

Reply to referee report #2

The aim of the first part of the paper is to give a broad – although incomplete – overview over very different conceptual approaches to (fundamental) uncertainty. As I made clear on page 5 all of these approaches have in common that they impose very structured assumptions about non-observable entities which constitute the core of the explanans. I feel uncomfortable with such an explanatory strategy for methodological reasons. Perhaps you don't buy my argument but why is this review "confusing"? It is a bit contradictory that on the one hand it is suggested that I should limit my survey and set a clear focus, and on the other hand I should add references to Ellsberg and discuss whether ad hoc concepts are appropriate to represent Ellsberg's paradox. But to give partially an answer: Yes, as it can be seen in the second part of the paper, I advocate the adoption of ad hoc rules – as long as it can be shown that the agent clearly benefits from them in terms of equilibrium outcomes. This is how I understand Aumann's "rule rationality".

The second part of the report is the recommendation to make references to Barberis, Huang, Santos in QJE 2001, and to compare their approach with my model. I doubt whether this would help to understand the point I have made. The BHS model is one of the numerous models with loss aversion as I have already reviewed in the first part of the paper. The authors refer to Prospect Theory, hence in a more strict sense it is not a model of bounded rationality. The representative agent's behavior is fully consistent to a preference structure which is described by a prominent axiomatized non-expected utility theory. Numerical adjustment of non-observable "penalty factors", "scale factors" etc. etc. will create behavior which mimicks empirical data – but does this *explain* observable behavior? How is this related to Keynesian fundamental uncertainty? My point is that a simple heuristic deviation of standard portfolio choice – as a response to fundamental uncertainty due to limited knowledge – creates benefits for the agent. The agent's experienced success of a behavioral pattern is the modeler's explanatory device.