Theory of Asset Pricing

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Contents

Preface xiii

I Single-Period Portfolio Choice and Asset Pricing 1

1 Expected Utility and Risk Aversion 3
  1.1 Preferences when Returns Are Uncertain . . . . . . . . . . . . . . 4
  1.2 Risk Aversion and Risk Premia . . . . . . . . . . . . . . . . . . . 14
  1.3 Risk Aversion and Portfolio Choice . . . . . . . . . . . . . . . . . 25
  1.4 Summary . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . 33
  1.5 Exercises . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . 34

2 Mean-Variance Analysis 37
  2.1 Assumptions on Preferences and Asset Returns . . . . . . . . . . 39
  2.2 Investor Indifference Relations . . . . . . . . . . . . . . . . . . . . 43
  2.3 The Efficient Frontier . . . . . . . . . . . . . . . . . . . . . . . . 46
    2.3.1 A Simple Example . . . . . . . . . . . . . . . . . . . . . . . . 47
    2.3.2 Mathematics of the Efficient Frontier . . . . . . . . . . . 51
    2.3.3 Portfolio Separation . . . . . . . . . . . . . . . . . . . . . . 56
  2.4 The Efficient Frontier with a Riskless Asset . . . . . . . . . . . 59
    2.4.1 An Example with Negative Exponential Utility . . . . . . 65

iii
CONTENTS

6.4 Summary ............................................. 187
6.5 Exercises ........................................... 188

III Contingent Claims Pricing 191

7 Basics of Derivative Pricing 193

7.1 Forward and Option Contracts ..................... 194
  7.1.1 Forward Contracts on Assets Paying Dividends .... 195
  7.1.2 Basic Characteristics of Option Prices ............. 198
7.2 Binomial Option Pricing ............................ 203
  7.2.1 Valuing a One-Period Option .................... 205
  7.2.2 Valuing a Multiperiod Option .................... 209
7.3 Binomial Model Applications ....................... 213
  7.3.1 Calibrating the Model .......................... 215
  7.3.2 Valuing an American Option ..................... 217
  7.3.3 Options on Dividend-Paying Assets ............... 223
7.4 Summary ............................................. 224
7.5 Exercises ........................................... 225

8 Diffusion Processes and Itô’s Lemma 229

8.1 Pure Brownian Motion ............................ 231
  8.1.1 The Continuous-Time Limit ..................... 232
8.2 Diffusion Processes ................................ 235
  8.2.1 Definition of an Itô Integral .................... 236
8.3 Itô’s Lemma ........................................ 238
  8.3.1 Geometric Brownian Motion ..................... 241
  8.3.2 Kolmogorov Equation .......................... 242
9 Dynamic Hedging and PDE Valuation

9.1 Black-Scholes Option Pricing 252
  9.1.1 Portfolio Dynamics in Continuous Time 253
  9.1.2 Black-Scholes Model Assumptions 257
  9.1.3 The Hedge Portfolio 258
  9.1.4 No-Arbitrage Implies a PDE 260

9.2 An Equilibrium Term Structure Model 263
  9.2.1 A Bond Risk Premium 266
  9.2.2 Characteristics of Bond Prices 268

9.3 Option Pricing with Random Interest Rates 270

9.4 Summary 275

9.5 Exercises 276

10 Arbitrage, Martingales, Pricing Kernels 279

10.1 Arbitrage and Martingales 281
  10.1.1 A Change in Probability: Girsanov’s Theorem 283
  10.1.2 Money Market Deflator 286
  10.1.3 Feynman-Kac Solution 287

10.2 Arbitrage and Pricing Kernels 288
  10.2.1 Linking the Valuation Methods 291
  10.2.2 The Multivariate Case 293

10.3 Alternative Price Deflators 294
<table>
<thead>
<tr>
<th>Section</th>
<th>Page</th>
</tr>
</thead>
<tbody>
<tr>
<td>10.4 Applications</td>
<td>297</td>
</tr>
<tr>
<td>10.4.1 Continuous Dividends</td>
<td>297</td>
</tr>
<tr>
<td>10.4.2 The Term Structure Revisited</td>
<td>303</td>
</tr>
<tr>
<td>10.5 Summary</td>
<td>305</td>
</tr>
<tr>
<td>10.6 Exercises</td>
<td>306</td>
</tr>
<tr>
<td>11 Mixing Diffusion and Jump Processes</td>
<td>311</td>
</tr>
<tr>
<td>11.1 Modeling Jumps in Continuous Time</td>
<td>312</td>
</tr>
<tr>
<td>11.2 Itô’s Lemma for Jump-Diffusion Processes</td>
<td>314</td>
</tr>
<tr>
<td>11.3 Valuing Contingent Claims</td>
<td>316</td>
</tr>
<tr>
<td>11.3.1 An Imperfect Hedge</td>
<td>317</td>
</tr>
<tr>
<td>11.3.2 Diversifiable Jump Risk</td>
<td>319</td>
</tr>
<tr>
<td>11.3.3 Lognormal Jump Proportions</td>
<td>321</td>
</tr>
<tr>
<td>11.3.4 Nondiversifiable Jump Risk</td>
<td>323</td>
</tr>
<tr>
<td>11.3.5 Black-Scholes versus Jump-Diffusion Model</td>
<td>323</td>
</tr>
<tr>
<td>11.4 Summary</td>
<td>326</td>
</tr>
<tr>
<td>11.5 Exercises</td>
<td>327</td>
</tr>
<tr>
<td>IV Asset Pricing in Continuous Time</td>
<td>329</td>
</tr>
<tr>
<td>12 Continuous Time Portfolio Choice</td>
<td>331</td>
</tr>
<tr>
<td>12.1 Model Assumptions</td>
<td>333</td>
</tr>
<tr>
<td>12.2 Continuous-Time Dynamic Programming</td>
<td>335</td>
</tr>
<tr>
<td>12.3 Solving the Continuous-Time Problem</td>
<td>338</td>
</tr>
<tr>
<td>12.3.1 Constant Investment Opportunities</td>
<td>340</td>
</tr>
<tr>
<td>12.3.2 Changing Investment Opportunities</td>
<td>347</td>
</tr>
<tr>
<td>12.4 The Martingale Approach</td>
<td>355</td>
</tr>
</tbody>
</table>
**CONTENTS**

