

Asset Pricing

Module 1, 2017-18

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Course information

Course Website: see my.nes.ru

Instructor's Office Hours: by appointment

Class Time: Tue 1.45-3.15, Wed 10-11.30

Room Number: 3.13

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Course description

This course gives an introduction to the economics and mathematics of financial markets. Two basic pricing principles are considered. The first is the absence of arbitrage and takes us a long way in pricing assets relative to other, basic assets. It is especially useful for pricing derivative instruments (e.g. an option contract) whenever we know (or assume) what the price of the underlying asset (e.g. a stock) is and how it evolves.

In order to price the whole universe of financial assets, however, we need to investigate how investors make their investment decisions (individual optimality) and how the coordination of these investors on the financial markets leads to the formation of prices. This is the second principle -- equilibrium analysis. We start with classical problems of how investors choose optimal portfolios (e.g., the mean-variance or Markowitz problem). Letting several investors interact leads us to equilibrium asset pricing models, such as the famous capital asset pricing model.

Although the focus of the course is on theory, we shall comment on some empirical evidence and on how these theories are tested and used in financial practice. It will be useful to absorb the ideas and mathematics of financial models by doing small applications on the computer. MATLAB and Mathematica are convenient programming languages for this purpose.

Course requirements, grading, and attendance policies

Prerequisites: Microeconomics II

Attendance: You would spend much more time if you do not attend lectures and work with textbooks and lecture notes alone since they do not include all topics covered in class and cover many other topics that we leave out in this course. So if you want to save time you should come to class. Also, class participation contributes to your grade.

Grading:

- *Problem sets* are marked and account for 15% of the final grade. Every homework problem set comes with a due date. Late submission up to 24 hours leads to a discount of 20%; submitting even later or not submitting leads to a zero grade for this assignment.
- *Participation* in class including the presentation of papers accounts for 10%. I will ask occasionally questions at the beginning of the class and in between. In addition, *your* questions will make the class more interesting and make sure that you understand the material fully.
- A short *test* in the middle of the term accounts for 15%.
- The rest of the grade (60%) comes from the *final exam*.
- Exam questions in the midterm and the final exam will be either exercises, similar to homework assignments, or questions on papers that were given for reading.

The *grading scale* is

%	Scale of 10	Scale of 5
< 34,99	fail	2
[35,41)	4	3
[41,48)	5	3
[48,56)	6	4
[56,63)	7	4
[63,73)	8	5
[73,80)	9	5
[80,100]	10	5

Missing an exam. If a student misses the midterm exam and the NES administration has verified that the reason is legitimate, the final exam will have a weight of 75%.

If a student misses the final exam and the NES administration has verified that the reason is legitimate, the student may take a replacement exam, covering all material in the course.

If a student's grade for the course is failing, the student retains the right to have one make-up (beyond the replacement exam mentioned above). It will be written and comprehensive, covering all material in the course. The degree of difficulty will be no less than in the original exam.

Course contents

This outline lists the topics to be covered in the course and gives an approximate time schedule.

Part 1 -- Asset Pricing Models and the No-Arbitrage Principle

- Week 1. Introduction: The terminology of financial markets; Bond prices and interest rates under certainty. Uncertainty, replicating portfolios, Arrow-Debreu securities.
- Week 2. Arbitrage and market completeness. The pricing of forwards and futures. The Fundamental Theorem of Finance.

- Week 3. The Binomial model and the pricing of options.

Part 2 -- Individual optimality

- Week 4. Review of individual preferences, utility theory, and risk-aversion. Optimal consumption and portfolio choice.
- Week 5. Mean-variance analysis. Portfolio and consumption choice in dynamic models.

Part 3 -- Equilibrium models

- Week 6. Short review of equilibrium fundamentals: Concept of equilibrium, representative agent, existence and Pareto-optimality. Consumption capital asset pricing model and the capital asset pricing model. Multi-factor models. The testing of asset pricing models.
- Week 7. Asset pricing in dynamic models: The Lucas model. Asset pricing puzzles. Review.

