ESSFM 2017 Asset Pricing Informal Evening Sessions

Date:	Monday 17 July	Tuesday 18 July	Wednesday 19 July	Thursday 20 July
Room:	**Bern**			
20:30-21:00	**Daniel L. Greenwald (MIT Sloan)** "Origins of Stock Market Fluctuations"	**Christian Schlag (Goethe University Frankfurt)** "The Leading Premium"	**Tatyana Marchuk (Goethe University)** "The Financial Intermediation Premium in the Cross Section of Stock Returns"	**Hengjie Ai (University of Minnesota)** "Asset pricing with endogenously uninsurable tail risks"
21:00-21:30	**Nina Boyarchenko (NY Fed)** "Vulnerable Growth"	**Magnus Dahlquist (Stockholm School of Economics and CEPR)** "The Missing Risk Premium in Exchange Rates"	**Jens Jackwerth (University of Konstanz)** "The Pricing Kernel Puzzle in Forward Looking Data"	**Kirill Shakhnov (EIEF)** "Limited Participation and Local Currency Sovereign Debt"
21:30-22:00	**Yang Liu (University of Pennsylvania)** "Volatility Risk Pass-Through"	**Claus Schmitt (Erasmus University Rotterdam)** "Distress Risk, Expected Shareholder Losses, and the Cross-Section of Expected Returns"	**Ansgar Walther (Warwick University)** "Sparse expectations: A unified theory of expectations and implications for asset pricing"	**Alberto Teguia (Swiss Finance Institute)** "Asset Pricing with Large Investors"
Room:	**Zürich**			
20:30-21:00	**Batchimeg Sambalaibat (Indiana University)** "Endogenous Specialization and Dealer Networks"	**Mathijs Cosemans (Erasmus University Rotterdam)** "Salience Theory and Stock Prices: Empirical Evidence"	**Nils Friewald (NHH Norwegian School of Economics and CEPR)** "Dealer Inventory and the Cross-Section of Corporate Bond Returns"	**Bastian von Beschwitz (Federal Reserve Board)** "Limits of Arbitrage under the Microscope: Evidence from detailed Hedge Fund Transaction Data"
21:00-21:30	**Petri Jylhä (Aalto University)** "Algorithmic Trading and Price Efficiency"	**Christoph Meinerding (Deutsche Bundesbank)** "Extreme inflation and time-varying disaster risk"	**Steven Baker (University of Virginia)** "Preventing Controversial Catastrophes"	**Savitar Sundaresan (Imperial College London)** "Market Power and Price Informativeness"
21:30-22:00	**Ariadna Dumitrescu (ESADE)** "Information and Optimal Trading Strategies with Dark Pools"	**Mattia Landoni (Southern Methodist University)** "Should the government be paying investment fees on $3 trillion of tax-deferred retirement assets?"	**Julien Penasse (University of Luxembourg)** "The Time-Varying Risk of Macroeconomic Disasters"	**Xing Huang (Michigan State University)** "Extrapolative Beliefs in the Cross-Section: What can We learn from the Crowds?"

ESSFM 2017 Asset Pricing Informal Evening Sessions

Monday 17 July

20.30 – 21.00

Room: Bern

"Origins of Stock Market Fluctuations"

Presenting author: Daniel L. Greenwald (MIT Sloan)

Abstract: Three mutually uncorrelated economic disturbances that we measure empirically explain 85% of the quarterly variation in real stock market wealth since 1952. A model is employed to interpret these disturbances in terms of three latent primitive shocks. In the short run, shocks that affect the willingness to bear risk independently of macroeconomic fundamentals explain most of the variation in the market. In the long run, the market is profoundly affected by shocks that reallocate the rewards of a given level of production between workers and shareholders. Productivity shocks play a small role in historical stock market fluctuations at all horizons.

20.30 – 21.00

Room: Zürich

"Endogenous Specialization and Dealer Networks"

Presenting author: Batchimeg Sambalaibat (Indiana University)

Abstract: OTC markets exhibit a core-periphery network: 10-30 central dealers trade frequently and with many dealers, while hundreds of peripheral dealers trade sparsely and with few dealers. Existing work rationalize this phenomenon with exogenous dealer heterogeneity. We build a search-based model of network formation and propose that a core-periphery network arises from specialization. Dealers endogenously specialize in different clients with different liquidity needs. The clientele difference across dealers, in turn, generates dealer heterogeneity and the core-periphery network: The dealers specializing in clients who trade frequently form the core, while the dealers specializing in buy-and-hold investors form the periphery.

