



Course: Finance

Faculty: Abhay Abhyankar

Term: Spring

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Office Hours: Upon request

Description

This course provides an introduction to selected topics and methods in empirical finance focusing on empirical issues in asset pricing and return predictability. We begin with a brief overview about efficient markets and the “stylized facts” about asset returns that theory seeks to explain. Next, we introduce the consumption-based asset pricing model, the stochastic discount factor and expected return-beta representations and factor models. Next, we review, very briefly, selected econometric techniques used to empirically test asset pricing models. The course concludes with a review and presentations by students of selected recent research on topics covered in the course. facts” about asset returns that theory seeks to explain. It will introduce the stochastic discount factor approach that is able to nest the main asset pricing models in a common structure and will review the main econometric techniques used to empirically test these models. The course concludes with a discussion of selected recent research topics that will illustrate the concepts developed in the course and suggest possible directions for further research.

References

I. Introduction: The Efficient Markets Hypothesis and Stylized Facts in the Data.

Basic ideas about the Efficient Markets Hypothesis and stylized facts in the data as well as a review of recent research on anomalies like the value-growth and momentum puzzles.

MacKinlay, A. Craig, Event Studies in Economics and Finance, Journal of Economic Literature, March 1997, 35 (1), 13-39.

Asness, Cliff, Tobias Moskowitz, and Lasse Heje Pedersen, 2013, Value and Momentum Everywhere, Journal of Finance 68(3), 929-985.

These two text book chapters provide nice overviews of the Efficient Markets Hypothesis and its role in finance:
Chapter 11: Bodie, Zvi, Alex Kane and Alan Marcus, Investments, 8th Edition on “The Efficient Market

Hypothesis” or similar chapter in earlier Editions.

Chapter 17: Elton, Gruber, Brown, Goetzmann: Modern Portfolio Theory and Investment Analysis, 6th Edition. .

II. Introduction to Asset Pricing: The Consumption CAPM, Stochastic Discount Factors, Factor Models and the Equity Premium Puzzle.

The Basic Pricing Equation & Classic Issues in Finance

Risk Corrections & Expected Return-Beta Representation

The Equity Premium Puzzle

Unconditional and Conditional Models

Cochrane, J, 2005, Asset Pricing, Princeton University Press (Revised Edition)

Ch. 1 & 2 excluding Asset Pricing in Continuous-Time i.e. 1.8, 1.8.1, 1.8.2.

Ch. 4:4.1, 4.2, 4.3, 4.4.

Ch. 5: 5.1, 5.2, 5.2.1, 5.2.2

Ch. 6, 8, 9.

II. Econometric Tests of Asset Pricing Models: Time Series & Cross-Sectional Regressions

Cochrane, J, 2005, Asset Pricing, Princeton University Press (Revised Edition)

Ch. 10, 11, 12, 13.

Campbell, J, A. Lo, and A. Craig Mackinlay (1997), Econometrics of Financial Markets, Princeton University Press, Chapters 5 and 6 (Nice treatment of Tests using Maximum Likelihood Estimation).

III. Present Value Models and Return Predictability.

Campbell, J, A. Lo, and A. Craig Mackinlay (1997), Econometrics of Financial Markets, Princeton University Press, Chapter 7 on PV Models

Campbell, J. Y., and T. Vuolteenaho, 2004, Bad beta, good beta, American Economic Review 94, 1249–1275.

Review of selected developments using recent work on return predictability.

Assessment

This will be based on an Individual Take Home assignment - full details will be provided at the start of the course.

General References

Course materials will include lecture notes/slides, review papers and selected recent papers in empirical asset pricing.

Textbooks

The course will rely mainly on Cochrane. However, CLM has some nice material on empirical tests of asset pricing models and on Campbell-Shiller decomposition etc. Pennachi is a nice modern survey of the theoretical foundations of asset pricing.

Cochrane, J., 2005, *Asset Pricing*, Princeton University Press,
Pennachi, G, 2007, *Theory of Asset Pricing*, Pearson Publishing.

Survey Papers

These are several excellent surveys of the work on empirical asset pricing.

Campbell, J., 2003, Consumption-Based Asset Pricing, Chapter 13, in *Handbook of the Economics of Finance*, Volume 1B, North Holland, 803-828. (CBAP)

Cochrane, J, 2005, Financial Markets and the Real Economy, draft Chapter 7, *Handbook of the Equity Risk Premium*. (FMRE)

Jagannathan, R, Skoulakis, G and Z. Wang, 2010, The Analysis of the Cross-section of Security Returns, Chapter 14, Vol. 2, *Handbook of Financial Econometrics*.

Lettau, M., and S. C. Ludvigson, 2010, Measuring and Modeling Variation in the Risk-Return Tradeoff, in *Handbook of Financial Econometrics*, ed. by Y. Ait-Sahalia, and L. P. Hansen, vol. 1, pp.617-690. Elsevier Science B.V., North Holland, Amsterdam.

Ludvigson, S, 2013, *Advances in Consumption-Based Asset Pricing: Empirical Tests*, (Forthcoming in Volume 2 of the *Handbook of the Economics of Finance*). (CBAPET).

Note: This is not an econometrics course and so some familiarity with the basic ideas of OLS/GLS regressions, Maximum Likelihood, Large Sample/Finite Sample Inference, Wald/LM and LR tests and GMM estimation etc at the level of Greene, Hamilton or Hayashi will be assumed.

Hamilton, J D, 1994, *Time Series Analysis*, Princeton University Press.

Greene, W., *Econometric Analysis*, 6th Edition, Prentice Hall, 2007.

Hayashi, F, 2000, *Econometrics*, Princeton University Press.

An intuitive and clear exposition of basic ideas is available in:

Wooldridge, J, 2008, *Introductory Econometrics*, 4th Edition, Thomson South-Western

Grading

The assessment will be based on an individual/Group Report - full details will be provided at the start of the course.

