

Author's Accepted Manuscript

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www.elsevier.com/locate/jedc

PII: S0165-1889(16)30212-3
DOI: <http://dx.doi.org/10.1016/j.jedc.2016.12.008>
Reference: DYNCON3382

To appear in: *Journal of Economic Dynamics and Control*

Received date: 18 March 2016
Revised date: 27 December 2016
Accepted date: 29 December 2016

Cite this article as: Jing Guo and Xue Dong He, Equilibrium asset pricing with Epstein-Zin and loss-averse investors, *Journal of Economic Dynamics and Control*, <http://dx.doi.org/10.1016/j.jedc.2016.12.008>

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Equilibrium Asset Pricing with Epstein-Zin and Loss-Averse Investors *

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First version: June 5, 2015; This version: December 31, 2016

Abstract

We study multi-period equilibrium asset pricing in an economy with Epstein-Zin (EZ-) agents whose preferences for consumption are represented by recursive utility and with loss averse (LA-) agents who derive additional utility of gains and losses and are averse to losses. We propose an equilibrium gain-loss ratio for stocks and show that the LA-agents are more (less) risk averse than the EZ-agents if their degree of loss aversion is higher (lower) than this ratio. When all the agents have unitary relative risk aversion degree and elasticity of intertemporal substitution, we prove the existence and uniqueness of the equilibrium and the market dominance of the EZ-agents in the long run. Finally, we extend our results to the case in which the LA-agents use probability weighting in their evaluation of gains and losses.

Key words: equilibrium asset pricing; heterogeneous agents; recursive utility; prospect theory; loss aversion; gain-loss ratio; market dominance

JEL Codes: D53, G02, G11, G12

*We thank the participants of the 2014 INFORMS Annual Meeting at San Francisco, the 2014 SIAM Conference on Financial Mathematics and Engineering at Chicago, and the 5th International IMS-FIPS Workshop at Rutgers University for their comments and suggestions. The second author acknowledges support from a start-up fund at The Chinese University of Hong Kong.

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