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21.00 – 21.30

Room: Bern

"Vulnerable Growth"

Presenting author: Nina Boyarchenko (NY Fed)

Abstract: We study the conditional distribution of GDP growth as a function of economic and financial conditions. Deteriorating financial conditions are associated with an increase in conditional volatility and a decline in the conditional mean of GDP growth, leading to a highly-skewed distribution, with the lower quantiles of GDP growth exhibiting strong variation as a function of financial conditions and the upper quantiles stable over time. We quantify vulnerability as the relative entropy between the conditional and unconditional distribution. We argue that the inclusion of a financial sector is crucial for generating the observed dynamics of growth vulnerability.

21.00 – 21.30

Room: Zürich

"Algorithmic Trading and Price Efficiency"

Presenting author: Petri Jylhä (Aalto University)

Abstract: We study the impact of increased algorithmic trading on the post-earnings announcement drift. Consistent with earlier literature, we interpret the post-earnings announcement drift as a measure of stock price efficiency over an investment-relevant time horizon, and utilize two significant changes to the trading systems of the New York Stock Exchange as exogenous shocks to algorithmic trading. These changes increased the speed of quote dissemination and of execution of trades, and led to a documented increase in algorithmic trading. We find no evidence of changes in post-earnings announcement drift after the implementation of the NYSE trading system upgrades. This result is robust to varying the definition of the post-earnings announcement drift, to measuring the drift over various horizons, and to using a matched sample of NASDAQ stocks as a control group. The returns to investment strategies exploiting the drift are also unaffected by the increase in trading automation. Hence, we conclude that algorithmic trading has had no impact on the post-earnings announcement drift or price efficiency at time horizons relevant to most investors.

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21.30 – 22.00

Room: Bern

"Volatility Risk Pass-Through"

Presenting author: Yang Liu (University of Pennsylvania)

Abstract: We show novel empirical evidence on the significance of output volatility (vol) shocks for both currency and international quantity dynamics. Focusing on G-17 countries, we document that (1) consumption and output vols are imperfectly correlated within countries; (2) across countries, consumption vol is more correlated than output vol; (3) the pass-through of relative output vol shocks onto relative consumption vol is significant, especially for small countries; and (4) the consumption differentials vol and exchange rate vol are disconnected. We rationalize these findings in a frictionless model with multiple goods and recursive preferences featuring a novel and rich risk sharing of vol shocks.

21.30 – 22.00

Room: Zürich

"Information and Optimal Trading Strategies with Dark Pools"

Presenting author: Ariadna Dumitrescu (ESADE)

Abstract: We study how asymmetric information affects market participants' choice of trading venue (either an exchange or dark pool), and the optimal submission strategies in a sequential trading game. The exchange is organized as a fully transparent limit order book, and the dark pool is an opaque venue where orders are continuously executed at the midpoint of the bid and ask prices that prevail in the exchange. We find that if the limit order book conveys no information then rational uninformed traders never trade in the dark pool due to price risk. However, price risk may be reduced when the information in the book induces an uninformed buyer (seller) to believe that the value of the asset is high (low) since the order was previously submitted by an informed buyer (seller). Thus, the optimal strategy of an informed trader takes into account the information leakage, and the strategic response of each type of trader in the subsequent stages. Our main finding is that, adding a dark pool alongside an exchange, may switch the optimal strategy in the first period of an uninformed trader from no trade to a limit order in the exchange, and may divert the informed trader's strategy from the exchange to the dark pool. This occurs if the execution risk in the dark is low and the best price in the limit order book is sufficiently attractive.

ESSFM 2017 Asset Pricing Informal Evening Sessions

Tuesday 18 July

20.30-21.00

Room: Bern

"The Leading Premium"

Presenting author: Christian Schlag (Goethe University Frankfurt)

Abstract: In this paper, we compute conditional measures of lead-lag relationships between GDP growth and industry-level cash-flow growth in the US. Results show that firms in leading industries pay an average annualized return 4% higher than that of firms in lagging industries. The difference in the returns of leading and lagging firms is priced in the cross section of equity returns, even after we adjust for the Fama-French three-factor model. This finding can be rationalized in a model in which (a) agents price growth news shocks, and (b) leading industries provide valuable resolution of uncertainty about the growth prospects of lagging industries.

