Asset Pricing And Portfolio Choice Theory Financial Management Association Survey And Synthesis

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This paper examines portfolio choice and asset pricing when some assets are nontraded, for instance when a country cannot trade claims to its output on world capital markets, when a government cannot trade claims to future tax revenues, or when an individual cannot trade claims to his future wages. The close relation between portfolio choice with and implicit pricing of nontraded assets is emphasized. A variant of Cox, Ingersoll and Ross's Fundamental Valuation Equation is derived and used to interpret the optimal portfolio. Explicit solutions are presented to the portfolio and pricing problem for some special cases, including when income from the nontraded assets is a diffusion process, not spanned by traded assets, and affected by a state variable.

In general, theories of portfolio choice and asset pricing let investors differ at most with respect to their preferences, their wealth and, possibly, their information sets. If there are multiple countries, however, the investment and consumption opportunity sets of investors depend on their country of residence. International portfolio choice and asset pricing theories attempt to understand how the existence of country-specific investment and consumption opportunity sets affect the portfolios held by investors and the expected returns of assets. In this paper, we review these theories within a common framework, discuss how they fare in empirical tests, and assess their relevance for the field of international finance.

An introduction to the theory and methods of empirical asset pricing, integrating classical foundations with recent developments. This book offers a comprehensive advanced introduction to asset pricing, the study of models for the prices and returns of various securities. The focus is empirical, emphasizing how the models relate to the data. The book offers a uniquely integrated treatment, combining classical foundations with more recent developments in the literature and relating some of the material to applications in investment management. It covers the theory of empirical asset pricing, the main empirical methods, and a range of applied topics. The book introduces the theory of empirical asset pricing through three main paradigms: mean variance analysis, stochastic discount factors, and beta pricing models. It describes empirical methods, beginning with the generalized method of moments (GMM) and viewing other methods as special cases of GMM; offers a comprehensive review of fund performance evaluation; and presents selected applied topics, including a substantial chapter on predictability in asset markets that covers predicting the level of returns, volatility and higher moments, and predicting cross-sectional differences in returns. Other chapters cover production-based asset pricing, long-run risk models, the Campbell-Shiller approximation, the debate on covariance versus characteristics, and the relation of volatility to the cross-section of stock returns. An extensive reference section captures the current state of the field. The book is intended for use by graduate students in finance and economics; it can also serve as a reference for professionals.

In the 2nd edition of Asset Pricing and Portfolio Choice Theory, Kerry E. Back offers a concise yet comprehensive introduction to and overview of asset pricing. Intended as a textbook for asset pricing theory courses at the Ph.D. or Masters in Quantitative Finance level with extensive exercises and a solutions manual available for professors, the book is also an essential reference for financial researchers and professionals, as it includes detailed proofs and calculations as section appendices. The first two parts of the book explain portfolio choice and asset pricing theory in single-period, discrete-time, and continuous-time models. For valuation, the focus throughout is on stochastic discount factors and their properties. A section on derivative securities covers the usual derivatives (options, forwards and futures, and term structure models) and also applications of perpetual options to corporate debt, real options, and optimal irreversible investment. A chapter on "explaining puzzles" and the last part of the book provide introductions to a number of additional current topics in asset pricing research, including rare disasters, long-run risks, external and internal habits, asymmetric and incomplete information, heterogeneous beliefs, and non-expected-utility preferences. Each chapter includes a "Notes and References" section providing additional pathways to the literature. Each chapter also includes extensive exercises.

From the field's leading authority, the most authoritative and comprehensive advanced-level textbook on asset pricing In Financial Decisions and Markets, John Campbell, one of the field's most respected authorities, provides a broad graduate-level overview of asset pricing. He introduces students to leading theories of portfolio choice, their implications for asset prices, and empirical patterns of risk and return in financial markets. Campbell emphasizes the interplay of theory and evidence, as theorists respond to empirical puzzles by developing models with new testable implications. The book shows how models make predictions not only about asset prices but also about investors' financial positions, and how they often draw on insights from behavioral economics. After a careful introduction to single-period models, Campbell develops multiperiod models with time-varying discount rates, reviews the leading approaches to consumption-based asset pricing, and integrates the study of equities and fixed-income securities. He discusses models with heterogeneous agents who use financial markets to share their risks, but also may speculate against one another on the basis of different beliefs or private information. Campbell takes a broad view of the field, linking asset pricing to related areas, including financial econometrics, household finance, and macroeconomics. The textbook works in discrete time throughout, and does not require stochastic calculus. Problems are provided at the end of each chapter to challenge students to develop their understanding of the main issues in financial economics. The most comprehensive and balanced textbook on asset pricing available, Financial Decisions and Markets is an essential resource for all graduate students and practitioners in finance and related fields. Integrated treatment of asset pricing theory and empirical evidence Emphasis on investors' decisions Broad view linking the field to financial econometrics, household finance, and macroeconomics Topics treated in discrete time, with no requirement for stochastic calculus Forthcoming solutions manual for problems available to professors

