Regret-Sensitive Equity Premium

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Abstract. In a static Lucas tree economy, we propose a model that the representative agent is sensitive to regret. Our model generalizes the classical simple regret models pioneered by Bell (1982) and Loomes and Sugden (1982). This generalization makes it possible to derive the equilibrium asset price and to see when the regret effect decreases the price. To verify that our model predicts su¢ cient decreases of the equilibrium price to explain the empirically high risk premium, we analyze the data of U.S. stock market and GDP growth rates during 1870-2006.

Key words: regret theory, equity premium, Lucas tree economy, equilibrium price