Volume 2B Financial Markets and Asset Pricing

12 Advances in Consumption-Based Asset Pricing: Empirical Tests
Sydney C. Ludvigson

1. Introduction 800
2. Consumption-Based Models: Notation and Background 803
3. GMM and Consumption-Based Models
   3.1 GMM Review (Hansen, 1982) 806
   3.2 A Classic Asset Pricing Application: Hansen and Singleton (1982) 807
   3.3 GMM Asset Pricing with Non-Optimal Weighting 810
4. Euler Equation Errors and Consumption-Based Models 815
5. Scaled Consumption-Based Models
   5.1 Econometric Findings 823
   5.2 Distinguishing Two Types of Conditioning 824
   5.3 Debate 829
6. Asset Pricing with Recursive Preferences
   6.1 EZW Recursive Preferences 840
   6.2 EZW Preferences with Unrestricted Dynamics: Distribution-Free Estimation 842
   6.3 EZW Preferences with Restricted Dynamics: Long-Run Risk 851
   6.4 Debate 867
7. Stochastic Consumption Volatility 872
8. Asset Pricing with Habits
   8.1 Structural Estimation of Campbell–Cochrane Habit 883
   8.2 Flexible Estimation of Habit Preferences with Unrestricted Dynamics 884
   8.3 Econometric Findings 887
   8.4 Debate 889
9. Asset Pricing with Heterogeneous Consumers and Limited Stock Market Participation 890
10. Conclusion 897

References 900

13 Bond Pricing and the Macroeconomy
Gregory R. Duffee

1. Introduction 908
2. A Factor Model
   2.1 A Bare-Bones Framework 909
   2.2 Implications and Alternatives 911
   2.3 What are the Factors? 912
2.4 Taylor Rule Stories 913

3. No-Arbitrage Restrictions 915
   3.1 Stochastic Discount Factors 915
   3.2 Bond Pricing 918
   3.3 Implications of No-Arbitrage Restrictions 919

4. The Variation of Yields with the Macroeconomy: US Evidence 921
   4.1 Macroeconomic Data 921
   4.2 Spanning 923
   4.3 A Workhorse Empirical Example 928
   4.4 Interpreting and Altering Cross-Sectional Accuracy 931

5. Modeling Risk Premia 933
   5.1 Practical Approaches to Modeling Risk Premia 933
   5.2 A Brief Example 934
   5.3 Some Properties of Observed Bond Returns 937
   5.4 Power Utility 940
   5.5 Recursive Utility 942
   5.6 The Empirical Performance of Power and Recursive Utility 943
   5.7 Predictable Variation of Excess Bond Returns 948
   5.8 Extensions to Power Utility and Recursive Utility 952
   5.9 Moving Away from Endogenous Risk Premia 955

6. New Keynesian Models 956
   6.1 A Reduced-Form New Keynesian Model 956
   6.2 Nesting the Model in a General Factor Structure 958
   6.3 Adding Nominal Bonds 960
   6.4 An Empirical Application 961

7. Concluding Comments 965

References 965

14 Investment Performance: A Review and Synthesis 969
Wayne E. Ferson 970

1. Introduction 970

2. The Stochastic Discount Factor (SDF) Framework 971
   2.1 Market Efficiency and Fund Performance 972
   2.2 The Treatment of Costs 974

3. Performance Measures 975
   3.1 Returns-Based Alpha and Appropriate Benchmarks 975
   3.2 The Sharpe Ratio 977
   3.3 Conditional Performance Evaluation (CPE) 978
2.2 Intraday Data and Realized Volatility 1142
2.3 Modeling Return Distributions 1156

3. Conditional Asset-Level Risk Analysis 1167
3.1 Modeling Time-Varying Covariances Using Daily Data and GARCH 1168
3.2 Intraday Data and Realized Covariances 1176
3.3 Modeling Multivariate Return Distributions 1190
3.4 Systemic Risk and Measurement 1199

4. Conditioning on Macroeconomic Fundamentals 1203
4.1 The Macroeconomy and Return Volatility 1204
4.2 The Macroeconomy and Fundamental Volatility 1205
4.3 Fundamental Volatility and Return Volatility 1207
4.4 Other Links 1207
4.5 Factors as Fundamentals 1209

5. Concluding Remarks 1211
References 1212

18 Bubbles, Financial Crises, and Systemic Risk 1221
Markus K. Brunnermeier and Martin Oehmke

1. Introduction 1222
2. A Brief Historical Overview of Bubbles and Crises 1225
3. Bubbles 1229
3.1 Rational Bubbles without Frictions 1231
3.2 OLG Frictions and Market Incompleteness 1233
3.3 Informational Frictions 1236
3.4 Delegated Investment and Credit Bubbles 1238
3.5 Heterogeneous-Beliefs Bubbles 1239
3.6 Empirical Evidence on Bubbles 1242
3.7 Experimental Evidence on Bubbles 1243

