

CONTENTS

List of Contributors

xxv

Volume 2: Applications

13 MCMC Methods for Continuous-Time Financial Econometrics	1
Michael Johannes <i>and</i> Nicholas Polson	
1. Introduction	2
2. Overview of Bayesian Inference and MCMC	5
2.1. MCMC Simulation and Estimation	5
2.2. Bayesian Inference	6
2.2.1. The Posterior Distribution	7
2.2.2. The Likelihood	7
2.2.3. The Prior Distribution	7
2.2.4. Marginal Parameter Posterior	8
2.2.5. State Estimation	8
2.2.6. Model Specification	8
3. MCMC: Methods and Theory	9
3.1. Clifford–Hammersley Theorem	9
3.2. Gibbs Sampling	10
3.2.1. The Griddy Gibbs Sampler	11
3.3. Metropolis–Hastings	12
3.3.1. Independence Metropolis–Hastings	13
3.3.2. Random-Walk Metropolis	14
3.4. Convergence Theory	14
3.4.1. Convergence of Markov Chains	15
3.4.2. Convergence of MCMC Algorithms	15
3.5. MCMC Algorithms: Issues and Practical Recommendations	20
3.5.1. Building MCMC Algorithms	20
3.5.2. Blocking	20
3.5.3. Simulation Studies	20
3.5.4. Provable Convergence	21
3.5.5. Choosing Proposal Densities and Tuning Metropolis Algorithms	21
3.5.6. Noninformative Priors	23

3.5.7.	Convergence Diagnostics and Starting Values	23
3.5.8.	Rao-Blackwellization	23
4.	Bayesian Inference and Asset Pricing Models	24
4.1.	States Variables and Prices	24
4.2.	Time-Discretization: Computing $p(Y X, \Theta)$ and $p(X \Theta)$	27
4.3.	Parameter Distribution	30
5.	Asset Pricing Applications	31
5.1.	Equity Asset Pricing Models	32
5.1.1.	Geometric Brownian Motion	32
5.1.2.	Black–Scholes	33
5.1.3.	A Multivariate Version of Merton’s Model	36
5.1.4.	Time-Varying Equity Premium	40
5.1.5.	Log-Stochastic Volatility Models	45
5.1.6.	Alternative Stochastic Volatility Models	50
5.2.	Term Structure Models	54
5.2.1.	Vasicek’s Model	54
5.2.2.	Vasicek with Jumps	57
5.2.3.	The CIR Model	61
5.3.	Regime Switching Models	63
6.	Conclusions and Future Directions	65
	Acknowledgments	66
	References	66

14 The Analysis of the Cross-Section of Security Returns 73

Ravi Jagannathan, Georgios Skoulakis, and Zhenyu Wang

1.	Introduction	74
2.	Linear Beta Pricing Models, Factors, and Characteristics	77
2.1.	Linear Beta Pricing Models	77
2.2.	Factor Selection	78
3.	Cross-Sectional Regression Methods	80
3.1.	Description of the CSR Method	80
3.2.	Consistency and Asymptotic Normality of the CSR Estimator	83
3.3.	Fama–MacBeth Variance Estimator	85
3.4.	Conditionally Homoskedastic Residuals Given the Factors	87
3.5.	Using Security Characteristics to Test Factor Pricing Models	90
3.5.1.	Consistency and Asymptotic Normality of the CSR Estimator	92
3.5.2.	Misspecification Bias and Protection Against Spurious Factors	93
3.6.	Time-Varying Security Characteristics	94
3.6.1.	No Pricing Restrictions Imposed on Traded Factors	94
3.6.2.	Traded Factors with Imposed Pricing Restrictions	97
3.6.3.	Using Time-Average Characteristics to Avoid the Bias	99
3.7.	N -Consistency of the CSR Estimator	101

4. Maximum Likelihood Methods	108
4.1. Nontraded Factors	108
4.2. Some Factors Are Traded	110
4.3. Single Risk-Free Lending and Borrowing Rates with Portfolio Returns as Factors	110
5. The Generalized Method of Moments	111
5.1. An Overview of the GMM	112
5.2. Evaluating Beta Pricing Models Using the Beta Representation	114
5.3. Evaluating Beta Pricing Models Using the Stochastic Discount Factor Representation	117
5.4. Models with Time-Varying Betas and Risk Premia	122
6. Conclusion	128
Acknowledgments	129
References	130
15 Option Pricing Bounds and Statistical Uncertainty: Using Econometrics to Find an Exit Strategy in Derivatives Trading	135
Per A. Mykland	
1. Introduction	136
1.1. Pricing Bounds, Trading Strategies, and Exit Strategies	136
1.2. Related Problems and Related Literature	140
2. Options Hedging from Prediction Sets: Basic Description	142
2.1. Setup and Super-Self-Financing Strategies	142
2.2. The Bounds and \mathbb{A} and \mathbb{B}	144
2.3. <i>The Practical Rôle of Prediction Set Trading: Reserves and Exit Strategies</i>	145
3. Options Hedging from Prediction Sets: The Original Cases	147
3.1. Pointwise Bounds	147
3.2. Integral Bounds	148
3.3. Comparison of Approaches	150
3.4. Trading with Integral Bounds and the Estimation of Consumed Volatility	151
3.5. An Implementation with Data	152
4. Properties of Trading Strategies	153
4.1. Super-Self-Financing and Supermartingale	153
4.2. Defining Self-Financing Strategies	156
4.3. Proofs for Section 4.1	157
4.3.1. Proof of Theorem 1	157
4.3.2. Proof of Corollary 1	158
4.3.3. Proof of Proposition 1	158
5. Prediction Sets: General Theory	159
5.1. The Prediction Set Theorem	159
5.2. Prediction Sets: A Problem of Definition	161
5.3. Prediction Regions from Historical Data: A Decoupled Procedure	163

