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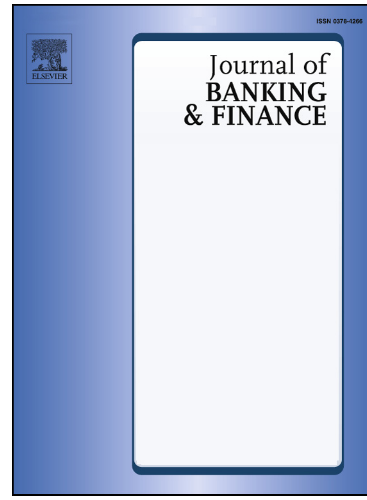

Limiting Losses May Be Injurious to Your Wealth

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Limiting Losses May Be Injurious to Your Wealth*

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Abstract

Theory tells us that if return distributions are independent over time, an expected utility maximizing logarithmic-utility investor will almost surely accumulate the most long-run wealth. This paper examines the robustness of the result. Specifically, it examines the expected and unexpected long-run and short-run consequences of imposing Value at Risk and other loss constraints on power-utility investors with a numerical example and empirically in an asset-allocation setting covering the 1934-2008 period. In addition, it examines the expected and unexpected long-run consequences of imposing Conditional Value at Risk constraints on power-utility and prospect-theory (kinked linear-utility) investors.

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Key words: Power-utility and prospect-theory portfolios; solvency, portfolio-insurance, value-at-risk and conditional-value-at-risk constraints

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