PROSPECT THEORY AND ASSET PRICES*

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We study asset prices in an economy where investors derive direct utility not only from consumption but also from fluctuations in the value of their financial wealth. They are loss averse over these fluctuations, and the degree of loss aversion depends on their prior investment performance. We find that our framework can help explain the high mean, excess volatility, and predictability of stock returns, as well as their low correlation with consumption growth. The design of our model is influenced by prospect theory and by experimental evidence on how prior outcomes affect risky choice.

I. Introduction

For many years now, the standard framework for thinking about aggregate stock market behavior has been the consumption-based approach. As is well-known, this approach presents a number of difficulties. In its simplest form, it does not come close to capturing the stock market's high historical average return and volatility, nor the striking variation in expected stock returns over time.[1] Over the past decade researchers have used ever more sophisticated specifications for utility over consumption in an attempt to approximate the data more closely.[2] These efforts have

1. See, for example, Hansen and Singleton [1983], Mehra and Prescott [1985], and Hansen and Jagannathan [1991].

2. Recent papers in this line of research include Abel [1990], Campbell and Cochrane [1999], Constantinides [1990], Epstein and Zin [1989, 1991], and Sundaresan [1989]. Another strand of the literature emphasizes market incompleteness due to uninsurable income shocks; see, for example, Heaton and Lucas