One-Factor Asset Pricing

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Presentation Outline

- Motivation and Related Literature
- Generalized Disappointment Aversion SDF
- Asset Pricing Tests
- Disappointment Events
- Robustness Checks
- Conclusions

Motivation

- Long tradition in asset pricing linking premia to consumption risk
- C-CAPM: aggregate consumption growth should be a sufficient statistic for expected returns (Breeden, 1979)
- Main implication: *Risk Premium* $\propto \gamma Cov\left(r_{i,t+1}, \Delta c_{t+1}\right)$
- However, aggregate consumption growth has proved too smooth to
  - generate the empirical equity premium (Mehra and Prescott, 1985)
  - explain the cross-section of equity premia

  $\rightarrow$implied Risk Aversion coefficient implausibly high (Rabin, 2000)
- Recent attempts to engineer a more volatile SDF via alternative definitions of consumption risk (Parker and Julliard, 2005, Yogo, 2006, Jagannathan and Wang, 2007, Savov, 2011) have had limited success

Motivation

- Empirical asset pricing literature dominated by multi-factor models since Fama and French (1993)
- Fishing license: Merton's ICAPM and Ross's APT
- Factors are typically return-generated and *a-theoretical*
- Unsettled debate whether factors proxy macro risks or capture anomalies
- Proliferation of factors and factor models (3-factor FF, 4-factor FFC, 4-factor HXZ, 5-factor FF...)
- Serious data mining concerns (Harvey et al., 2016)

This Paper

- Propose a *single-factor*, *consumption-based* asset pricing model to explain the cross-section of equity returns
- Sole factor is an indicator of consumption growth being less than its certainty equivalent, derived from GDA preferences
- Intuitive interpretation of "bad times" and consumption risk
- Very good and robust empirical fit for various portfolio sorts and frequencies, comparable to Fama-French multi-factor models
- Plausible Disappointment Aversion coefficients

Disappointment Aversion

- Model is based on Disappointment Aversion preferences (Gul, 1991)
- Axiomatic framework, but relaxing the independence axiom of EU
- *Asymmetric* treatment of losses vs gains à la Kahneman and Tversky (1979) & Benartzi and Thaler (1995) $\longrightarrow$ kink in the utility function
- *But* reference point is endogenously defined (certainty equivalent of lottery) rather than imposed ad hoc
- Can resolve Allais paradox and explain Samuelson's famous gamble
- Investor exhibits *first-order risk aversion* (Segal and Spivak, 1990) unlike the traditional second-order risk aversion framework

Generalized Disappointment Aversion

- Functional form for GDA preferences (Routledge and Zin, 2010):

$$u(\mu(p)) = \sum_{x_i \in X} p(x_i)\, u(x_i) - \theta \sum_{x_i \leq \delta\mu(p)} p(x_i)\, (u(\delta\mu(p)) - u(x_i))$$

  where $\mu(p)$ is the certainty equivalent for lottery p, θ is the DA coefficient, and δ is the multiplier of $\mu(p)$

- Interpretation: Investor imposes a penalty proportional to θ on lottery outcomes below the disappointment threshold

- Can be combined with separable or non-separable utility functions

Related Studies with (G)DA Preferences

- Portfolio Choice:
  - Ang, Bekaert and Liu (2005)
  - Khanapure (2012)
  - Dahlquist, Faragó and Tédongap (2017)
- Equity premium:
  - Epstein and Zin (2001)
  - Routledge and Zin (2010)
  - Bonomo, Garcia, Meddahi and Tédongap (2011)
  - Dolmas (2014)
- Cross-sectional asset pricing:
  - Ostrovnaya, Routledge and Zin (2006)
  - Faragó and Tédongap (2017)
  - Delikouras (2017)

Routledge and Zin (2010) SDF

- Starting point: GDA intertemporal SDF of Routledge and Zin (2010)

$$M_{t+1}^{GDA} =$$

$$\overbrace{\underbrace{\beta\left(\frac{C_{t+1}}{C_t}\right)^{\rho-1}}_{\text{C-CAPM}}\left[\frac{V_{t+1}}{\mu_t\left(V_{t+1}\right)}\right]^{\alpha-\rho}}^{\text{Epstein-Zin terms}}\underbrace{\left[\frac{1+\theta\mathbf{1}\{V_{t+1} \leq \delta\mu_t\}}{1+\theta\delta^{\alpha}\mathbb{E}_t[\mathbf{1}\{V_{t+1} \leq \delta\mu_t\}]}\right]}_{\text{Disappointment Aversion correction}}$$

