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Downside Risks and the Cross-Section of Asset Returns*

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Abstract

In an intertemporal equilibrium asset pricing model featuring disappointment aversion and changing macroeconomic uncertainty, we show that besides the market return and market volatility, three disappointment-related factors are also priced: a downstate factor, a market downside factor, and a volatility downside factor. We find that expected returns on various asset classes reflect premiums for bearing undesirable exposures to these factors. The signs of estimated risk premiums are consistent with the theoretical predictions. Our most general, five-factor model is very successful in jointly pricing stock, option, and currency portfolios, and provides considerable improvement over nested specifications previously discussed in the literature.

Keywords: Generalized Disappointment Aversion, Downside Risks, Cross-Section

JEL Classification: G12, C12, C31, C32

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