Topics in Asset Pricing (B40.2330)

New York University, Stern School of Business, Fall 2002

Professors

Lasse H. Pedersen
Email: lpederse@stern.nyu.edu
Homepage: http://www.stern.nyu.edu/∼lpederse/

Jessica Wachter
Email: jwachter@stern.nyu.edu
Homepage: http://www.stern.nyu.edu/∼jwachter/

Course Website

http://www.stern.nyu.edu/∼lpederse/courses/PHD
http://www.stern.nyu.edu/∼jwachter/courses/PHD

Organization of the Class

This class covers a wide range of advanced topics in asset pricing. The topics represent issues that the instructors find exciting and that we hope will help the participants think about research ideas.

In the first two classes, the instructors give an overview of the topics to be covered. In the following weeks, we discuss two papers per class. One student will be assigned to present each paper. An important part of the class, however, is the research discussion. All students are expected to carefully read the main papers and actively participate in the discussion. Indeed, the discussion will assume that everybody has read the papers.

A presentation of a theoretical paper should include *(i)* the important assumptions in the model, the main results, and the robustness of the results to deviations in the assumptions, *(ii)* the technique used to derive the results, *(iii)* the economic intuition behind the results, *(iv)* and possible steps for future research (including, but not limited to, improvements in the methodology or scope of the paper). A presentation of an empirical paper should include *(i)* the main hypotheses and their theoretical foundations, *(ii)* the methods for testing the hypotheses and their appropriateness, *(iii)* the main findings, *(iv)* and possible steps for future research.

Notation

- • Paper to be presented in detail.
- ○ Background paper.

Topics and Papers

<u>Transactions Costs and Liquidity Risk</u>

- ○ Acharya and Pedersen (2002), Asset Pricing with Liquidity Risk, Working Paper, New York University.
- ○ Amihud (2002), Illiquidity and Stock Returns, Journal of Financial Markets 5, 31-56.
- ○ Amihud and Mendelson (1986), Asset Pricing and the Bid-Ask Spread, Journal of Financial Economics 17, 223-249.
- ○ Chordia, Roll and Subrahmanyam (2000), Commonality in Liquidity, Journal of Financial Economics 56, 3-28.
- ○ Constantinides (1986), Capital Market Equilibrium with Transaction Costs, Journal of Political Economy 94, 842-862.
- ○ Hasbrouck and Seppi (2001), Common Factors in Prices, Order Flows and Liquidity, Journal of Financial Economics 59, 383-411.
- ○ He and Modest (1995), Market Frictions and Consumption-Based Asst Pricing, Journal of Political Economy 103, 94-117.
- • Pastor and Stambaugh (2002), Liquidity risk and expected stock returns, Working Paper, Chicago and Wharton. [Artem, 9/23]
- • Vayanos (1998), Transaction Costs and Asset Prices: A Dynamic Equilibrium Model, Review of Financial Studies 11, 1-58. [Keith Siilatz, 9/23]

- ◦ Vayanos and Vila (1999), Equilibrium Interest Rate and Liquidity Premium With Transaction Costs, Economic Theory 13, 509-539.

<u>Incomplete Markets and Undiversifiable Labor Income</u>

- ◦ Brav, Constantinides, and Geczy (2002), Asset Pricing with Heterogeneous Consumers and Limited Participation: Empirical Evidence, Journal of Political Economy 110, 793-824.
- • Constantinides and Duffie (1996), Asset Pricing with Heterogeneous Consumers, Journal of Political Economy 104, 219-240. [Nikoley Halov, 9/30]
- ◦ Grossman and Shiller (1982), Consumption correlatedness and risk measurement in economies with non-traded assets and heterogenous information, Journal of Financial Economics 51, 1379-1403.
- • Heaton and Lucas (1996), Evaluating the Effects of Incomplete Markets on Risk Sharing and Asset Pricing, Journal of Political Economy 104, 443-487. [Antonios Sangvinatsos, 9/30]
- ◦ Mankiw (1986), The Equity Premium and the Concentration of Aggregate Shocks, Journal of Financial Economics 17, 211-219.

<u>Differences of Opinion</u>

- ◦ Harris and Raviv (1993), Differences of opinion make a horse race, Review of Financial Studies 6, 473-506.
- • Harrison and Kreps (1978), Speculative investor behavior in a stock market with heterogeneous expectations, Quarterly Journal of Economics 92, 323-336. [Zheng Sun, 10/7]
- ◦ Hong and Stein (1999), Differences of Opinion, Rational Arbitrage, and Market Crashes, forthcoming, Review of Financial Studies.
- ◦ Miller (1977), Risk, Uncertainty, and Divergence of Opinion, Journal of Finance 32, 1151–1168.

