

Chapter 8: Dynamic Securities Markets

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Assets and Returns

- Dates $t = 0, 1, 2, \dots$. No tildes anymore for random things. Information grows over time as random variables are observed.
- D_{it} = dividend of asset i at date t . Ex-dividend price $P_{it} > 0$.
- Return from t to $t + 1$ is

$$R_{i,t+1} := \frac{P_{i,t+1} + D_{i,t+1}}{P_{it}}$$

- Risk-free return from t to $t + 1$ is $R_{f,t+1}$. Known at t (so risk-free from t to $t + 1$) but maybe not known until t (randomly evolving interest rates).

SDFs

One-Period SDFs

- SDF at t for pricing at $t + 1$ is a r.v. Z_{t+1} depending on date $t + 1$ information such that

$$E_t[Z_{t+1}R_{i,t+1}] = 1$$

for all assets i .

- Equivalently, price at t of any portfolio payoff X_{t+1} at $t + 1$ is

$$E_t[Z_{t+1}X_{t+1}]$$

- With no uncertainty or with risk neutrality,

$$Z_{t+1} = \frac{1}{R_{f,t+1}} := \frac{1}{1 + r_{f,t+1}}$$

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- So price at $t - 1$ is

$$E_{t-1}\left[Z_t E_t[Z_{t+1}X_{t+1}]\right] = E_{t-1}\left[E_t[Z_t Z_{t+1}X_{t+1}]\right] = E_{t-1}\left[Z_t Z_{t+1}X_{t+1}\right]$$

- We're compounding discount factors.
- With no uncertainty, price is

$$\frac{X_{t+1}}{(1 + r_{f,t})(1 + r_{f,t+1})}$$

- Define M by compounding discount factors:

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$$M_t := Z_1 \times Z_2 \times \cdots \times Z_t$$

- Set $M_0 = 1$.
- Price at date 0 of a payoff X_t at date t is $E[M_t X_t]$.
- Price at date $s < t$ of payoff X_t at date t is

$$E_s[Z_{s+1} \cdots Z_t X_t] = E_s \left[\frac{Z_1 \cdots Z_t}{Z_1 \cdots Z_s} X_t \right] = E_s \left[\frac{M_t}{M_s} X_t \right]$$

Factor Model

Dynamic Factor Model

- From

$$1 = E_t \left[\frac{M_{t+1}}{M_t} R_{i,t+1} \right]$$

we get

$$1 = \frac{E_t[R_{i,t+1}]}{R_{f,t+1}} + \text{cov}_t \left(\frac{M_{t+1}}{M_t}, R_{i,t+1} \right)$$

- So

$$E_t[R_{i,t+1}] - R_{f,t+1} = -R_{f,t+1} \text{cov}_t \left(\frac{M_{t+1}}{M_t}, R_{i,t+1} \right)$$

Portfolio Choice

Portfolio Choice

- Stack returns into an n -vector R_{t+1} . One may be risk-free (return $= R_{f,t+1}$).
- Investor chooses consumption C_t and a portfolio $\pi_t \in \mathbb{R}^n$. $\iota' \pi_t = 1$. Labor income Y_t .
- Suppose investor seeks to maximize

$$\sum_{t=0}^{\infty} \delta^t u(C_t)$$

Wealth (actually financial wealth) W satisfies the **intertemporal budget constraint**

$$W_{t+1} = (W_t - C_t)\pi_t' R_{t+1} + Y_{t+1}$$

Euler Equation

- A necessary condition for consumption/investment optimality is that, for all dates t and assets i ,

$$E_t \left[\frac{\delta u'(C_{t+1})}{u'(C_t)} R_{i,t+1} \right] = 1$$

- This is called the Euler equation. It is derived by the same logic as in a single-period model.
- The Euler equation is equivalent to:

$$M_t := \frac{\delta^t u'(C_t)}{u'(C_0)}$$

is an SDF process.

