

# Contents

<i>List of Figures</i>	page xv
<i>List of Tables</i>	xix
<i>Preface</i>	xxi
<i>Acknowledgments</i>	xxv
<i>Notation and Conventions</i>	xxvii

<b>1 Introduction and Background</b>	<b>1</b>
1.1 Why Do We Have Financial Markets?	1
1.2 Classification of Financial Markets	3
1.3 Types of Markets and Trading	8
1.4 Financial Returns	12
1.5 Risk Aversion	27
1.6 Mean Variance Portfolio Analysis	39
1.7 Capital Asset Pricing Model	45
1.8 Arbitrage Pricing Theory	49
1.9 Appendix	53
<b>2 Econometric Background</b>	<b>55</b>
2.1 Linear Regression	55
2.2 Time Series	61
<b>3 Return Predictability and the Efficient Markets Hypothesis</b>	<b>75</b>
3.1 Efficient Markets Hypothesis	75
3.2 The Random Walk Model for Prices	81
3.3 Testing of Linear Weak Form Predictability	85
3.4 Testing under More General Conditions than rw1	106
3.5 Some Alternative Hypotheses	118
3.6 Empirical Evidence regarding Linear Predictability based on Variance Ratios	121
3.7 Trading Strategy Based Evidence	124
3.8 Regression Based Tests of Semi-Strong Form Predictability	129
3.9 Summary of Chapter	132

<b>4</b>	<b>Robust Tests and Tests of Nonlinear Predictability of Returns</b>	<b>134</b>
4.1	Robust Tests	134
4.2	Nonlinear Predictability and Nonparametric Autoregression	146
4.3	Further Empirical Evidence on Semistrong and Strong Form EMH	148
4.4	Explanations for Predictability	150
4.5	Summary of Chapter	151
<b>5</b>	<b>Empirical Market Microstructure</b>	<b>152</b>
5.1	Stale Prices	152
5.2	Discrete Prices and Quantities	164
5.3	Bid, Ask, and Transaction Prices	168
5.4	What Determines the Bid-Ask Spread?	173
5.5	Strategic Trade Models	183
5.6	Electronic Markets	187
5.7	Summary of Chapter	196
5.8	Appendix	196
<b>6</b>	<b>Event Study Analysis</b>	<b>201</b>
6.1	Some Applications	201
6.2	Basic Structure of an Event Study	202
6.3	Regression Framework	218
6.4	Nonparametric and Robust Tests	221
6.5	Cross-sectional Regressions	222
6.6	Time Series Heteroskedasticity	223
6.7	Panel Regression for Estimating Treatment Effects	224
6.8	Matching Approach	228
6.9	Stock Splits	229
6.10	Summary of Chapter	237
6.11	Appendix	237
<b>7</b>	<b>Portfolio Choice and Testing the Capital Asset Pricing Model</b>	<b>238</b>
7.1	Portfolio Choice	238
7.2	Testing the Capital Asset Pricing Model	241
7.3	Maximum Likelihood Estimation and Testing	246
7.4	Cross-sectional Regression Tests	259
7.5	Portfolio Grouping	264
7.6	Time Varying Model	268
7.7	Empirical Evidence on the CAPM	270
7.8	Summary of Chapter	273
7.9	Appendix	274

<b>8</b>	<b>Multifactor Pricing Models</b>	<b>279</b>
<hr/>		
8.1	Linear Factor Model	279
8.2	Diversification	280
8.3	Pervasive Factors	286
8.4	The Econometric Model	288
8.5	Multivariate Tests of the Multibeta Pricing Model with Observable Factors	290
8.6	Which Factors to Use?	293
8.7	Observable Characteristic Based Models	299
8.8	Statistical Factor Models	300
8.9	Testing the APT with Estimated Factors	312
8.10	The MacKinlay Critique	312
8.11	Summary of Chapter	312
8.12	Appendix	312
<b>9</b>	<b>Present Value Relations</b>	<b>314</b>
<hr/>		
9.1	Fundamentals versus Bubbles	314
9.2	Present Value Relations	316
9.3	Rational Bubbles	319
9.4	Econometric Bubble Detection	321
9.5	Shiller Excess Volatility Tests	323
9.6	An Approximate Model of Log Returns	326
9.7	Predictive Regressions	329
9.8	Summary of Chapter	335
9.9	Appendix	336
<b>10</b>	<b>Intertemporal Equilibrium Pricing</b>	<b>337</b>
<hr/>		
10.1	Dynamic Representative Agent Models	337
10.2	The Stochastic Discount Factor	338
10.3	The Consumption Capital Asset Pricing Model	339
10.4	The Equity Premium Puzzle and the Risk Free Rate Puzzle	345
10.5	Explanations for the Puzzles	346
10.6	Other Asset Pricing Approaches	353
10.7	Summary of Chapter	357
<b>11</b>	<b>Volatility</b>	<b>358</b>
<hr/>		
11.1	Why is Volatility Important?	358
11.2	Implied Volatility from Option Prices	359
11.3	Intra Period Volatility	362
11.4	Cross-sectional Volatility	370
11.5	Empirical Studies	371

11.6	Discrete Time Series Models	374
11.7	Engle's ARCH Model	377
11.8	The GARCH Model	380
11.9	Asymmetric Volatility Models and Other Specifications	389
11.10	Mean and Variance Dynamics	392
11.11	Estimation of Parameters	395
11.12	Stochastic Volatility Models	402
11.13	Long Memory	404
11.14	Multivariate Models	407
11.15	Nonparametric and Semiparametric Models	412
11.16	Summary of Chapter	419
11.17	Appendix	419
<b>12</b>	<b>Continuous Time Processes</b>	<b>422</b>
12.1	Brownian Motion	422
12.2	Stochastic Integrals	427
12.3	Diffusion Processes	428
12.4	Estimation of Diffusion Models	436
12.5	Estimation of Quadratic Variation Volatility from High Frequency Data	450
12.6	Levy Processes	459
12.7	Summary of Chapter	462
<b>13</b>	<b>Yield Curve</b>	<b>463</b>
13.1	Discount Function, Yield Curve, and Forward Rates	463
13.2	Estimation of the Yield Curve from Coupon Bonds	464
13.3	Discrete Time Models of Bond Pricing	469
13.4	Arbitrage and Pricing Kernels	471
13.5	Summary of Chapter	475
<b>14</b>	<b>Risk Management and Tail Estimation</b>	<b>476</b>
14.1	Types of Risks	476
14.2	Value at Risk	477
14.3	Extreme Value Theory	479
14.4	A Semiparametric Model of Tail Thickness	482
14.5	Dynamic Models and VAR	487
14.6	The Multivariate Case	489
14.7	Coherent Risk Measures	492
14.8	Expected Shortfall	493
14.9	Black Swan Theory	494
14.10	Summary of Chapter	496

<b>15 Exercises and Complements</b>	497
<hr/>	
<b>16 Appendix</b>	524
<hr/>	
16.1 Common Abbreviations	524
16.2 Two Inequalities	526
16.3 Signal Extraction	527
16.4 Lognormal Random Variables	528
16.5 Data Sources	529
16.6 A Short Introduction to Eviews	530
<i>Bibliography</i>	533
<i>Index</i>	553