Investor Behavior and Financial Innovation:
Callable Bull/Bear Contracts

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Abstract

We examine the notion that financial innovations cater to investors’ behavioral biases. Specifically, we consider the popularity of knockout barrier options termed callable bull/bear contracts (CBBCs), that can be called back by the issuer when the prices of underlying assets reach a pre-specified threshold. Our analysis of prices and trading activity indicates that investors treat CBBCs in a manner similar to lottery tickets in that they prefer CBBCs with low prices, high volatilities, high levels of positive skewness, and prefer trading them when the underlying assets trade at prices close to their callback thresholds. Further, we find that during the year 2012, investors lost 1.82 billion HKD (US$235 million) by trading CBBCs written on the Hang Seng Index. Our analysis highlights the importance of cumulative prospect theory in financial innovation.

Keywords: Lotteries; Gambling; Financial Innovation; Cumulative Prospect Theory; Callable Bull/Bear Contract (CBBC); Turbo Warrant

JEL Classification: D03, D81, G02, G12, G23