12.4.1 Market Completeness Assumptions ............................. 356
12.4.2 The Optimal Consumption Plan .................................. 357
12.4.3 The Portfolio Allocation ........................................... 362
12.4.4 An Example ......................................................... 363

12.5 Summary ............................................................... 368
12.6 Exercises ............................................................... 369

13 Equilibrium Asset Returns .............................................. 379
13.1 An Intertemporal Capital Asset Pricing Model ....................... 380
  13.1.1 Constant Investment Opportunities ............................... 381
  13.1.2 Stochastic Investment Opportunities ............................. 383
  13.1.3 An Extension to State-Dependent Utility ......................... 386
13.2 Breeden’s Consumption CAPM ........................................ 387
13.3 A Cox, Ingersoll, and Ross Production Economy .................... 391
  13.3.1 An Example Using Log Utility .................................... 399
13.4 Summary ............................................................... 404
13.5 Exercises ............................................................... 404

14 Time-Inseparable Utility .................................................... 409
14.1 Constantinides’ Internal Habit Model ................................. 411
  14.1.1 Assumptions ....................................................... 411
  14.1.2 Consumption and Portfolio Choices ............................... 416
14.2 Campbell and Cochrane’s External Habit Model ..................... 421
  14.2.1 Assumptions ....................................................... 421
  14.2.2 Equilibrium Asset Prices ........................................ 423
14.3 Recursive Utility ....................................................... 426
  14.3.1 A Model by Obstfeld ............................................. 427
CONTENTS

16.2.1 Kyle Model Assumptions ................................. 486
16.2.2 Trading and Pricing Strategies ......................... 487
16.2.3 Analysis of the Results ............................... 491

16.3 Summary ......................................................... 494
16.4 Exercises ...................................................... 494

17 Term Structure Models 499

17.1 Equilibrium Term Structure Models ...................... 500
17.1.1 Affine Models ............................................. 503
17.1.2 Quadratic Gaussian Models ............................ 509
17.1.3 Other Equilibrium Models .............................. 512

17.2 Valuation Models for Interest Rate Derivatives .......... 513
17.2.1 Heath-Jarrow-Morton Models ......................... 514
17.2.2 Market Models ............................................. 528
17.2.3 Random Field Models ................................. 537

17.3 Summary ......................................................... 543
17.4 Exercises ...................................................... 544

18 Models of Default Risk 547

18.1 The Structural Approach ................................. 548

18.2 The Reduced-Form Approach ............................. 553
18.2.1 A Zero-Recovery Bond ................................. 554
18.2.2Specifying Recovery Values ............................. 557
18.2.3 Examples ..................................................... 562
18.3 Summary ................................................. 567

18.4 Exercises .................................................. 568
Preface

The genesis of this book comes from my experience teaching asset pricing theory to beginning doctoral students in finance and economics. What I found was that no existing text included all of the major theories and techniques of asset valuation that students studying for a Ph.D. in financial economics should know. While there are many excellent books in this area, none seemed ideal as a stand-alone text for a one-semester first course in theoretical asset pricing. My choice of this book’s topics were those that I believe are most valuable to someone at the start of a career in financial research. Probably the two features that most distinguish this book from others are its broad coverage and its user-friendliness.

Contents of this book have been used for over a decade in introductory finance theory courses presented to doctoral students and advanced masters students at the University of Illinois at Urbana-Champaign. The book presumes students have a background in mathematical probability and statistics and that they are familiar with constrained maximization (Lagrange multiplier) problems. A prior course in microeconomics at the graduate or advanced undergraduate level would be helpful preparation for a course based on this book. However, I have found that doctoral students from mathematics, engineering, and the physical sciences who had little prior knowledge of economics often are able to understand the course material.
This book covers theories of asset pricing that are the foundation of current theoretical and empirical research in financial economics. It analyzes models of individual consumption and portfolio choice and their implications for equilibrium asset prices. In addition, contingent claims valuation techniques based on the absence of arbitrage are presented. Most of the consumption-portfolio choice models assume individuals have standard, time-separable expected utility functions, but the book also considers more recent models of utility that are not time separable or that incorporate behavioral biases. Further, while much of the analysis makes standard “perfect markets” assumptions, the book also examines the impact of asymmetric information on trading and asset prices. Many of the later chapters build on earlier ones, and important topics reoccur as models of increasing complexity are introduced to address them. Both discrete-time and continuous-time models are presented in a manner that attempts to be intuitive, easy to follow, and that avoids excessive formalism.