- The one-period SDFs are one-period marginal rates of substitution:

$$\frac{M_{t+1}}{M_t} = \frac{\delta u'(C_{t+1})}{u'(C_t)}$$

Equity Premium Puzzle

Representative Investor and SDF Process

- Let C denote aggregate consumption.
- Assume there is a representative investor with CRRA utility and risk aversion ρ .
- Then, the one-period SDF is

$$\frac{M_{t+1}}{M_t} = \delta \left(\frac{C_{t+1}}{C_t} \right)^{-\rho}$$

- The SDF process is

$$M_t = \delta^t \left(\frac{C_t}{C_0} \right)^{-\rho}$$

Market Price-Dividend Ratio

- Define the market portfolio as the claim to future consumption.
- Consumption is then the dividend of the market portfolio. Assume consumption growth C_{t+1}/C_t is iid lognormal.
- The ex-dividend date- t price of the market portfolio is

$$P_t := E_t \sum_{u=t+1}^{\infty} \frac{M_u}{M_t} C_u = E_t \sum_{u=t+1}^{\infty} \delta^{u-t} \left(\frac{C_u}{C_t} \right)^{-\rho} C_u$$

- So, the price-dividend ratio is

$$\begin{aligned} \frac{P_t}{C_t} &= E_t \sum_{u=t+1}^{\infty} \delta^{u-t} \left(\frac{C_u}{C_t} \right)^{1-\rho} \\ &= E \sum_{u=1}^{\infty} \delta^u \left(\frac{C_u}{C_0} \right)^{1-\rho} \end{aligned}$$

- Assume $\log C_{t+1} = \log C_t + \mu + \sigma \varepsilon_{t+1}$ for iid standard normals ε .
- Then

$$\log C_u = \log C_0 + u\mu + \sigma \sum_{n=1}^u \varepsilon_n$$

- Hence,

$$\begin{aligned} \mathbb{E} \left[\left(\frac{C_u}{C_0} \right)^{1-\rho} \right] &= \mathbb{E} \left[\exp \left((1-\rho) \left\{ u\mu + \sigma \sum_{n=1}^u \varepsilon_n \right\} \right) \right] \\ &= \exp \left((1-\rho)u\mu + \frac{1}{2}(1-\rho)^2 u \sigma^2 \right) \\ &= \left(e^{(1-\rho)\mu + (1-\rho)^2 \sigma^2 / 2} \right)^u \end{aligned}$$

- So, the price-dividend ratio is

$$\sum_{u=1}^{\infty} \left(\delta e^{(1-\rho)\mu + (1-\rho)^2\sigma^2/2} \right)^u = \frac{\nu_1}{1 - \nu_1}$$

where

$$\nu_1 = \delta E \left[\left(\frac{C_1}{C_0} \right)^{1-\rho} \right] = \delta e^{(1-\rho)\mu + (1-\rho)^2\sigma^2/2}$$

provided $\nu_1 < 1$.

- This is the same ν_1 we saw in Chapter 7.
- Everything else—risk-free return, expected market return, log equity premium, equity premium puzzle—is exactly the same as in Chapter 7.

Risk-Neutral Probability

Risk-Neutral Probability

- Consider an arbitrary finite (possibly large) horizon T .
- Consider an event A that can be distinguished by date T (at date T , you know whether A happened or not).
- Define

$$Q(A) = E[R_{f1} \cdots R_{fT} M_T 1_A]$$

- Then Q is a probability measure.
- Define E^* as expectation with respect to Q . Then for all assets i and dates t ,

$$E_t^*[R_{i,t+1}] = R_{f,t+1}$$

- And, the price at t of a payoff X_{t+1} at date $t + 1$ is

$$\frac{E_t^*[X_{t+1}]}{1 + r_{f,t+1}}$$

Martingales

Martingales

- A martingale is a sequence of random variables Y such that $Y_s = E_s[Y_t]$ for all $s < t$.
- Equivalently, $E_s[Y_t - Y_s] = 0$.
- Consider any payoff at date u with value V_t at date t . Then
 1. The sequence $M_t V_t$ is a martingale (up to u).
 2. The sequence

$$\frac{V_t}{(1 + r_{f1}) \cdots (1 + r_{ft})}$$

is a Q -martingale.

Testing

Testing Conditional Models

Suppose we have a model for an SDF. Call the model value \hat{M} . We want to test whether

$$(\forall t, i) \quad E_t[\hat{M}_{t+1} R_{i,t+1}] = 1 \quad (\star)$$

Let I_t be any variable observed at t . Multiply both sides by I_t and rearrange as:

$$(\forall t, i) \quad E_t[I_t \hat{M}_{t+1} R_{i,t+1}] - I_t = 0$$

Take the expectation and use the law of iterated expectations to obtain

$$(\forall t, i) \quad E[I_t(\hat{M}_{t+1} R_{i,t+1} - 1)] = 0 \quad (\star\star)$$

The conditional model (\star) implies the unconditional moment condition $(\star\star)$ for every **instrument** I . If we reject the unconditional moment conditions, then we reject the model.