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Reference-dependent preferences and the risk-return trade-off

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ABSTRACT

This paper studies the cross-sectional risk-return trade-off in the stock market. A fundamental principle in finance is the positive relation between risk and expected return. However, recent empirical evidence suggests the opposite. Using several intuitive risk measures, we show that the negative risk-return relation is much more pronounced among firms in which investors face prior losses, but the risk-return relation is positive among firms in which investors face prior gains. We consider a number of possible explanations for this new empirical finding and conclude that reference-dependent preference is the most promising explanation.

JEL classification: G12, G14

Keywords: Prospect theory, Risk-return trade-off, Risk, Uncertainty, Capital gains overhang

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