THEORY OF Asset Pricing

George Pennacchi

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Preface

he genesis of this book came 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. I chose topics for this book 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 that 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 obvious, 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 the binomial option pricing material covered in Chapter 7 may be cut if students have seen this material in a masters-level derivatives course. Any or all of the chapters in Part V, Additional Topics in Asset Pricing, 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 so I suspect that some readers will choose to skip this material altogether 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 in 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 www.aw.com/finance.

Acknowledgments

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: Mark Anderson, Gurdip Bakshi, Evangelos Benos, Michael W. Brandt, Murillo Campello, David Chapman, Gregory Chaudoin, Mikhail Chernov, Michael Cliff, Pierre Collin-Dufresne, Bradford Cornell, Michael Gallmeyer, Christos Giannikos, Antonio Gledson de Carvalho, Olesya Grishchenko, Hui Guo, Jason Karceski, Mark Laplante, Dietmar Leisen, Sergio Lence, Tongshu Ma, Galina Ovtcharova, Kwangwoo Park, Christian Pedersen, Glenn Pedersen, Monika Piazzesi, Allen Poteshman, James Reineck, Peter Ritchken, Saurav Roychoudhury, Nejat Seyhun, Timothy Simin, Chester Spatt, P. V. Viswanath, Qinghai Wang, and Hong Yan.

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Contents

Prefac	е		χv
PART		gle-Period Portfolio Choice d Asset Pricing	1
1	Expec	ted Utility and Risk Aversion	3
	1.1	Preferences When Returns Are Uncertain 4	
	1.2	Risk Aversion and Risk Premia 11	
	1.3	Risk Aversion and Portfolio Choice 19	
	1.4	Summary 24	
	1.5	Exercises 25	
2	Mean	-Variance Analysis	27
	2.1	Assumptions on Preferences and Asset Returns 28	
	2.2	Investor Indifference Relations 31	
	2.3	The Efficient Frontier 34	
	2.3.1	A Simple Example 35	
	2.3.2	Mathematics of the Efficient Frontier 37	
	2.3.3	Portfolio Separation 40	
	2.4	The Efficient Frontier with a Riskless Asset 44	
	2.4.1	An Example with Negative Exponential Utility 48	
	2.5	An Application to Cross-Hedging 50	
	2.6	Summary 53	
	2.7	Exercises 54	

3	CAPN	M, Arbitrage, and Linear Factor Models	57
	3.1 3.1.1 3.1.2	The Capital Asset Pricing Model 58 Characteristics of the Tangency Portfolio 59 Market Equilibrium 60	
	3.2 3.2.1	Arbitrage 66 Examples of Arbitrage Pricing 67	
	3.3	Linear Factor Models 70	
	3.4	Summary 76	
	3.5	Exercises 77	
4	Consi	umption-Savings Decisions and State Pricing	79
	4.1	Consumption and Portfolio Choices 80	
	4.2	An Asset Pricing Interpretation 84	
	4.2.1	Real versus Nominal Returns 85	
	4.2.2	Risk Premia and the Marginal Utility of Consumption	86
	4.2.3 4.2.4	The Relationship to CAPM 86 Bounds on Risk Premia 88	
	4.3 4.3.1	Market Completeness, Arbitrage, and State Pricing 91 Complete Markets Assumptions 92	
	4.3.2	Arbitrage and State Prices 93	
	4.3.3	Risk-Neutral Probabilities 95	
	4.3.4	State Pricing Extensions 97	
	4.4	Summary 97	
	4.5	Exercises 98	
PART	II M	Iultiperiod Consumption,	
	P	ortfolio Choice, and Asset Pricing 1	01
5	A Mu	ultiperiod Discrete-Time Model of Consumptio	n
		· · · · · · · · · · · · · · · · · · ·	103
	5.1	Assumptions and Notation of the Model 105	
	5.1.1	Preferences 105	
	5.1.2	The Dynamics of Wealth 106	
	5.2	Solving the Multiperiod Model 107	
	5.2.1	The Final Period Solution 108	