Sample tasks for course evaluation

1a) Define and draw a graph of the mean-variance frontier. Show the efficient part of the frontier on the graph.

1b) In the mean-variance optimization problem *with a risk-less asset* available, we found the following expression for the optimal weights of each asset within the portfolio of risky assets

$$\tilde{\pi}^* = \frac{V^{-1}(\boldsymbol{\mu} - r\mathbf{1})}{A - rC}$$

Assuming $r < A/C$, show that this portfolio lies on the *efficient frontier with only risky assets*. Recall that optimal portfolios in the problem with risky assets only are of the form

$$\pi^* = \mathbf{g} + \mathbf{h}\bar{\mu}$$

where

$$\mathbf{g} = \frac{1}{D} [B(V^{-1}\mathbf{1}) - A(V^{-1}\boldsymbol{\mu})] \quad \text{and} \quad \mathbf{h} = \frac{1}{D} [C(V^{-1}\boldsymbol{\mu}) - A(V^{-1}\mathbf{1})]$$

and

$$\begin{aligned} A &= \mathbf{1}^\top V^{-1} \boldsymbol{\mu} = \boldsymbol{\mu}^\top V^{-1} \mathbf{1} \\ B &= \boldsymbol{\mu}^\top V^{-1} \boldsymbol{\mu} \\ C &= \mathbf{1}^\top V^{-1} \mathbf{1} \\ D &= BC - A^2 \end{aligned}$$

2) Suppose the existence of a return-generating process in the form of a two-factors model without idiosyncratic risk. The information about the expected returns of three assets (A, B and C) and their factor loadings(sensitivities) with respect to the two factors are given in the following table:

	$E[R_j]$	β_{j1}	β_{j2}
A	0.033	0.9	0.8
B	0.0315	0.7	0.9
C	0.0325	1.0	0.5

- Obtain the portfolio weights of the two factor portfolios and their expected returns.
- Obtain also the replicating portfolio for the risk-less asset and its return.

c) If the return of the riskless asset were $r = 0.025$, which arbitrage strategy would you pursue, and what would be the profit of this strategy?

d) Recall that the fundamental pricing equation of the APT reads (in the case of a two-factor model)

$$E[R_j] = \lambda_0 + \lambda_1\beta_{j1} + \lambda_2\beta_{j2}$$

Compute the values of λ_0 , λ_1 , and λ_2 and confirm that they represent the risk-less return and the risk premia of the two factor portfolios, respectively.

3) St. Petersburg Associates, a firm of financial analysts specializing in Russian financial markets, forecasts that the stock of the Siberian Drilling Company will be worth 1,000 rubles per share one year from today. If the riskless interest rate on Russian government securities is 10% and the expected return to the market portfolio is 18%. Determine how much you would pay for a share of Siberian Drilling stock today if the beta of Siberian Drilling is 3.

Course material

Required textbooks and materials

- Lecture notes
- Pennacchi, George, *The Theory of Asset Pricing*, Pearson Addison Wesley, 2008
- Back, Kerry, *Asset Pricing and Portfolio Choice Theory*, Oxford University Press, 2013.

Additional materials

- Brandimarte, Paolo, *Numerical Methods in Finance and Economics*, Wiley, 2006.
- Capiński, Marek and Tomasz Zastawniak, *Mathematics for Finance – An Introduction to Financial Engineering*, 2nd edition, Springer 2011.
- Cvitanic, Jaksa and Fernando Zapatero, *Introduction to the Economics and Mathematics of Financial Markets*, MIT Press, 2004.
- Joshi, Mark S. and Jane M. Paterson, *Introduction to mathematical portfolio theory*, Cambridge University Press
- LeRoy, Stephen and Jan Werner, *Principles of Financial Economics*, Cambridge University Press, 2001.

Academic integrity policy

Cheating, plagiarism, and any other violations of academic ethics at NES are not tolerated. Assume that all work is to be done on your own without outside assistance unless otherwise stated. When you use or repeat someone else's idea, you must cite the author or source.

For computer exercises you are permitted to use computer code you find in books or on the internet, but please note the source in your code to give credit to the author or source. You may not use classmate's or classmates' computer code.