We analyze a model of optimal consumption and portfolio selection in which consumption services are generated by holding a durable good. The durable good is illiquid in that a transaction cost must be paid when the good is sold. It is shown that optimal consumption is not a smooth function of wealth; it is optimal for the consumer to wait until a large change in wealth occurs before adjusting his consumption. As a consequence, the consumption based capital asset pricing model fails to hold. Nevertheless, it is shown that the standard, one factor, market portfolio based capital asset pricing model does hold in this environment. It is shown that the optimal durable level is characterized by three numbers (not random variables), say x, y, and z (where x

In Investors and Markets, Nobel Prize-winning financial economist William Sharpe shows that investment professionals cannot make good portfolio choices unless they understand the determinants of asset prices. But until now asset-price analysis has largely been inaccessible to everyone except PhDs in financial economics. In this book, Sharpe changes that by setting out his state-of-the-art approach to asset pricing in a nonmathematical form that will be comprehensible to a broad range of investment professionals, including investment advisors, money managers, and financial analysts. Bridging the gap between the best financial theory and investment practice, Investors and Markets will help investment professionals make better portfolio choices by being smarter about asset prices. Based on Sharpe's Princeton Lectures in Finance, Investors and Markets presents a method of analyzing asset prices that accounts for the real behavior of investors. Sharpe makes this technique accessible through a new, one-of-a-kind computer program (available for free on his Web site, at http://www.stanford.edu/~wfsharpe/apsim/index.html) that enables users to create virtual markets, setting the starting conditions and then allowing trading until equilibrium is reached and trading stops. Program users can then analyze the final portfolios and asset prices, see expected returns, and measure risk. In addition to popularizing the most sophisticated form of asset-price analysis, Investors and Markets summarizes much of Sharpe's most important previous work and reflects a lifetime of thinking about investing by one of the leading minds in financial economics. Any serious investment professional will benefit from Sharpe's unique insights.

This book provides a broad introduction to modern asset pricing theory. The theory is self-contained and unified in presentation. Both the no-arbitrage and the general equilibrium approaches of asset pricing theory are treated coherently within the general equilibrium framework. It fills a gap in the body of literature on asset pricing for being both advanced and comprehensive. The absence of arbitrage opportunities represents a necessary condition for equilibrium in the financial markets. However, the absence of arbitrage is not a sufficient condition for establishing equilibrium. These interrelationships are overlooked by the proponents of the no-arbitrage approach to asset pricing.This book also tackles recent advancement on inversion problems raised in asset pricing theory, which include the information role of financial options and the information content of term structure of interest rates and interest rates contingent claims.The inclusion of the proofs and derivations to enhance the transparency of the underlying arguments and conditions for the validity of the economic theory made it an ideal advanced textbook or reference book for graduate students specializing in financial economics and quantitative finance. The detailed explanations will capture the interest of the curious reader, and it is complete enough to provide the necessary background material needed to delve deeper into the subject and explore the research literature.Postgraduate students in economics with a good grasp of calculus, linear algebra, and probability and statistics will find themselves ready to tackle topics covered in this book. They will certainly benefit from the mathematical coverage in stochastic processes and stochastic differential equation with applications in finance. Postgraduate students in financial mathematics and financial engineering will also benefit, not only from the mathematical tools introduced in this book, but also from the economic ideas underpinning the economic modeling of financial markets.Both these groups of postgraduate students will learn the economic issues involved in financial modeling. The book can be used as an advanced text for Masters and PhD students in all subjects of financial economics, financial mathematics, mathematical finance, and financial engineering. It is also an ideal reference for practitioners and researchers in the subjects.

