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

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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

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