- $\mu_t(V_{t+1})$: Certainty Equivalent of Lifetime Utility V_{t+1}
- α : Risk Aversion coefficient, $1/(1-\rho)$: EIS, δ : multiplier of μ_t
- θ : Disappointment Aversion coefficient (overweigh losses)
- $\mathbf{1}\{V_{t+1} \leq \delta\mu_t\}$: Indicator of disappointment events
- Nested preferences:
    - $\theta = 0 \rightarrow$ Epstein-Zin preferences
    - $\theta = 0$ & $\alpha = \rho \rightarrow$ Power utility preferences

GDA-I SDF

1. Homoscedastic AR(1) consumption growth with normal shocks
2. Disappointment Aversion *only* ($\alpha = \rho = 1$)

- Derive GDA-I SDF for *excess returns*:

$$M_{t+1}^{GDA-I} \propto \theta \mathbf{1}\{\Delta c_{t+1} \leq \underbrace{\overbrace{\mu_c(1-\phi_c) + \phi_c \Delta c_t}^{\text{conditional mean}} + d_2 \overbrace{\sqrt{1-\phi_c^2}\sigma_c}^{\text{st dev}}}_{\text{certainty equivalent}}\}$$

- Threshold for disappointment event depends on deviation from expected consumption growth controlled by d_2
- Consumption growth covariance risk is not priced
- GDA-I is an indicator function of consumption growth being less than its certainty equivalent $\longrightarrow$ *bi-modal SDF*

Comparison with Popular SDFs

- C-CAPM SDF:

$$M_{t+1}^{C-CAPM} \propto -\gamma \Delta c_{t+1}$$

- CAPM SDF:

$$M_{t+1}^{CAPM} \propto -b_m R_{m,t+1}^{x}$$

- NBER SDF:

$$M_{t+1}^{NBER} \propto \lambda \mathbf{1}\{> 4 \text{ NBER recession months in a year}\}$$

- Fama-French 3-factor SDF:

$$M_{t+1}^{FF3} \propto -b_m R_{m,t+1}^{x} - b_{SMB} R_{SMB,t+1} - b_{HML} R_{HML,t+1}$$

- Fama-French 5-factor SDF:

$$M_{t+1}^{FF5} \propto -b_m R_{m,t+1}^{x} - b_{SMB} R_{SMB,t+1} - b_{HML} R_{HML,t+1} - b_{RMW} R_{RMW,t+1} - b_{CMA} R_{CMA,t+1}$$

Data

- Sample period: 1933-2012
- BEA consumption of services and non-durables
- Normalized by population and PCE price index
- NBER recession periods
- K. French's online data library
    - 6 & 25 & 100 Size/BM portfolios
    - 25 Size/OP & 25 Size/INV portfolios (post '64)
    - 10 LTR portfolios
    - 10 E/P portfolios (post '53)
    - Fama-French factors
- Corporate bond and equity index option portfolios

Estimation

- Need to specify consumption growth moments to identify disappointment events and test GDA-I model
- Fit the empirical consumption growth moments *jointly* with Euler equations for excess portfolio returns for each cross-section via GMM:

$$\begin{bmatrix} \mathbb{E}[\Delta c_t] - \mu_c \\ \mathbb{E}[\Delta c_t^2] - \mu_c^2 - \sigma_c^2 \\ \mathbb{E}[\Delta c_t \Delta c_{t-1}] - \mu_c^2 - \phi_c \sigma_c^2 \\ \mathbb{E}\left[(R_{i,t} - R_{1y,t})\left(1 - \mathbb{E}\left[M_t^{GDA-I}\right] + M_t^{GDA-I}\right)\right] \end{bmatrix} = \mathbf{0}$$

- Weighting matrix ensures consumption growth moments matching
- Competing asset pricing models estimated via GMM using identity weighting matrix

Annual 25 Size/BM Portfolios: Estimates

	GDA-I	CCAPM	CAPM	FF3	FF5	NBER
GDA ind	**4.126**					
	[4.207]					
d_2	**-0.77**					
	[-3.006]					
CONS		**57.331**				
		[3.499]				
MKT			**2.935**	**2.043**	**3.191**	
			[4.781]	[2.375]	[2.218]	
SMB				**0.335**	**1.912**	
				[0.309]	[1.242]	
HML				**3.026**	**-0.473**	
				[3.079]	[-0.153]	
RMW					**0.967**	
					[0.308]	
CMA					**9.321**	
					[2.080]	
NBER ind						**9.157**
						[1.053]
χ^2	**28.795**	**87.58**	**97.94**	**62.46**	**42.57**	**5.543**
dof	**23**	**24**	**24**	**22**	**20**	**24**
p	**0.187**	**0**	**0**	**0**	**0.002**	**1**
RMSE	**1.345**	**2.107**	**2.973**	**1.648**	**1.563**	**2.358**
R^2	**0.901**	**0.758**	**0.519**	**0.852**	**0.821**	**0.697**

