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Economics 214B

Financial Decisions

This course covers three areas of finance: Dynamic asset pricing models, portfolio selection and financial econometrics.

The main text of the course is

John H. Cochrane, 2001, Asset Pricing. Princeton University Press.

This book provides a good background to many of the topics we will cover, but we will also make extensive use of journal articles as well as chapters from a couple of other textbooks.

I. Fundamental Asset Pricing Models

1. The Fundamental Asset Pricing Model
Cochrane chapters 1, 2, Appendix on continuous time mathematics, p. 489-495.

2. Factor Pricing Models (CAPM, ICAPM, APT)
Cochrane chapter 9.

Balvers, R.J., Cosimano, T.F. and B. MacDonald, 1990, Predicting stock returns in an efficient market. Journal of Finance 45, 1109-28.

3. Term Structure of Interest Rates
Cochrane, chapter 19

Backus, D., S. Foresi and C. Telmer (1998), Discrete-time Models of Bond Pricing. NBER working paper 6736.

4. Currency Pricing
Backus, D., S. Foresi and C. Telmer, 1998, Affine Models of Currency Pricing: Accounting for the Forward Premium Anomaly. Forthcoming in Journal of Finance.

II. Optimal Portfolio Decisions

1. Basic Models and Techniques
Jonathan E. Ingersoll, Jr., 1987, Theory of Financial Decision Making. Rowman and Littlefield. Chs. 11,13.

Merton, R., 1969, Lifetime Portfolio Selection under Uncertainty: The Continuous Time Case. Review of Economics and Statistics 51, 247-257.

Samuelson, P., 1969, Lifetime portfolio selection by dynamic stochastic programming. Review of Economics and Statistics 51, 239-46.

2. Optimal Asset Allocation under Predictability of Returns
Barberis, N., 2000, Investing for the long run when returns are predictable. Journal of Finance 55, 225-264.

Campbell, J. and L. Viceira, 1999, Consumption and Portfolio decisions when expected returns are time varying. Quarterly Journal of Economics 114, 433-495.

Campbell, J. and L. Viceira, 2001, Who Should Buy Long-Term Bonds? American Economic Review 91, 99-127.

Guidolin, M. and A. Timmermann, 2002, Optimal Portfolio Decisions under mixtures of normal return distributions. Manuscript, UCSD.

Kandel, S. and R. Stambaugh, 1996, On the predictability of stock returns: An asset allocation perspective. Journal of Finance 51, 385-424.

Lynch, A., 2001, Portfolio choice and equity characteristics: Characterizing the hedging demands induced by return predictability. Journal of Financial Economics 62, 67-130.

III. Empirical Modeling and Testing

1. Introduction: Properties of financial time series. Nonlinearity, fat tails, volatility clustering, long-run serial correlation.

Campbell, J.Y., A.W. Lo and A.C. MacKinlay, 1997, The Econometrics of Financial Markets, Chs. 2,12.

2. Puzzles in Asset Pricing
Cochrane, Ch. 20, p. 387-389.

Fama, E.F., 1991, Efficient Capital Markets: II. Journal of Finance 46, 1575-1617.

Faust, J., 1992, When Are Variance Ratio Tests for Serial Dependence Optimal? Econometrica 60, 1215-1226.

Poterba, J.M. and L.H. Summers, 1988, Mean Reversion in Stock Prices: Evidence and Implications. Journal of Financial Economics 22, 27-60.

3. GMM tests of asset pricing models
Cochrane Chs. 10,11,14.

Hansen, L. and K. Singleton, 1982, Generalized Instrumental Variables Estimation of Nonlinear Rational Expectations Models. Econometrica 50, 1269-1288.

4. Model Instability: Testing, Modeling and Forecasting
Andrews, D.W.K., 1993, Tests for Parameter Instability and Structural Change with Unknown Change Point. Econometrica 61, 821-856.

Bai, J. and P. Perron, 1998, Estimating and Testing Linear Models with Multiple Structural Changes. Econometrica 66, 47-78.

Bai, J., Perron, P., 2001, Computation and Analysis of Multiple Structural Change Models. Forthcoming in Journal of Applied Econometrics.

Hamilton, J. Time Series Analysis, 1994. Princeton University Press. Chapters 13,22.

Hansen, B., 2001, The New Econometrics of Structual Change: Dating Breaks in U.S. Labor Productivity. The Journal of Economic Perspectives 15 (Fall), 117-128.