Asset Pricing Theory is an advanced textbook for doctoral students and researchers that offers a modern introduction to the theoretical and methodological foundations of competitive asset pricing. Costis Skiadas develops in depth the fundamentals of arbitrage pricing, mean-variance analysis, equilibrium pricing, and optimal consumption/portfolio choice in discrete settings, but with emphasis on geometric and martingale methods that facilitate an effortless transition to the more advanced continuous-time theory. Among the book's many innovations are its use of recursive utility as the benchmark representation of dynamic preferences, and an associated theory of equilibrium pricing and optimal portfolio choice that goes beyond the existing literature. Asset Pricing Theory is complete with extensive exercises at the end of every chapter and comprehensive mathematical appendixes, making this book a self-contained resource for graduate students and academic researchers, as well as mathematically sophisticated practitioners seeking a deeper understanding of concepts and methods on which practical models are built. Covers in depth the modern theoretical foundations of competitive asset pricing and consumption/portfolio choice Uses recursive utility as the benchmark preference representation in dynamic settings Sets the foundations for advanced modeling using geometric arguments and martingale methodology Features self-contained mathematical appendixes Includes extensive end-of-chapter exercises

Academic finance has had a remarkable impact on many financial services. Yet long-term investors have received curiously little guidance from academic financial economists. Mean-variance analysis, developed almost fifty years ago, has provided a basic paradigm for portfolio choice. This approach usefully emphasizes the ability of diversification to reduce risk, but it ignores several critically important factors. Most notably, the analysis is static; it assumes that investors care only about risks to wealth one period ahead. However, many investors—-both individuals and institutions such as charitable foundations or universities—-seek to finance a stream of consumption over a long lifetime. In addition, mean-variance analysis treats financial wealth in isolation from income. Long-term investors typically receive a stream of income and use it, along with financial wealth, to support their consumption. At the theoretical level, it is well understood that the solution to a long-term portfolio choice problem can be very different from the solution to a short-term problem. Long-term investors care about intertemporal shocks to investment opportunities and labor income as well as shocks to wealth itself, and they may use financial assets to hedge their intertemporal risks. This should be important in practice because there is a great deal of empirical evidence that investment opportunities—-both interest rates and risk premia on bonds and stocks—-vary through time. Yet this insight has had little influence on investment practice because it is hard to solve for optimal portfolios in intertemporal models. This book seeks to develop the intertemporal approach into an empirical paradigm that can compete with the standard mean-variance analysis. The book shows that long-term inflation-indexed bonds are the riskless asset for long-term investors, it explains the conditions under which stocks are safer assets for long-term than for short-term investors, and it shows how labor income influences portfolio choice. These results shed new light on the rules of thumb used by financial planners. The book explains recent advances in both analytical and numerical methods, and shows how they can be used to understand the portfolio choice problems of long-term investors.

In Asset Pricing and Portfolio Choice Theory, Kerry E. Back at last offers what is at once a welcoming introduction to and a comprehensive overview of asset pricing. Useful as a textbook for graduate students in finance, with extensive exercises and a solutions manual available for professors, the book will also serve as an essential reference for scholars and professionals, as it includes detailed proofs and calculations as section appendices. Topics covered include the classical results on single-period, discrete-time, and continuous-time models, as well as various proposed explanations for the equity premium and risk-free rate puzzles and chapters on heterogeneous beliefs, asymmetric information, non-expected utility preferences, and production models. The book includes numerous exercises designed to provide practice with the concepts and to introduce additional results. Each chapter concludes with a notes and references section that supplies pathways to additional developments in the field.

This book is intended as a textbook for Ph.D. students in finance and as a reference book for academics. It is written at an introductory level but includes detailed proofs and calculations as section appendices. It covers the classical results on single-period, discrete-time, and continuous-time models. It also treats various proposed explanations for the equity premium and risk-

free rate puzzles: persistent heterogeneous idiosyncratic risks, internal habits, external habits, and recursive utility. Most of the book assumes rational behavior, but two topics important for behavioral finance are covered: heterogeneous beliefs and non-expected-utility preferences. There are also chapters on asymmetric information and production models. The book includes numerous exercises designed to provide practice with the concepts and also to introduce additional results. Each chapter concludes with a notes and references section that supplies references to additional developments in the field.

