EXPECTATIONS-BASED REFERENCE-DEPENDENT PREFERENCES AND ASSET PRICING

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Abstract
This paper explores the quantitative asset-pricing implications of expectations-based reference-dependent preferences, as introduced by ?, in an otherwise traditional Lucas-tree model. I find that the model easily succeeds in matching the historical equity premium and its variability when the preference parameters are calibrated in line with micro evidence. The equity premium is high because expectations-based loss aversion makes uncertain fluctuations in consumption more painful. Additionally, loss aversion introduces variation in returns because unexpected cuts in consumption are particularly painful, and the agent wants to postpone such cuts to let his reference point decrease. This variation generates strong predictability. However, it also causes counterfactually high volatility in the risk-free rate, which I address by allowing for variation in expected consumption growth, heteroskedasticity in consumption growth, time-variant disaster risk, and sluggish belief updating. (JEL: G02, D03, G12)

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