	5.2.2	Deriving the Bellman Equation 110	
	5.2.3	The General Solution 112	
	5.3	Example Using Log Utility 113	
	5.4	Summary 117	
	5.5	Exercises 118	
6	Multij	period Market Equilibrium	121
	6.1 6.1.1	Asset Pricing in the Multiperiod Model 122 The Multiperiod Pricing Kernel 122	
	6.2 6.2.1 6.2.2 6.2.3 6.2.4	The Lucas Model of Asset Pricing 124 Including Dividends in Asset Returns 125 Equating Dividends to Consumption 127 Asset Pricing Examples 127 A Lucas Model with Labor Income 129	
	6.3 6.3.1 6.3.2	Rational Asset Price Bubbles 131 Examples of Bubble Solutions 133 The Likelihood of Rational Bubbles 133	
	6.4	Summary 135	
	6.5	Exercises 136	
PART	III C	Contingent Claims Pricing	139
7	Basic	s of Derivative Pricing	141
	7.1	Forward and Option Contracts 142	
	7.1.1	<u>-</u>	142
	7.1.2	Basic Characteristics of Option Prices 145	
	7.2 7.2.1 7.2.2	Binomial Option Pricing 149 Valuing a One-Period Option 150 Valuing a Multiperiod Option 153	
	7.3	Binomial Model Applications 156	
	7.3.1	Calibrating the Model 157	
	7.3.2	Valuing an American Option 158	
	7.3.3	Options on Dividend-Paying Assets 162	
	7.4	Summary 162	
	7.5	Exercises 163	

8	Essen	tials of Diffusion Processes and Itô's Lemma 16	35
	8.1 8.1.1	Pure Brownian Motion 166 The Continuous-Time Limit 167	
	8.2 8.2.1	Diffusion Processes 169 Definition of an Itô Integral 170	
	8.3	Functions of Continuous-Time Processes and Itô's Lemma 172	
	8.3.1 8.3.2	Geometric Brownian Motion 174 Kolmogorov Equation 175	
	8.3.3	Multivariate Diffusions and Itô's Lemma 177	
	8.4	Summary 178	
	8.5	Exercises 179	
9	Dynar	mic Hedging and PDE Valuation 18	31
	9.1	Black-Scholes Option Pricing 182	
	9.1.1	Portfolio Dynamics in Continuous Time 182	
	9.1.2	Black-Scholes Model Assumptions 185	
	9.1.3	The Hedge Portfolio 186	
	9.1.4	No-Arbitrage Implies a PDE 187	
	9.2	An Equilibrium Term Structure Model 189	
	9.2.1 9.2.2	A Bond Risk Premium 193 Characteristics of Bond Prices 194	
	9.3	Option Pricing with Random Interest Rates 195	
	9.4	Summary 199	
	9.5	Exercises 200	
	7.5	Lacterises 200	
10	Arbitr	age, Martingales, and Pricing Kernels 20	3
	10.1	Arbitrage and Martingales 204	
	10.1.1	A Change in Probability: Girsanov's Theorem 206	
	10.1.2 10.1.3	Money Market Deflator 208	
		Feynman-Kac Solution 209	
	10.2 10.2.1	Arbitrage and Pricing Kernels 210 Linking the Valuation Methods 212	
	10.2.1	The Multivariate Case 213	
	10.3	Alternative Price Deflators 213	
	10.4	Applications 215	

