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David Easley, Liyan Yang

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Loss Aversion, Survival and Asset Prices

David Easley and Liyan Yang*

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Abstract

This paper studies the wealth and pricing implications of loss aversion in the presence of arbitrageurs with Epstein-Zin preferences. Loss aversion affects an investor's survival prospects mainly through its effect on the investor's portfolio holdings. Loss-averse investors will be driven out of the market and do not affect long-run prices if their portfolio positions are further away from those corresponding to the log investor than arbitrageurs. In terms of wealth shares, the market selection process can be slow, but the selection force is nonetheless effective in terms of price impact, which highlights the importance of introducing preference heterogeneity in understanding asset prices.

Keywords: loss aversion; narrow framing; Epstein-Zin preferences; market selection; asset prices **JEL Classifications:** G11, G12, D50

***David Easley:** dae3@cornell.edu, Department of Economics, Cornell University, Ithaca, NY 14853.
Liyan Yang: liyan.yang@rotman.utoronto.ca, Department of Finance, Joseph L. Rotman School of Management, University of Toronto, 105 St. George Street, Toronto, Ontario M5S 3E6, Canada; Guanghua School of Management, Peking University, 100871, Peking, China. We thank the editor (Xavier Vives) and three anonymous referees for constructive comments that have significantly improved the paper. We also thank Hengjie Ai, Nick Barberis, Shmuel Baruch, Suleyman Basak, Hank Bessembinder, Larry Blume, Peter Bossaerts, Melanie Cao, Scott Condie, Ian Dew-Becker, Guo Ying (Rosemary) Luo, Ted O'Donoghue, Maureen O'Hara, Cedric Okou, Paolo Pasquariello, Lin Peng, Hersh Shefrin, Xinli Wang, Jason Wei, Wei Xiong, Hongjun Yan and the audiences at various conferences and seminars for helpful comments. We thank the 2012 NFA Annual Conference for awarding the best-paper prize to this paper. Yang thanks SSHRC for financial support.

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