more responsive to risk by making an exponential adjustment to the objective of the decision-maker in the same way used by Epstein and Stanley E. Zin (1989) and Darrell Duffie and Epstein (1992). Hansen and Sargent (1995) and Anderson et al. (2000) show how risk-sensitive control theory can be motivated through recursive utility theory.
\[ dx_i = \mu(c_i, x_i)dt + \sigma(c_i, x_i)(h, dt + dB_i). \]

We can view \( h \) as a second control process in a two-player zero-sum game. Given \( h \), we can fix the distribution for \( \tilde{B} \) as a multivariate standard Brownian motion. Then there is a single probability distribution in play, and we use the notation \( \tilde{E} \) to denote the associated expectation operator. W. H. Fleming and P. E. Souganidis (1989) tell how a Bellman-Isaacs condition justifies a recursive solution by relating a solution to a date-0 commitment game to a Markov perfect game in which the decision rules of both agents are functions of the state vector \( x_t \). The Bellman-Isaacs condition is as follows.

**ASSUMPTION 1:** There exists a value function \( V \) such that:

\[
\delta V = \max_c \min_h U(c, x) + \frac{\theta}{2} (h \cdot h) \\
+ \left[ \mu(c, x) + \sigma(c, x)h \right] \frac{\partial V(x)}{\partial x} \\
+ \text{trace} \left[ \sigma(c, x)' \frac{\partial^2 V(x)}{\partial x \partial x'} \sigma(c, x) \right]
\]

\[= \min_h \max_c U(c, x) + \frac{\theta}{2} (h \cdot h) \\
+ \left[ \mu(c, x) + \sigma(c, x)h \right] \frac{\partial V(x)}{\partial x} \\
+ \text{trace} \left[ \sigma(c, x)' \frac{\partial^2 V(x)}{\partial x \partial x'} \sigma(c, x) \right].\]

The Bellman-Isaacs condition defines a Bellman equation for a two-player zero-sum game in which both players decide at time 0 or recursively. The associated decision rules for \( c \) and \( h \) also solve our two robust-control problems.

**V. Two Preference Orderings**

While the Lagrange multiplier theorem links the two robust-control problems, the implied preference orders differ. However, they are related at the common solution to both problems, where their indifference curves are tangent.

\[ ds_t = \mu_s(s_t, c_t)dt \]

where this differential equation can be solved uniquely for \( s_t \) given \( s_0 \) and process \{\( c_s \); \( 0 \leq s < t \}\). We assume that the solution is a progressively measurable process \( \{s_t; t \geq 0\} \). We think of \( s_t \) as an endogenous component of the state vector \( x_t \). We use \( s_t \) to make preferences nonseparable over time as in models with habit persistence. We use the felicity function \( u(s_t, c_t) \) to represent preferences that are additively separable in \( (s_t, c_t) \).

We define preference orders for times \( \tau \geq 0 \) in terms of two functions, \( D_\tau(c, s_\tau) \) and \( R_\tau(Q) \).

First, define

\[ D_\tau(c, s_\tau) = \int_{s_\tau}^{\infty} \exp(-\delta t)u(s_{t+\tau}, c_{t+\tau})dt \]

where \( s_{t+\tau} \) is the date-\( \tau \) initial condition for differential equation (4). The impact of consumption between dates 0 and \( \tau \) is captured by the state variable \( s_\tau \).

Next, define a time-\( \tau \) model discrepancy measure,

\[ R_\tau(Q) = \delta \int_{0}^{\infty} \exp(-\delta t) \]

\[\times E_Q (\log q_{t+\tau} - \log q_t) dt.\]

The local evolution of \( R_\tau(Q) \) is given by the following:

\[ dR_\tau(Q) = \left[ -\frac{|h|^2}{2} + \delta R_\tau(Q) \right] dt \]

with initial condition \( R_0(Q) = R(Q) \). We use \( D_\tau(c, s_\tau) \) to represent both preference specifications at \( \tau \), and we use \( R_\tau(Q) \) to help us represent preferences under the constraint specification.

