15.470 Midterm Cheat Sheet
by Shreyas V. Srinivasan, page 1 of 1

1 Basic Framework

Environment

State space $\Omega = \{\omega_i\}_{i=1}^M$

$\mathbb{P}(\omega_m) = p_m > 0$

Agents

Agents $k = 1, \ldots, K$

Rational expectations, homogeneous beliefs

Prior $\mathbb{P}$ beliefs

Endowment e_0^k and $e_{1\omega}^k$

Production $y_1(I) = [f_w(I)]^\intercal$

Consumption $c_0, c_{1\omega}$

Securities Market

Securities $n = 1, \ldots, N$

Payoffs $D_{1n} = [D_{1\omega n}]$

Prices $P = [P_n]$

Portfolio $\theta = [\theta_n]$

Mkt. Equilibrium

Endowment e^k, constraints

$c_0^k = e_0^k - P^\intercal \theta$,

$c_1^k = e_1^k + D_1 \theta$,

$c^k \geq 0$

Optimize $u_k(c)$

Solution $\theta^k(P, e)$

Mkt. clearing $\sum_{k=1}^K \theta^k \left(P, e^k\right) = 0$

2 Mathematics

Expected Value

$\mathbb{E}[X] = \sum_{m=1}^M p_m X(\omega_m) = \int_{-\infty}^{\infty} x f_X(x)\,\mathrm{d}x$

Linearity: $\mathbb{E}[aX + bY] = a\mathbb{E}[X] + b\mathbb{E}[Y]$

Jensen's: g convex $\mathbb{E}[g(X)] \geq g(\mathbb{E}[X])$

Variance

$\mathrm{Cov}(X, Y) = \mathbb{E}[(X - \mathbb{E}[X])(Y - \mathbb{E}[Y])]$

$\mathrm{Var}(X) = \mathrm{Cov}(X, X)$

$\rho_{X,Y} = \frac{\mathrm{Cov}(X,Y)}{\sigma_X \sigma_Y}$

Billinearity, symmetry

$\mathrm{Var}(X + Y) = \mathrm{Var}(X) + \mathrm{Var}(Y) + 2\,\mathrm{Cov}(X, Y)$

Independence

$\mathbb{P}(X \in A, Y \in B) = \mathbb{P}(X \in A)\,\mathbb{P}(Y \in B)$

$\mathbb{E}[XY] = \mathbb{E}[X]\,\mathbb{E}[Y]$

$\mathrm{Cov}(X, Y) = 0$

Log-normal RV

$X \sim \mathcal{N}\left(\mu, \sigma^2\right) \implies$

$\mathbb{E}[\exp(X)] = \exp\left(\mu + \frac{\sigma^2}{2}\right)$

Returns

$1 + \underbrace{r_t}_{\text{Net Ret}} = \underbrace{R_t}_{\text{Gross Ret}}$

$I_t = I_0 \prod_{t=1}^T R_t$

$\overline{R}_T^A = \frac{1}{T} \sum_{t=1}^T R_t$

$\overline{R}_T^G = \left(\prod_{t=1}^T R_t\right)^{\frac{1}{T}}$

3 Utility Functions

CARA (Exponential)

$u(c) = \frac{1 - \exp(-\alpha c)}{\alpha}$, $\alpha > 0$

Abs. risk aversion $\alpha_u(w_0) = -\frac{u''(w_0)}{u'(w_0)}$

CRRA

$u(c) = \frac{c^{1-\gamma} - 1}{1 - \gamma}$, $\gamma > 0$

Rel. risk aversion $\gamma_u(w_0) \equiv -\frac{w_0 u''(w_0)}{u'(w_0)} = w_0 \alpha_u(w_0)$

4 Canonical Model

Redundancy

$\exists \theta_{\backslash n} : D_{\backslash n} \theta_{\backslash n} = D_n$

Complete: $\forall c_1 \in \mathbb{R}^m \exists \theta \in \mathbb{R}^n : D\theta = c_1$

Complete $\iff \operatorname{rank}(D) = M$

Arrow-Debreu Mkt.

ϕ_ω state-contingent claim

Arrow-Debreu mkt complete

Risk Aversion

Fair gamble: $\mathbb{E}[x] = 0$

Risk averse: $\mathbb{E}[u(w + x)] \leq \mathbb{E}[u(w)]$

Risk prem π: $u(w - \pi) = \mathbb{E}[u(w + x)]$

Portfolio choice

SDF $\eta = \frac{u_1'(c_{1\omega})}{u_0'(c_0)} = \frac{\phi_\omega}{p_\omega}$

$\eta_\omega c_{1\omega} \propto 1$

Euler Equation

$P_n = \mathbb{E}\left[\frac{u_1'(c_1)}{u_0'(c_0)} D_n\right]$

Valuation Formulas

DCF/PV: $P_n = \phi^\intercal D_n$

Risk-Neutral $q_\omega \equiv \frac{\phi_\omega}{\sum_{\omega'} \phi_{\omega'}}$

$P_n = \frac{\mathbb{E}^{\mathbb{Q}}[D_n]}{1 + r_f}$

SPD/SDF: $P_n = \mathbb{E}^{\mathbb{P}}[\eta D^n]$

$R_f = \mathbb{E}^{\mathbb{P}}[\eta]^{-1}$

Risk Premia

$\mathbb{E}\left[R_n - R_f\right] = -R_f \,\mathrm{Cov}\left[\eta, R_n - R_f\right]$

Lucas: $\mathbb{E}\left[R_n - R_f\right] \approx -\gamma \,\mathrm{Cov}\left[R_n, \frac{c_1}{c_0}\right]$

SPD/SDF Bounds

$\frac{\sqrt{\mathrm{Var}^{\mathbb{P}}[\eta]}}{\mathbb{E}^{\mathbb{P}}[\eta]} \geq \frac{\mathbb{E}^{\mathbb{P}}\left[r_n - r_f\right]}{\sqrt{\mathrm{Var}^{\mathbb{P}}\left[r_n - r_f\right]}}$

5 Arbitrage

Definition

1) $P^T \theta \leq 0$,

2) $D\theta \geq 0$,

3) One or both of above strict;

No Arbitrage in frictionless mkt.