Winner of the prestigious Paul A. Samuelson Award for scholarly writing on lifelong financial security, John Cochrane's Asset Pricing now appears in a revised edition that unifies and brings the science of asset pricing up to date for advanced students and professionals. Cochrane traces the pricing of all assets back to a single idea--price equals expected discounted payoff--that captures the macro-economic risks underlying each security's value. By using a single, stochastic discount factor rather than a separate set of tricks for each asset class, Cochrane builds a unified account of modern asset pricing. He presents applications to stocks, bonds, and options. Each model--consumption based, CAPM, multifactor, term structure, and option pricing--is derived as a different specification of the discounted factor. The discount factor framework also leads to a state-space geometry for mean-variance frontiers and asset pricing models. It puts payoffs in different states of nature on the axes rather than mean and variance of return, leading to a new and conveniently linear geometrical representation of asset pricing ideas. Cochrane approaches empirical work with the Generalized Method of Moments, which studies sample average prices and discounted payoffs to determine whether price does equal expected discounted payoff. He translates between the discount factor, GMM, and state-space language and the beta, mean-variance, and regression language common in empirical work and earlier theory. The book also includes a review of recent empirical work on return predictability, value and other puzzles in the cross section, and equity premium puzzles and their resolution. Written to be a summary for academics and professionals as well as a textbook, this book condenses and advances recent scholarship in financial economics.

This is a thoroughly updated edition of Dynamic Asset Pricing Theory, the standard text for doctoral students and researchers on the theory of asset pricing and portfolio selection in multiperiod settings under uncertainty. The asset pricing results are based on the three increasingly restrictive assumptions: absence of arbitrage, single-agent optimality, and equilibrium. These results are unified with two key concepts, state prices and martingales. Technicalities are given relatively little emphasis, so as to draw connections between these concepts and to make plain the similarities between discrete and continuous-time models. Readers will be particularly intrigued by this latest edition's most significant new feature: a chapter on corporate securities that offers alternative approaches to the valuation of corporate debt. Also, while much of the continuous-time portion of the theory is based on Brownian motion, this third edition introduces jumps--for example, those associated with Poisson arrivals--in order to accommodate surprise events such as bond defaults. Applications include term-structure models, derivative valuation, and hedging methods. Numerical methods covered include Monte Carlo simulation and finite-difference solutions for partial differential equations. Each chapter provides extensive problem exercises and notes to the literature. A system of appendixes reviews the necessary mathematical concepts. And references have been updated throughout. With this new edition, Dynamic Asset Pricing Theory remains at the head of the field.

The second essay, "Non-durable Consumption Volatility and Illiquid Assets," finds that factors beyond the volatility of asset payoffs may significantly affect the volatility of the agent's consumption stream. The empirical failure of consumption-based asset pricing models is often attributed to the lack of volatility in aggregate measures of consumption. However, I illustrate in this paper that frictions faced by agents may lead to much higher levels of volatility in individual consumption than we observe in the aggregate data. I develop a life-cycle model of in which the consumer derives utility from non-durable consumption and stock in a risky asset: housing. Non-convex adjustment costs generate lumpy changes in the stock of the risky asset over the life-cycle. The model predicts that non-durable consumption volatility is increasing in both the ability to borrow against the assets held in the consumer's portfolio and in the illiquidity of the portfolio.

In the ??1rst essay, I decompose in??2ation risk into (i) a part that is correlated with real returns on the market portfolio and factors that determine investor0?9s preferences and investment opportunities and (ii) a residual part. I show that only the ??1rst part earns a risk premium. All nominal Treasury bonds, including the nominal money-market account, are equally exposed to the residual part except in??2ation-protected Treasury bonds, which provide a means to hedge it. Every investor should put 100% of his wealth in the market portfolio and in??2ation-protected Treasury bonds and hold a zero-investment portfolio of nominal Treasury bonds and the nominal money market account. In the second essay, I solve the dynamic asset allocation problem of ??1nite lived, constant relative risk averse investors who face in??2ation risk and can invest in cash, nominal bonds, equity, and in??2ation-protected bonds when the investment opportunityset is determined by the expected in??2ation rate. I estimate the model with nominal bond, in??2ation, and stock market data and show that if expected in??2ation increases, then investors should substitute in??2ation-protected bonds for stocks and they should borrow cash to buy long-term nominal bonds. In the lastessay, I discuss how heterogeneity in preferences among investors withexternal non-addictive habit forming preferences a??0ects the equilibrium nominal term structure of interest rates in a pure continuous time exchange economy and complete securities markets. Aggregate real consumption growth and in??2ation are exogenously speci??1ed and contain stochastic components thata??0ect their means andvolatilities. There are two classes of investors who have external habit forming preferences and di??0erent localcurvatures oftheir utility functions. The e??0ects of time varying risk aversion and di??0erent in??2ation regimes on the nominal short rate and the nominal market price of risk are explored, and simple formulas for nominal bonds, real bonds, and in??2ation risk premia that can be numerically evaluated using Monte Carlo simulation techniques are provided.