For fixed \( \theta \), we represent the date-\( \tau \) multiplier preferences using the valuation function

\[ \hat{W}_\tau(c; \theta) = \inf_{\bar{Q}} E_Q [D_\tau(c, s_\tau)|\bar{F}_t] + \theta R_\tau(Q). \]
For a nonnegative $r_\tau$ that is $\mathcal{F}_\tau$ measurable, we represent the time-$\tau$ constraint preferences in terms of the valuation function

$$W_\tau(c; r_\tau) = \inf_{r_\tau(Q) = r_\tau} E_0[D_\tau(c, s_\tau)|\mathcal{F}_\tau].$$

For convenience, denote the time-0 versions $W_0(c, r_0) = W(c, \eta)$ and $\hat{W}_0(c, \theta) = \hat{W}(c, \theta)$.

We define preference orderings as follows. For any two progressively measurable $c$ and $c^*$, $c^* \succeq_\eta c$ if $W(c^*; \eta) \geq W(c; \eta)$. For any two progressively measurable $c$ and $c^*$, $c^* \succeq_{\theta^*} c$ if $\hat{W}(c^*; \theta) \geq \hat{W}(c; \theta)$. We would use analogous definitions for time-$\tau$ versions of the preference orderings.

The multiplier preference ordering coincides with a recursive, risk-sensitive preference ordering provided that $0 > 0.5$.

B. Relation between the Preference Orders

The two time-0 preference orderings differ. Furthermore, given $\eta$, there exists no $\theta$ that makes the two preference orderings agree. However, the Lagrange multiplier theorem delivers a weaker result that is very useful to us. While globally the preference orderings differ, indifference curves that pass through the solution $c^*$ to the optimal-resource-allocation problem are tangent.

Use the Lagrange multiplier theorem to write

$$W(c^*; \eta^*) = \max_\theta \inf_\theta E_0[D(c^*) + \theta[\mathcal{R}(Q) - \eta^*]]$$

and let $\theta^*$ denote the maximizing value of $\theta$, which we assume to be strictly positive. Suppose that $c^* \succeq_\eta c$. Then,

$$\hat{W}(c; \theta^*) - \theta^* \eta^* \leq W(c; \eta^*) \leq W(c^*; \eta^*)$$

$$= \hat{W}(c^*; \theta^*) - \theta^* \eta^*.$$

Thus, $c^* \succeq_{\theta^*} c$.

The observational equivalence results from Propositions 1 and 2 apply to consumption profile $c^*$. At this point, the indifference curves are tangent, implying that they are supported by the same prices. Observational equivalence claims made by econometricians typically refer to equilibrium trajectories and not to off-equilibrium aspects of the preference orders.

VI. Recursivity of the Preference Orderings

To study time consistency, we describe the relation between the time-0 and time-$\tau > 0$ valuation functions that define preference orders. At date $\tau$, some information has been realized, and some consumption has taken place. Our preference orderings focus the attention of the decision-maker on subsequent consumption in states that can be realized given current information. These considerations underlie our use of $D_\tau$ and $\mathcal{R}_\tau$ to depict $W_\tau(c, \theta)$ and $\hat{W}_\tau(c, \theta)$. The function $D_\tau$ reflects a change in vantage point as time passes. Except through $s_\tau$, the function $D_\tau$ depends only on the consumption process from date $\tau$ forward.

In addition, at date $\tau$, the decision-maker focuses on states that can be realized from date $\tau$ forward. Expectations used to average over states are conditioned on date-$\tau$ information. In this context, while conditioning on time-$\tau$ information, it would be inappropriate to constrain probabilities using only date-0 relative entropy. Imposing a date-0 relative-entropy constraint at date $\tau$ would introduce a temporal inconsistency by letting the minimizing agent put no probability distortions at dates that have already occurred and in states that at date $\tau$ cannot be realized. Instead, we make the date-$\tau$ decision-maker explore only probability distortions that alter his preferences from date $\tau$ forward. This leads us to use $\mathcal{R}_\tau$ as a conditional counterpart to our relative-entropy measure.