No Arbitrage

$\exists V(\cdot)$ pricing operator

$P = V(d)$; Law of One Price:

$V(d_1) = V(d_2) \iff d_1 = d_2$;

V monotonic & linear

FTAP: $\exists \phi : P^\intercal = \phi^\intercal D$

NA $\iff \exists \phi > 0$

6 Corporate Finance

Opt Prod/Investment

Production: $y_{1\omega} = y_\omega(y_0)$

NPV: $v = \sum_{\omega \in \Omega} \phi_\omega y_\omega(y_0) - y_0$

Max NPV *or* utility

Capital Structure

$y_0 = d_0 + e_0$

$D = \phi^\intercal d_1$

$E = \phi^\intercal e_1$

q Theory

$q_j \equiv \frac{\mathbb{E}^{\mathbb{Q}}\left[A_j\right]}{1 + r_f}$

7 Fixed Income

Term Structure

$P_{N,t} = \mathbb{E}_t\left[\prod_{i=t+1}^{t+N} \eta_i\right]$

$P_{N,t} = Y_{N,t}^{-N}$

Nominal: $P_{N,t}^{\$} = P_{N,t} \times \mathrm{CPI}_t$

$\Pi_t = \mathrm{CPI}_t / \mathrm{CPI}_{t-1}$

$1 = \mathbb{E}_t\left[\frac{\eta_{t+1}}{\Pi_{t+1}} \frac{P_{N-1,t+1}^{\$}}{P_{N,t}^{\$}}\right]$

$\eta_{t+1}^{\$} = \frac{\eta_{t+1}}{\Pi_{t+1}}$ nominal SDF

Real: $1 = \mathbb{E}_t\left[\eta_{t+1} \frac{P_{N-1,t+1}}{P_{N,t}}\right]$

8 Option Pricing

Derivative Defn.

Payoff $f(X_T)$ at $t = T$

$P = \mathbb{E}_t\left[f(X_T) \prod_{i=t+1}^T \eta_i\right]$

$P = \sum_{\omega \in \Omega} \phi_\omega f(X_\omega)$

$P = \int \phi(\omega) f(X(\omega))\,\mathrm{d}\omega$

Options

$[x]_+ \equiv \max[0, x]$

$c_1 = [S_1 - K]_+, p_1 = [K - S_1]_+$

$P_X = \mathbb{E}[\eta X] = \mathrm{Cov}[\eta, X] + R_f^{-1} \mathbb{E}[X]$

Intrinsic value, ITM/ATM/OTM;

Prices convex in K

$S \geq c(S, K) \geq \left[S - \frac{K}{1 + r_f}\right]_+$

$c(S, K) - p(S, K) = S - \frac{K}{1 + r_f}$

Backing Out $\mathbb{Q}$

$q(K) = \frac{\partial^2 c(K)}{\partial K^2} \Big/ \int_0^\infty \frac{\partial^2 c(K)}{\partial K^2}\,\mathrm{d}K$

9 Arbitrage Pricing

Decomposition

$r_{n,t} - r_f = \alpha_n + \beta_n \left(r_{-\eta,t} - r_f\right) + \varepsilon_{n,t}$

$\mathrm{Var}\left[r_n - r_f\right] = \beta_n^2 \,\mathrm{Var}\left[r_{-\eta} - r_f\right] + \mathrm{Var}[\varepsilon_n]$

Factors

F basis for $R - \overline{R}_n$

$R_n = \overline{R}_n + F\beta_n$

$\mathbb{E}^{\mathbb{Q}}[R_n] = R_f$ APT: $\overline{R}_n - R_f = \lambda^\intercal \beta_n$,

where $\lambda_k = -\mathbb{E}^{\mathbb{Q}}[F_k]$

λ_k factor premium

Diversification

Portfolio θ *well diversified* if

$\theta_n = O\left(\frac{1}{n}\right)$

Sequence $\{\theta_i\}$, $|\theta_1| = 1$

well diversified if $\exists 0 < \kappa < \infty$ s.t.

$\theta_{n,j}^2 < \frac{\kappa}{n^2}$.

APT

Asymptotic: $\mathbb{E}\left[r_{\theta_n}\right] \to \alpha > 0$,

but $\mathrm{Var}\left[r_{\theta_n}\right] \to 0$.

No asymptotic arb. $\implies \exists r_f, \lambda, A :$

$\sum_{i=1}^n \left[\overline{r}_i - \left(r_f + \lambda^\intercal \beta_i\right)\right]^2 = \sum_{i=1}^n \left[\overline{r}_i - \left(r_f + \sum_k \lambda_k \beta_{ik}\right)\right]^2 < A < \infty.$