	10.4.1	Continuous Dividends 216	
	10.4.2	The Term Structure Revisited 219	
	10,5	Summary 220	
	10.6	Exercises 221	
11	Mixin	g Diffusion and Jump Processes	225
	11.1	Modeling Jumps in Continuous Time 226	
	11.2	Itô's Lemma for Jump-Diffusion Processes 227	
	11.3	Valuing Contingent Claims 228	
	11.3.1	An Imperfect Hedge 229	
	11.3.2	Diversifiable Jump Risk 231	
	11.3.3	Lognormal Jump Proportions 232	
	11.3.4	Nondiversifiable Jump Risk 233	
	11.3.5	Black-Scholes versus Jump-Diffusion Model 234	
	11.4	Summary 235	
	11.5	Exercises 236	
PART	IV A	sset Pricing in Continuous Time	239
		_	239
	Conti	usset Pricing in Continuous Time nuous-Time Consumption ortfolio Choice	239 241
	Conti	nuous-Time Consumption ortfolio Choice	
	Continuand P	nuous-Time Consumption ortfolio Choice Model Assumptions 242	
	Continand P	nuous-Time Consumption ortfolio Choice Model Assumptions 242 Continuous-Time Dynamic Programming 244	
	Continuand P	nuous-Time Consumption ortfolio Choice Model Assumptions 242 Continuous-Time Dynamic Programming 244 Solving the Continuous-Time Problem 246	
	Continuand P 12.1 12.2 12.3	nuous-Time Consumption ortfolio Choice Model Assumptions 242 Continuous-Time Dynamic Programming 244 Solving the Continuous-Time Problem 246	
	Continuand P 12.1 12.2 12.3 12.3.1	nuous-Time Consumption ortfolio Choice Model Assumptions 242 Continuous-Time Dynamic Programming 244 Solving the Continuous-Time Problem 246 Constant Investment Opportunities 247	241
	Continand P 12.1 12.2 12.3 12.3.1 12.3.2	nuous-Time Consumption ortfolio Choice Model Assumptions 242 Continuous-Time Dynamic Programming 244 Solving the Continuous-Time Problem 246 Constant Investment Opportunities 247 Changing Investment Opportunities 252 The Martingale Approach to Consumption and Portfo	241
	Continand P 12.1 12.2 12.3 12.3.1 12.3.2 12.4 12.4.1 12.4.2	nuous-Time Consumption Portfolio Choice Model Assumptions 242 Continuous-Time Dynamic Programming 244 Solving the Continuous-Time Problem 246 Constant Investment Opportunities 247 Changing Investment Opportunities 252 The Martingale Approach to Consumption and Portfo Choice 258 Market Completeness Assumptions 259 The Optimal Consumption Plan 260	241
	Continand P 12.1 12.2 12.3 12.3.1 12.3.2 12.4 12.4.1 12.4.2 12.4.3	nuous-Time Consumption ortfolio Choice Model Assumptions 242 Continuous-Time Dynamic Programming 244 Solving the Continuous-Time Problem 246 Constant Investment Opportunities 247 Changing Investment Opportunities 252 The Martingale Approach to Consumption and Portfo Choice 258 Market Completeness Assumptions 259 The Optimal Consumption Plan 260 The Portfolio Allocation 263	241
	Continand P 12.1 12.2 12.3 12.3.1 12.3.2 12.4 12.4.1 12.4.2	nuous-Time Consumption Portfolio Choice Model Assumptions 242 Continuous-Time Dynamic Programming 244 Solving the Continuous-Time Problem 246 Constant Investment Opportunities 247 Changing Investment Opportunities 252 The Martingale Approach to Consumption and Portfo Choice 258 Market Completeness Assumptions 259 The Optimal Consumption Plan 260	241
	Continand P 12.1 12.2 12.3 12.3.1 12.3.2 12.4 12.4.1 12.4.2 12.4.3	nuous-Time Consumption ortfolio Choice Model Assumptions 242 Continuous-Time Dynamic Programming 244 Solving the Continuous-Time Problem 246 Constant Investment Opportunities 247 Changing Investment Opportunities 252 The Martingale Approach to Consumption and Portfo Choice 258 Market Completeness Assumptions 259 The Optimal Consumption Plan 260 The Portfolio Allocation 263	241

13	Equilil	orium Asset Returns	275
	13.1 13.1.1 13.1.2 13.1.3	An Intertemporal Capital Asset Pricing Model Constant Investment Opportunities 276 Stochastic Investment Opportunities 278 An Extension to State-Dependent Utility 280	76
	13.2	Breeden's Consumption CAPM 280	
	13.3 13.3.1	A Cox, Ingersoll, and Ross Production Economy An Example Using Log Utility 289	283
	13.4	Summary 292	
	13.5	Exercises 293	
14	Time-l	Inseparable Utility	295
	14.1 14.1.1 14.1.2	Constantinides' Internal Habit Model 296 Assumptions 297 Consumption and Portfolio Choices 300	
	14.2 14.2.1 14.2.2	Campbell and Cochrane's External Habit Model Assumptions 304 Equilibrium Asset Prices 305	304
	14.3 14.3.1 14.3.2	Recursive Utility 308 A Model by Obstfeld 309 Discussion of the Model 313	
	14.4	Summary 315	
	14.5	Exercises 316	
PART	V Ac	dditional Topics in Asset Pricing	319
15	Behav	ioral Finance and Asset Pricing	321
	15.1 15.1.1 15.1.2 15.1.3	The Effects of Psychological Biases on Asset Prices Assumptions 323 Solving the Model 326 Model Results 329	323
	15.2 15.2.1 15.2.2	The Impact of Irrational Traders on Asset Prices Assumptions 329 Solution Technique 331	329

