Generalized Disappointment Aversion, Learning, and Asset Prices [☆]

Mykola Babiak [*]

CERGE-EI [**]

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Abstract

This paper provides a generalized disappointment aversion (GDA) interpretation of the variance and skew risk premia in equity returns and the volatility skew in equity index options. The key ingredients are Bayesian learning about a hidden consumption growth rate and the investor's tail aversion induced by GDA preferences which amplify the impact of consumption shocks. This model with disappointment risk reproduces salient properties of the variance and skew risk premia and generates a realistic volatility skew implied by index options, while simultaneously matching the mean and volatility of risk-free rate and equity returns, and the level of the price-dividend ratio. Additionally, the time-varying probability of disappointment events generates a wide range of dynamic asset pricing phenomena.

Keywords: Equity Premium, Variance and Skew Risk Premia, Volatility Skew, Generalized Disappointment Aversion, Learning, Markov Switching

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