4. Crises 1245
4.1 Counterparty/Bank Runs 1247
4.2 Collateral/Margin Runs 1253
4.3 Lenders' or Borrowers' Friction? 1261
4.4 Network Externalities 1264
4.5 Feedback Effects Between Financial Sector Risk and Sovereign Risk 1268

5. Measuring Systemic Risk 1271
5.1 Systemic Risk Measures 1271
5.2 Data Collection and Macro Modeling 1273
5.3 Challenges in Estimating Systemic Risk Measures 1275
5.4 Some Specific Measures of Systemic Risk 1277
6. Conclusion 1280
References 1281

19 Market Liquidity—Theory and Empirical Evidence 1289
Dimitri Vayanos and Jiang Wang

1. Introduction 1289

2. Theory 1295
   2.1 Perfect-Market Benchmark 1297
   2.2 Participation Costs 1300
   2.3 Transaction Costs 1304
   2.4 Asymmetric Information 1309
   2.5 Imperfect Competition 1314
   2.6 Funding Constraints 1322
   2.7 Search 1328

3. Empirical Evidence 1333
   3.1 Empirical Measures of Illiquidity 1334
   3.2 Properties of Illiquidity Measures 1341
   3.3 Illiquidity and Asset Returns 1346

4. Conclusion 1351
References 1352

20 Credit Derivatives 1363
John Hull and Alan White

1. Introduction 1363

2. Risk-Neutral Default Probability Estimates 1364
   2.1 The Risk-Free Rate 1368

3. Physical Default Probability Estimates 1369
   3.1 Empirical Research on Default Probability Estimates 1370
   3.2 Empirical Research on Credit Spreads 1373

4. Credit Default Swaps 1376
   4.1 Credit Indices 1378
   4.2 Fixed Coupons 1379

5. Collateralized Debt Obligations 1380
   5.1 Cash CDOs 1380
   5.2 Synthetic CDOs 1382
   5.3 Synthetic CDO Valuation 1383
5.4 Default Correlation Models and the Probability of Default 1385
5.5 A Non-Homogeneous Model 1385
5.6 Gaussian and Other Factor Copula Models 1387
5.7 Index CDOs 1389
5.8 CDO Economics 1390

6. Credit Derivatives and the Crisis 1392

7. Conclusions 1394

References 1395

21 Household Finance: An Emerging Field 1397
Luigi Guiso and Paolo Sodini

1. The Rise of Household Finance 1398
   1.1 Why a New Field? 1399
   1.2 Why Now? 1401

2. Facts About Household Assets and Liabilities 1402
   2.1 Components of Lifetime Wealth: Human Capital 1403
   2.2 Components of Lifetime Wealth: Tangible Assets 1406
   2.3 Liabilities 1417
   2.4 Trends 1419
   2.5 Overall Reliance on Financial Markets 1420
   2.6 International Comparisons 1421

3. Household Risk Preferences and Beliefs: What Do We Know? 1424
   3.1 Measuring Individual Risk Aversion 1425
   3.2 Determinants of Risk Attitudes 1432
   3.3 Time-Varying Risk Aversion? 1443
   3.4 Heterogeneity in the Financial Wealth Elasticity of the Risky Share 1445
   3.5 Ambiguity and Regret 1446
   3.6 Beliefs 1449
   3.7 Risk Aversion, Beliefs, and Financial Choices; Putting Merton's Model to the Test 1450

4. Household Portfolio Decisions: From Normative Models to Observed Behavior 1452
   4.1 Stock Market Participation 1453
   4.2 Portfolio Selection 1459
   4.3 Portfolio Rebalancing in Response to Market Movements 1475
   4.4 Portfolio Rebalancing Over the Life-Cycle 1478

5. Household Borrowing Decisions 1496
   5.1 Liabilities of the Household Sector: Magnitudes and Trends 1496
   5.2 Credit Availability 1496
   5.3 Optimal Mortgage Choice 1499
<table>
<thead>
<tr>
<th>Section</th>
<th>Page</th>
</tr>
</thead>
<tbody>
<tr>
<td>3. Cash-Flow Pricing</td>
<td>1583</td>
</tr>
<tr>
<td>3.1 Incorporating Stochastic Growth in the Cash Flows</td>
<td>1583</td>
</tr>
<tr>
<td>3.2 Holding-Period Returns on Cash Flows</td>
<td>1585</td>
</tr>
<tr>
<td>3.3 Shock Elasticities</td>
<td>1585</td>
</tr>
<tr>
<td>4. Market Restrictions</td>
<td>1594</td>
</tr>
<tr>
<td>4.1 Incomplete Contracting</td>
<td>1596</td>
</tr>
<tr>
<td>4.2 Solvency Constraints</td>
<td>1602</td>
</tr>
<tr>
<td>4.3 Segmented Market and Nominal Shocks</td>
<td>1606</td>
</tr>
<tr>
<td>5. Conclusions</td>
<td>1607</td>
</tr>
<tr>
<td>Appendix A: Limited Contracting Economies Revisited</td>
<td>1608</td>
</tr>
<tr>
<td>References</td>
<td>1609</td>
</tr>
</tbody>
</table>

Index to Volume 2B