5.4. Proofs for Section 5	165
5.4.1. Proof of Theorem 2	165
5.4.2. Proof of Proposition 3	168
5.4.3. Proof of Proposition 4	168
6. Prediction Sets: The Effect of Interest Rates and General Formulae for European Options	168
6.1. Interest Rates: Market Structure and Types of Prediction Sets	168
6.2. The Effect of Interest Rates: The Case of the Ornstein-Uhlenbeck Model	170
6.3. General European Options	171
6.4. General European Options: The Case of Two Intervals and a Zero-Coupon Bond	172
6.5. Proofs for Section 6	174
6.5.1. Proof of Theorem 4	174
6.5.2. Proof of Theorem 5	175
7. Prediction Sets and the Interpolation of Options	175
7.1. Motivation	175
7.2. Interpolating European Payoffs	176
7.3. The Case of European Calls	177
7.4. The Usefulness of Interpolation	182
7.5. Proofs for Section 7	182
7.5.1. Proof of Theorem 6	182
7.5.2. Proof of Theorem 7 (and Algorithm)	182
7.5.3. Proof of Corollary	186
8. Bounds that are not Based on Prediction Sets	186
Acknowledgments	188
References	188

16 Inference for Stochastic Processes

197

Jean Jacod

1. Introduction	198
2. About Diffusion Processes	199
2.1. The Basic Setting	200
2.2. The Markov Property and the Infinitesimal Generator	202
2.3. Examples – Diffusions on a Domain	202
2.4. Likelihood Ratio	204
3. Parametric Estimation: Asymptotic Optimality Criteria	206
3.1. The Local Asymptotic Normality Property	208
3.2. Local Asymptotic Mixed Normality and Local Asymptotic Quadraticity	209
4. Diffusions and Statistics	210
4.1. Observation Over a Whole Interval	211
4.2. Discrete Observations	214
4.3. Observations with Errors	215

5. Discrete Observations with Decreasing Stepsize	216
5.1. Observations on a Fixed Interval	216
5.2. Observations on an Increasing Interval	219
6. Discrete Observations with Constant Stepsize	223
6.1. Approximating the Likelihood	224
6.2. Contrast Functions and Estimating Functions	225
7. Observations with Errors	228
7.1. Additive Errors	228
7.1.1. Neglecting the Errors	229
7.1.2. Taking Care of the Errors	230
7.2. Round-Off Errors	233
7.2.1. Neglecting the Errors	233
7.2.2. Taking Care of the Errors	234
8. Concluding Remarks	236
References	237

17 Stock Market Trading Volume

241

Andrew W. Lo *and* Jiang Wang

1. Introduction	242
2. Measuring Trading Activity	244
2.1. Notation	245
2.2. Motivation	246
2.3. Defining Individual and Portfolio Turnover	248
2.4. Time Aggregation	250
2.5. The Data	250
3. Time-Series Properties	251
3.1. Seasonalities	255
3.2. Secular Trends and Detrending	258
4. Cross-Sectional Properties	267
4.1. Specification of Cross-Sectional Regressions	272
4.2. Summary Statistics for Regressors	275
4.3. Regression Results	280
5. Volume Implications of Portfolio Theory	284
5.1. Two-Fund Separation	286
5.2. $(K + 1)$ -Fund Separation	288
5.3. <i>Empirical Tests of $(K + 1)$-Fund Separation</i>	290
6. Volume Implications of Intertemporal Asset Pricing Models	294
6.1. An ICAPM	295
6.1.1. The Economy	295
6.1.2. Equilibrium	296
6.2. The Behavior of Returns and Volume	298
6.2.1. The Cross-Section of Volume	299

6.2.2.	Time-Series Implications for the Hedging Portfolio	300
6.2.3.	Cross-Sectional Implications for the Hedging Portfolio	300
6.3.	Empirical Construction of the Hedging Portfolio	302
6.4.	The Forecast Power of the Hedging Portfolio	313
6.4.1.	Hedging-Portfolio Returns	313
6.4.2.	Optimal Forecasting Portfolios	314
6.4.3.	Hedging-Portfolio Return as a Predictor of Market Returns	317
6.5.	The Hedging-Portfolio Return as a Risk Factor	320
6.6.	Updated Empirical Results	327
7.	Conclusion	335
	Acknowledgments	337
	References	337
	Index	343