- ○ Morris, Stephen (1996), Speculative investor behavior and learning, Quarterly Journal of Economics 110, 1111-1133.
- • Scheinkman and Xiong, Overconfidence and Speculative Bubbles, Working Paper, Princeton. [Victoria Ivashina, 10/7]

<u>Limited Arbitrage</u>

- • DeLong, Shleifer, Summers, and Waldman (1990), Noise trader risk in financial markets, Journal of Political Economy 98, 703-738. [Yang Lu, 10/14]
- ○ De Long, Bradford, Shleifer, Summers, Waldman (1991), The Survival of Noise Traders in Financial Markets, Journal of Business 64, 1-19.
- ○ Gromb and Vayanos (2002), Equilibrium and Welfare in Markets with Financially Constrained Arbitrageurs, Journal of Financial Economics, forthcoming.
- ○ Kogan, Ross, Wang, and Westerfield (2002), The Survival and Price Impact of Irrational Traders, Working Paper, MIT.
- • Mitchell, Pulvino, and Stafford (2002), Limited Arbitrage in Equity Markets, The Journal of Finance 57, 551-584. [Zheng Sun, 10/21]
- • Perold (1999), Long-Term Capital Management, L.P., Harvard Business School Cases 200-007, 200-008, 200-009 and 200-010. [Jonathan Spitzer, 10/14]
- • Shleifer and Vishny (1997), The Limits of Arbitrage, Journal of Finance 52, 35-55. [Prachi Deuskar, 10/21]

<u>Predictability in stock returns</u>

- • Campbell and Cochrane (1999), By Force of Habit: A Consumption-Based Explanation of Aggregate Stock Market Behavior, Journal of Political Economy 107, 205-251. [Walter Boudry, 10/28]

- Lettau and Ludvigson (2001), Consumption, Aggregate Wealth, and Expected Stock Returns, Journal of Finance 56, 815-849. [Yang Lu, Olesya Grishchenko, 10/28]

- ◦ Campbell and Shiller (1988), The dividend-price ratio and expectations of future dividends and discount factors, Review of Financial Studies 1, 195-227.

- ◦ Fama and French (1989), Business conditions and expected returns on stocks and bonds, Journal of Financial Economics 25,23-49.

- ◦ Wachter (2002), Habit formation and returns on bonds and stocks, Working paper, New York University.

- ◦ Whitelaw (2000), Stock market risk and return: An equilibrium approach, Review of Financial Studies 13, 521-547.

Private Information

- ◦ Admati (1985), A Noisy Rational Expectations Equilibrium for Multi-asset Securities Markets, Econometrica 53, 629–657.

- ◦ Akerlof (1970), The Market for Lemons: Qualitative Uncertainty and Market Mechanism, Quarterly Journal of Economics 84, 488–500.

- ◦ Campbell and Kyle (1993), Smart Money, Noise Trading and Stock Price Behavior, Review of Economic Studies 60:1-34.

- ◦ Diamond and Verrecchia (1981), Information Aggregation in a Noisy Rational Expectations Economy, Journal of Financial Economics 9, 221–235.

- ◦ Diamond and Verrecchia (1991), Disclosure, Liquidity, and the Cost of Capital, Journal of Finance 46, 1325–1359.

- ◦ Easley, Hvidkjaer, and O'Hara (2002), Is Information Risk a Determinant of Asset Returns, forthcoming, Journal of Finance.

- ◦ Garleanu and Pedersen, Adverse Selection with Re-Trade, Working Paper, NYU.

- ◦ Glosten and Milgrom (1985), Bid, Ask and Transaction Prices in a Specialist Market with Heterogeneously Informed Traders, Journal of Financial Economics 14, 71–100.
- • Grossman and Stiglitz (1980), On the Impossibility of Informationally Efficient Markets, American Economic Review 70, 393–408. [Jonathan Spitzer, 11/4]
- • Kyle (1985), Continuous Auctions and Insider Trading, Econometrica 53, 1315-1335. [Yuanxing Dong, 11/11]
- ◦ Llorente, Michaely, Saar, and Wang, Dynamic Volume-Return Relation of Individual Stocks, forthcoming, Review of Financial Studies.
- • Vayanos (2001), Strategic Trading in a Dynamic Noisy Market, Journal of Finance 56, 131-171. [Artem, 11/11]
- • Wang (1993), A Model of Intertemporal Asset Prices Under Asymmetric Information, Review of Economic Studies 60, 249–282. [Keith Siilatz, 11/4]

