

Attitudes Toward Risk and The Risk-Return Paradox: Prospect Theory Explanations

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Abstract

This study attempted to explain Bowman's risk-return paradox in terms of recent research in behavioral decision theory and prospect theory. The research emphasized the role of reference, or target, return levels in analyzing risky choices. For returns below target, a large majority of individuals appear to be risk seeking; for returns above target, a large majority appear to be risk averse. Using extensive COMPUSTAT-based data on U.S. firms, we consistently found a negative risk-return association for firms having returns below target levels and a positive association for firms with returns above target. These results support the basic propositions of prospect theory and are extremely robust within and across industries and for all time periods studied.



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