	15.2.3	Analysis of the Results 335	
	15.3	Summary 341	
	15.4	Exercises 341	
16	Asset	Pricing with Differential Information	343
	16.1	Equilibrium with Private Information 344	
	16.1.1	Grossman Model Assumptions 344	
	16.1.2	Individuals' Asset Demands 345	
	16.1.3	A Competitive Equilibrium 346	
	16.1.4	A Rational Expectations Equilibrium 347	
	16.1.5	A Noisy Rational Expectations Equilibrium 349	
	16.2	Asymmetric Information, Trading, and Markets 352	
	16.2.1	Kyle Model Assumptions 352	
	16.2.2	Trading and Pricing Strategies 353	
	16.2.3	Analysis of the Results 356	
	16.3	Summary 358	
	16.4	Exercises 358	
17	Mode	Is of the Term Structure of Interest Rates	361
	171		
	17.1	Equilibrium Term Structure Models 361	
	17.1 17.1.1	Equilibrium Term Structure Models 361 Affine Models 364	
		Affine Models 364	
	17.1.1	Affine Models 364	
	17.1.1 17.1.2	Affine Models 364 Quadratic Gaussian Models 368	
	17.1.1 17.1.2 17.1.3	Affine Models 364 Quadratic Gaussian Models 368 Other Equilibrium Models 371	
	17.1.1 17.1.2 17.1.3 17.2 17.2.1 17.2.2	Affine Models 364 Quadratic Gaussian Models 368 Other Equilibrium Models 371 Valuation Models for Interest Rate Derivatives 371 Heath-Jarrow-Morton Models 372	
	17.1.1 17.1.2 17.1.3 17.2 17.2.1	Affine Models 364 Quadratic Gaussian Models 368 Other Equilibrium Models 371 Valuation Models for Interest Rate Derivatives 371 Heath-Jarrow-Morton Models 372	
	17.1.1 17.1.2 17.1.3 17.2 17.2.1 17.2.2	Affine Models 364 Quadratic Gaussian Models 368 Other Equilibrium Models 371 Valuation Models for Interest Rate Derivatives 371 Heath-Jarrow-Morton Models 372 Market Models 382	
	17.1.1 17.1.2 17.1.3 17.2 17.2.1 17.2.2 17.2.3	Affine Models 364 Quadratic Gaussian Models 368 Other Equilibrium Models 371 Valuation Models for Interest Rate Derivatives 371 Heath-Jarrow-Morton Models 372 Market Models 382 Random Field Models 389	
10	17.1.1 17.1.2 17.1.3 17.2 17.2.1 17.2.2 17.2.3 17.3 17.4	Affine Models 364 Quadratic Gaussian Models 368 Other Equilibrium Models 371 Valuation Models for Interest Rate Derivatives 371 Heath-Jarrow-Morton Models 372 Market Models 382 Random Field Models 389 Summary 394 Exercises 394	707
18	17.1.1 17.1.2 17.1.3 17.2 17.2.1 17.2.2 17.2.3 17.3 17.4 Mode	Affine Models 364 Quadratic Gaussian Models 368 Other Equilibrium Models 371 Valuation Models for Interest Rate Derivatives 371 Heath-Jarrow-Morton Models 372 Market Models 382 Random Field Models 389 Summary 394 Exercises 394 Is of Default Risk	397
18	17.1.1 17.1.2 17.1.3 17.2 17.2.1 17.2.2 17.2.3 17.3 17.4	Affine Models 364 Quadratic Gaussian Models 368 Other Equilibrium Models 371 Valuation Models for Interest Rate Derivatives 371 Heath-Jarrow-Morton Models 372 Market Models 382 Random Field Models 389 Summary 394 Exercises 394	397
18	17.1.1 17.1.2 17.1.3 17.2 17.2.1 17.2.2 17.2.3 17.3 17.4 Mode	Affine Models 364 Quadratic Gaussian Models 368 Other Equilibrium Models 371 Valuation Models for Interest Rate Derivatives 371 Heath-Jarrow-Morton Models 372 Market Models 382 Random Field Models 389 Summary 394 Exercises 394 Is of Default Risk	397

xiv Contents

Index

18.3	Summary	411		
18.4	Exercises	412		
References				415

433

18.2.2 Specifying Recovery Values 404

408

18.2.3 Examples

SINGLE-PERIOD PORTFOLIO CHOICE AND ASSET PRICING