Our entropy measure has a recursive structure. Date-0 relative entropy is easily constructed from the conditional relative entropies in future time periods. We can write

$$\mathcal{R}(Q) = E_0 \left[ \int_0^\tau \exp(-\delta t) \frac{|h_t|^2}{2} dt + \exp(-\delta \tau) \mathcal{R}_\tau(Q) \right].$$

The recursive structure of the multiplier prefer-
ences follows from this representation. In effect the date-0 valuation function \( \bar{W} \) can be separated by disjoint date- events and depicted as

\[
\bar{W}(c; \theta) = \inf_{\{h; 0 \leq t < \tau\}} \mathbb{E} \left( \int_{0}^{\tau} \exp(-\delta t) \right.
\]

\[
\times \left[ U(c_t, s_t) + \theta \frac{|h_t|^2}{2} \right] dt + \hat{W}(c; \theta) \right)
\]

subject to

\[
(6) \quad dB_t = d\hat{B} + h_t dt
\]

\[
(7) \quad ds_t = \mu_s(s_t, c_t) dt.
\]

The constraint preferences at time \( \tau \) make the decision-maker explore changes in probability distributions from date \( \tau \) forward. We also want to exclude the possibility of changing the probabilities of events known in previous dates and of events known not to occur. For the date-0 constraint preferences, given \( c \), we can find an \( h \) process used to construct \( W(c; \eta) \). Associated with this \( h \) process, we can compute the time- conditional relative entropy \( R(h) \). Thus, implicit in the construction of the valuation function \( W(c, \eta) \) is a partition of relative entropy over time and across states as in (5). At date \( \tau \) we ask the decision-maker to explore only changes in beliefs that affect outcomes that can be realized in the future. That is, we impose the constraint \( R(h) \leq r_\tau \) for \( r_\tau = R(h) \), along with fixing \( h_t \) for \( 0 \leq t < \tau \). Notice that, with this constraint imposed, \( R(h) \leq R(h) \), so that we continue to satisfy our date-0 relative-entropy constraint. We tie the hands of the date-\( \tau \) decision-maker to inherit how conditional relative entropy is to be allocated across states that are realized at date \( \tau \). (Chen and Epstein [2000] avoid this extra hand-tying by imposing separate constraints on \( h \) for every date and state.) We can write the valuation function for the constrained problem recursively as

\[
W(c, \eta) = \inf_{\{h; 0 \leq t < \tau\}} \mathbb{E} \left( \int_{0}^{\tau} \exp(-\delta t) U(c_t, s_t) dt \right.
\]

\[
+ \mathbb{E} W_t(c, r_\tau)
\]

subject to (6), (7), and \( r_\tau \geq 0 \), where \( r_\tau \) solves

\[
dr_t = (\delta r_t - |h_t|^2/2) dt \quad 0 \leq t < \tau \quad \text{with initial condition} \quad r_0 = \eta.
\]

**VII. Concluding Remarks**

Empirical work in macroeconomics and finance typically assumes a unique and explicitly specified dynamic statistical model. To use Gilboa and Schmeidler’s (1989) multiple-model expected utility theory, we have turned to robust-control theory for a parsimonious (one-parameter) set of alternative models with rich alternative dynamics. Those alternative models come from perturbing the decision-maker’s approximating model to allow its shocks to feed back on state variables arbitrarily. This allows the approximating model to miss functional forms, the serial correlation of shocks and exogenous variables, and how those exogenous variables impinge on endogenous state variables. Anderson et al. (2000) show how the multiplier parameter in the robust-control problems indexes a set of perturbed models that is difficult to distinguish statistically from the approximating model given a sample of \( T \) time-series observations.

**REFERENCES**


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