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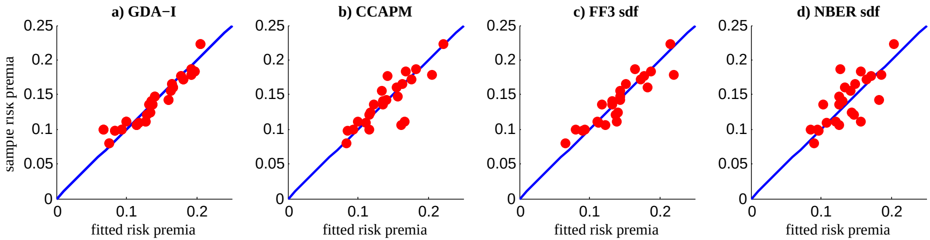
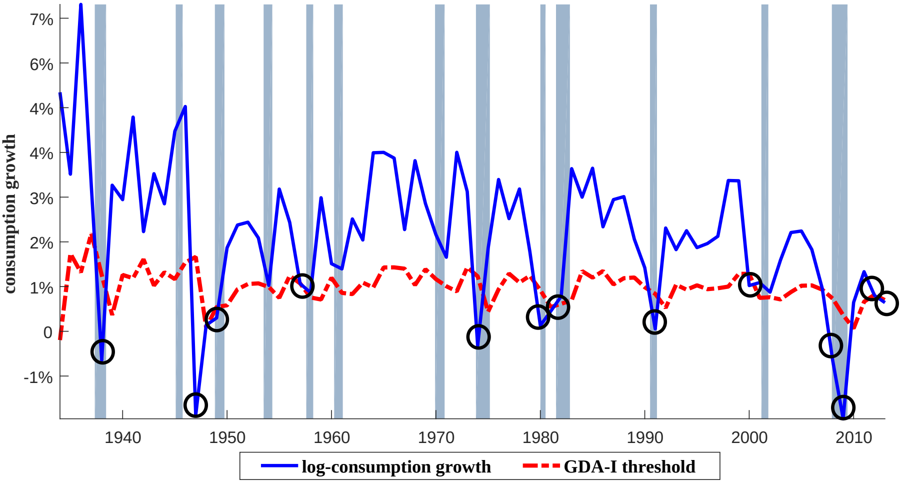
Annual 25 Size/BM Portfolios: Fit



Disappointment Years

{1937, ’46, ’48, ’56, ’73, ’79-80, ’90, ’99, 2007-08, 2011-12}



Disappointment Years' Characteristics

	Full Sample	Disappointment Yrs	Non-Disappointment Yrs
Market Premium	9.16%	-3.05%	11.52%
SMB Premium	2.12%	-5.68%	3.63%
HML Premium	9.02%	4.23%	9.95%
S&P 500 Daily St. Dev.	15.43%	19.22%	14.70%
Term spread	1.62%	0.99%	1.74%
Real Consumption growth	2.21%	-0.07%	2.65%
Earnings growth	11.23%	3.20%	12.78%
Net Equity Expansion	1.52%	0.77%	1.66%
cay	0.00%	-0.16%	0.03%
Change in unemployment, t+1	0.06%	0.97%	-0.10%
Δ% in Consumer Confidence	0.16%	-7.49%	1.80%

Monthly 25 Size/BM Portfolios: Estimates

	GDA-I	CCAPM	CAPM	FF3	FF5	NBER
GDA ind	**3.673**					
	[3.293]					
CONS		**248.151**				
		[2.464]				
MKT			**3.579**	**2.342**	**3.625**	
			[4.974]	[2.847]	[2.245]	
SMB				**0.517**	**6.724**	
				[0.434]	[3.638]	
HML				**4.905**	**2.138**	
				[4.521]	[0.367]	
RMW					**9.49**	
					[1.837]	
CMA					**10.265**	
					[0.891]	
NBER ind						**7.786**
						[1.374]
χ^2	**41.296**	**70.582**	**121.875**	**94.856**	**94.631**	**9.662**
dof	**24**	**24**	**24**	**22**	**20**	**24**
p	**0.015**	**0**	**0**	**0**	**0**	**0.995**
RMSE	**0.119**	**0.283**	**0.249**	**0.156**	**0.142**	**0.174**
R^2	**0.818**	**-0.496**	**0.178**	**0.677**	**0.673**	**0.601**