Lending Fees and Short Sales

- ◦ D'Avolio, The market for borrowing stock, Journal of Financial Economics, forthcoming.
- ◦ Duffie (1996), Special Repo Rates, Journal of Finance 51, 493-526.
- • Duffie, Garleanu and Pedersen, Securities Lending, Shorting, and Pricing, forthcoming, Journal of Financial Economics. [Lubomir Litov, 11/18]
- ◦ Evans, Geczy, Musto and Reed, Impediments to Short-Selling and Option Prices, Working Paper, Wharton.
- ◦ Geczy, Musto, and Reed, Stocks are Special Too: An Analysis of the Equity Lending Market, forthcoming, Journal of Financial Economics.
- ◦ Krishnamurthy, The Bond/Old-Bond Spread, Working Paper, Kellogg.
- • Ofek, Richardson and Whitelaw, Limited Arbitrage and Short Sales Restrictions: Evidence from the Options Markets, Working Paper, New York University. [Nikolay Halov, 11/18]

Dynamic Portfolio Choice

- ○ Balduzzi and Lynch (1999), Transaction Costs and Predictability: Some Utility Cost Calculations, Journal of Financial Economics 52, 47-78.
- • Barberis (2000), Investing for the Long Run when Returns are Predictable, Journal of Finance 55, 225-264. [Walter Boudry, 11/25]
- ○ Brandt (1999), Estimating Portfolio and Consumption Choice: A Conditional Euler Equations Approach, Journal of Finance 54, 1609-1645.
- • Campbell and Viceira (1999), Consumption and Portfolio Decisions when Expected Returns are Time-Varying, Quarterly Journal of Economics 114, 433-495. [Yuanxing Dong, Olesya Grishchenko, 11/25]
- ○ Kandel and Stambaugh (1996), On the predictability of stock returns: An asset allocation perspective, Journal of Finance 51, 385-424.
- ○ Kim and Omberg (1996), Dynamic Nonmyopic Portfolio Behavior, Review of Financial Studies 9, 141-161.
- ○ Wachter (2002), Portfolio and Consumption Decisions under Mean-Reverting Returns: An Exact Solution for Complete Markets, Journal of Financial and Quantitative Analysis 37, 63-91.
- ○ Xia (2001), Learning about Predictability: The Effects of Parameter Uncertainty on Dynamic Asset Allocation, Journal of Finance 56, 205-246.

Bubbles

- • Abreu and Brunnermeier, Bubbles and Crashes, forthcoming Econometrica. [Prachi Deuskar, 12/2]
- • Allen and Gorton (1993), Churning Bubbles, Review of Economic Studies 60, 813-836. [Victoria Ivashina, 12/2]
- ○ Allen and Gale (2000), Bubbles and Crises, Economic Journal 110, 236-255.

○ Allen, Morris and Postlewaite (1993), Finite Bubbles with Short Sale Constraints and Asymmetric Information, Journal of Economic Theory 61, 206-229.

○ Blanchard and Watson (1982), Bubbles, rational expectations and financial markets, in P. Wachtel (ed.) Crisis in the Economic and Financial Structure: Bubbles, Bursts, and Shocks, Lexington Press, Lexington, MA.

<u>Limited Participation</u>

○ Allen and Gale (1994), Limited Market Participation and Volatility of Asset Prices, American Economic Review 84,933-955.

• Basak and Cuoco (1998), An Equilibrium Model with Restricted Stock Market Participation, Review of Financial Studies 11, 309-341.

○ Shapiro (2002), The Investor Recognition Hypothesis in a Dynamic General Equilibrium: Theory and Evidence, Review of Financial Studies 15, 97-141.

• Vissing-Jorgenson (2002), Limited Asset Market Participation and the Elasticity of Intertemporal Substitution, Journal of Political Economy 110,825-853.

<u>Limited Commitment</u>

○ Alvarez and Jermann (2000), Efficiency, Equilibrium, and Asset Pricing with Risk of Default, Econometrica 68:775-797.

• Alvarez and Jermann (2001), Quantitative Asset Pricing Implications of Endogenous Solvency Constraints, Review of Financial Studies 14, 1117-1152.

• Lustig (2001), The Market Price of Aggregate Risk and the Wealth Distribution, Working paper, Stanford University, November.