Pastor, L. and R. F. Stambaugh, 2001, The equity premium and structural breaks. Journal of Finance 56, 1207-1239.

Paye, B. and A. Timmermann, 2002, How stable are Financial Prediction Models? Evidence from US and International Stock Market Data. Mimeo, UCSD.

Perez-Quiros, G. and A. Timmermann, 2000, Firm Size and Cyclical Variations in Stock Returns. Journal of Finance, 1229-1262.

Pesaran, M.H. and A. Timmermann, 2002, Market Timing and Return Prediction under Model Instability. Forthcoming in Journal of Empirical Finance.

Pesaran, M.H. and A. Timmermann, 2002, Model Instability and Choice of Observation Window. Mimeo, UCSD.

5. Predictability of Stock Returns
Cochrane ch. 20.1, 20.3

Ait-Sahalia, Y. and M. Brandt, 2001, Variable selection for portfolio choice. Journal of Finance 56, 1297-1350.

Brandt, M., 1999, Estimating Portfolio and Consumption Choice: A Conditional Euler Equations Approach, Journal of Finance 54, 1609-1645.

Engle and Rosenberg, 2002, JFE.

Lettau, M. and S. Ludvigson, 2001, Consumption, aggregate wealth, and expected stock returns. Journal of Finance 56, 815-850.

Pesaran, M.H. and A. Timmermann, 1995, Predictability of Stock Returns: Robustness and Economic Significance. Journal of Finance 50, 1201-1228

Satchell, S. and A. Timmermann, 1995, An Assessment of the Economic Value of Non-linear Foreign Exchange Rate Forecasts. Journal of Forecasting 14, 477-497.

Timmermann, A. and C.W.J. Granger, 2002, Efficient Market Theory and Forecasting. Forthcoming in International Journal of Forecasting.

6. Extreme risks, dependencies in asset returns

Diebold, F.X., T.A. Gunther and A.S. Tay, 1998, Evaluating Density Forecasts with Applications to Financial Risk Management, *International Economic Review* 39, 863-883.

Embrechts, Paul, McNeil, Alexander and Daniel Straumann (1999) Correlation and Dependence in Risk Management: Properties and Pitfalls. Unpublished Manuscript.

Engle, R.F. and S. Manganelli, 2001, CAViaR: Conditional Value At Risk By Regression Quantiles

Gourieroux, C. and J. Jasiak, Financial Econometrics, Princeton University Press, 2002. Ch. 16.

Longin, F. and B., 1999, Solnik, Extreme correlation of international equity markets. Journal of Finance, 56, 649-676.

Perez-Quiros, G. and A. Timmermann, 2001, Business Cycle Asymmetries in Stock Returns: Evidence from Higher Order Moments and Conditional Densities. Journal of Econometrics vol 103, 259-306.

Soderlind, P. and L. Svensson, 1997, New Techniques to Extract Market Expectations from Financial Instruments. Journal of Monetary Economics 40, 383-429.

Tay, A.S. and K.F. Wallis, 2000, Density Forecasting: A Survey. Journal of Forecasting 19, 235-254.

7. Speculative Bubbles and Noise Trading

De Long, J.B., A. Shleifer, L.H. Summers and R.J. Waldmann, 1990, Noise Trader Risk in Financial Markets. Journal of Political Economy 98, 703-738.

Evans, G.W., 1991, Pitfalls in Testing for Explosive Bubbles in Asset Prices. American Economic Review, 81, 922-930.

Froot, K. and M. Obstfeld, 1991, Intrinsic Bubbles: The case of Stock Prices. American Economic Review 81,1189-1214.

8. Data-Snooping

Foster, F.D., T. Smith, R.E. Whaley, 1997, Assessing Goodness-of-fit of Asset Pricing Models: The Distribution of the Maximal R^2. Journal of Finance 52, 591-607.

Hansen, P.R., 2001, An unbiased and powerful test for superior predictive ability. Brown University discussion paper.

Lo, A. and A.C. MacKinlay, 1990, Data-Snooping Biases in Tests of Financial Asset Pricing Models. Review of Financial Studies 3, 431-468.

Sullivan, R., A. Timmermann, and H. White, 1999, Data-Snooping, Technical Trading Rules and the Bootstrap. Journal of Finance, 54, 1647-1692.

White, H., 2000, A Reality Check for Data Snooping. Econometrica 68, 1097-1126.