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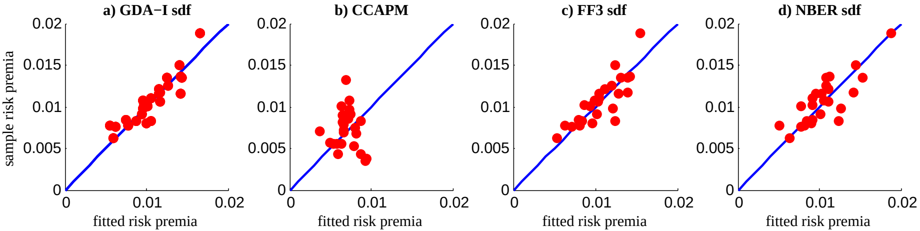


Why does GDA-I SDF work?

- GDA-I SDF implies that an asset's **premium** should be a **linear function** of its **losses** during **disappointment events**

- The standard asset pricing equation

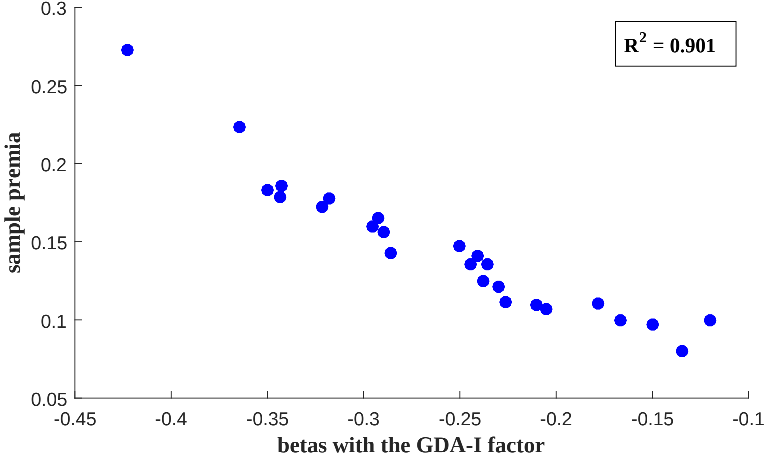
$$\mathbb{E}[R_{i,t} - R_{f,t}] = -Cov\left(R_{i,t} - R_{f,t}, M_t\right)$$

yields for GDA-I SDF:

$$\mathbb{E}[R_{i,t} - R_{f,t}] = -\frac{\theta \mathbb{E}[\mathbf{1}_t]}{1 - \theta \mathbb{E}[\mathbf{1}_t]} \mathbb{E}[(R_{i,t} - R_{f,t}) | \mathbf{1}_t = 1]$$

- GDA-I SDF successfully aligns portfolio premia with their *disappointment betas*

Premia & Disappointment Betas: 25 Size/BM Portfolios



Robustness Checks

GDA-I SDF performs very well with:

1. Other equity cross-sections (Size/OP, Size/INV, LTR, E/P, Joint)
2. Great Depression, pre-crisis & post-WWII periods
3. Recursive estimation of disappointment events
4. Value-weighted portfolios
5. Quarterly data
6. Two-stage GMM estimation
7. Other asset classes (corporate bond & equity index option portfolios)

Further Robustness Checks

1. Weak Identification?

   Disappointment betas are statistically significant and exhibit substantial cross-sectional dispersion

2. Sensitivity to Disappointment Threshold?

   Explanatory power remains strong even if we use $\widetilde{d_2} = \widehat{d_2} \pm std\ error(\widehat{d_2})$ to determine new disappointment threshold & events

3. Spurious Explanatory Power?

   1m *placebo* indicators confirm that the success of GDA-I SDF is not spuriously driven by its functional form

Conclusions

- Propose a simple SDF to explain the cross-section of equity returns
- GDA-I SDF consists of an indicator function of consumption growth being less than its certainty equivalent
- Founded on (G)DA preferences of Gul & Routledge and Zin
- Yields very good empirical fit and plausible DA coefficients for various cross-sections
- Question the ability of second-order risk aversion (smooth utility functions) to explain the cross-section of equity returns
- Support consumption-based asset pricing but highlight the importance of downside consumption risk