As its title makes clear, this book focuses on theory. While it sometimes contains brief remarks on whether a particular theory has been successful in explaining empirical findings, I expect that doctoral students will have additional exposure to an empirical investments seminar. Some of the material in the book may be skipped if time is limited to a one-semester course. For example, parts of Chapter 7’s coverage of binomial option pricing may be cut if students have seen this material in a masters-level derivatives course. Any or all of the chapters in Section V also may be omitted. In my teaching, I cover Chapter 15 on behavioral finance and asset pricing, in part because current research on this topic is expanding rapidly. However, if reviewer response is any indication, there are strongly held opinions about behavioral finance and asset pricing, and so I suspect some readers will choose to skip this material all together while others may wish to see it expanded.
Typically, I also cover Chapter 16 which outlines some of the important models of asymmetric information that I believe all doctoral students should know. However, many Ph.D. programs may offer a course entirely devoted to this topic, so that this material could be deleted under that circumstance. Chapters 17 and 18 on modeling default-free and defaultable bond prices contain advanced material that I typically do not have time to cover during a single semester. Still, there is a vast amount of research on default-free term structure models and a growing interest in modeling default risk. Thus, in response to reviewers’ suggestions, I have included this material because some may find coverage of these topics helpful for their future research. A final note on the end of chapter problems: most of these problems derive from assignments and exams given to my students at the University of Illinois. The solutions are available for instructor download at the Addison Wesley website.

Acknowledgements

I owe a debt to the individuals who first sparked my interest in financial economics. I was lucky to have been a graduate student at MIT during the early 1980s where I could absorb the insights of great financial economists, including Fischer Black, Stanley Fischer, Robert Merton, Franco Modigliani, Stewart Myers, and Paul Samuelson. Also, I am grateful to my former colleague at Wharton, Alessandro Penati, who first encouraged the writing of this book when we team taught a finance theory course at Università Bocconi during the mid-1990s. He contributed notes on some of the book’s beginning chapters.

Many thanks are due to my colleagues and students at the University of Illinois who provided comments and corrections to the manuscript. In addition, I have profited from the valuable suggestions of many individuals from other universities who reviewed drafts of some chapters. I am particularly indebted to the following individuals who provided extensive comments on parts of the book:

The level of support that I received from the staff at Addison-Wesley greatly exceeded my initial expectations. Writing a book of this scope was a time-consuming process that was made manageable with their valuable assistance. Senior Acquisitions Editor Donna Battista deserves very special thanks for her encouragement and suggestions.

Last but not least my wife Peggy and our triplets George, Laura, and Sally deserve recognition for the love and patience they have shown to me. Their enthusiasm buoyed my spirits and helped bring this project to fruition.
Contingent Claims Theory
Leaving aside options, the equity of an investment is the most volatile investment that funds the assets of an economic entity. The equity of an entity controls it and possesses a valuable option - to abandon it all and hand the company over to the next most junior investor. Option valuation can tell us a lot about about the cost of capital. This is my theory of asset/liability/equity pricing in broad. Comments are welcomed. My Theory Of Asset Pricing. Add a Comment. Related Articles. Arbitrage Pricing Theory
Formula. In the APT model, an asset's or a portfolio's returns follow a factor intensity structure if the returns could be expressed using this formula: \[ r_i = a_i + \beta_{i1} \cdot F_1 + \beta_{i2} \cdot F_2 + + \beta_{kn} \cdot F_n + \mu_i, \] where \( a_i \) is a constant for the asset; \( F \) is a systematic factor, such as a macroeconomic or company-specific factor; \( \beta \) is the sensitivity of the asset or portfolio in relation to the specified factor; and \( \mu_i \) is the asset's idiosyncratic random shock with an expected mean of zero, also known as the error term. The APT formula is \( E(r_i) = r_f + \beta_{i1} \cdot R_P1 + \) This article compares two leading models of asset pricing: the capital asset pricing model (CAPM) and the arbitrage pricing theory (APT): I argue that while the APT is compatible with the data available for testing theories of asset pricing, the CAPM is not. In reaching this conclusion emphasis is placed on the distinction between the unconditional (relatively incomplete) information which econometricians must use to estimate asset pricing models and the conditional (complete) information which investors use in making the portfolio decisions which determine asset prices. This note introduces asset pricing theory to Ph.D. students in finance. The emphasis is put on dynamic asset pricing models that are built on continuous-time stochastic processes. It is very preliminary. Please let me know if you discover any mistake. Preface. i 1 Introduction to Asset Pricing Theory. 1 1 1 Basic Abstractions . .