20.30 – 21.00

Room: Zürich

"Salience Theory and Stock Prices: Empirical Evidence"

Presenting author: Mathijs Cosemans (Erasmus University Rotterdam)

Abstract: We present empirical evidence on the asset pricing implications of salience theory. In our model, investors overweight salient past returns when forming expectations about future returns. Consequently, investors are attracted to stocks with salient upsides, which are overvalued and earn low subsequent returns. Conversely, stocks with salient downsides are undervalued and yield high future returns. We find strong empirical support for these predictions in the cross-section of U.S. stocks. The salience effect is stronger among stocks with greater limits to arbitrage and during high-sentiment periods and not explained by common risk factors and proxies for lottery demand and investor attention.

ESSFM 2017 Asset Pricing Informal Evening Sessions

21.00 – 21.30

Room: Bern

"The Missing Risk Premium in Exchange Rates"

Presenting author: Magnus Dahlquist (Stockholm School of Economics and CEPR)

Abstract: It is well known that the interest rate differential (the forward premium) predicts currency returns. However, we find that the real exchange rate, not the interest rate differential, is the main predictor of currency returns at longer horizons. We relate this finding to other puzzling features of currency markets, namely that the real exchange rate contemporaneously appreciates with the interest rate differential and that the positive relationship between currency risk premia and the interest rate differential reverses over longer horizons. Models in which the currency risk premium depends on the interest rate differential and a missing risk premium, capturing deviations from the purchasing power parity, can rationalize these observations.

21.00 – 21.30

Room: Zürich

"Extreme inflation and time-varying disaster risk"

Presenting author: Christoph Meinerding (Deutsche Bundesbank)

Abstract: Low consumption growth tends to occur together with either very high or very low inflation. The probability of low expected consumption growth estimated from a Markov chain for consumption growth and inflation is highly correlated with a measure for the likelihood of consumption disasters suggested by Wachter (2013). A simple asset pricing model with recursive utility and unobservable states reproduces the time variation in volatilities and correlations of stock and bond returns very well. Our results indicate that the disaster risk paradigm may be extended towards and explanation of stock-bond return correlations if one takes the informational role of inflation into account.

ESSFM 2017 Asset Pricing Informal Evening Sessions

21.30 – 22.00

Room: Bern

"Distress Risk, Expected Shareholder Losses, and the Cross-Section of Expected Returns"

Claus Schmitt (Erasmus University Rotterdam)

Abstract: We analyse the impact of financial distress on expected stock returns accounting for the severity of default. Whereas shareholders' average losses amount to 32% of equity value from the day before to the day after a bankruptcy filing, outcomes differ substantially among firms. We specify and estimate a model that predicts these losses for individual firms. When sorting stocks into portfolios according to their predicted bankruptcy losses, we find that a long-short strategy buying stocks with high predicted bankruptcy losses and selling stocks with low predicted bankruptcy losses earns a monthly premium of 0.5%. We also sort stocks independently into quintiles according to predicted bankruptcy loss and failure probability. We find that the distress-risk puzzle is not present among stocks in the highest quintile of predicted bankruptcy loss. On the contrary, the long-short returns of stocks sorted by predicted bankruptcy losses are strongest for stocks in the highest quintile of failure probability.

21.30 – 22.00

Room: Zürich

"Should the government be paying investment fees on $3 trillion of tax-deferred retirement assets?"

Presenting author: Mattia Landoni (Southern Methodist University)

Abstract: Governments incentivize retirement saving by allowing individuals to contribute to tax-advantaged accounts where the returns to financial assets receive special tax treatment. In accounts with 'back-loaded' taxation, the individual contributes pre-tax money and pays taxes when the money is withdrawn. In accounts with 'front-loaded' taxation, the individual contributes after-tax money and pays no future taxes. Under some simplifying assumptions, a standard benchmark result is that both the individual and the government are indifferent between the two types of accounts. We add investment management fees to the benchmark model and show that the neutrality result breaks down. Assuming fees are fixed as a percent of assets under management (AUM), we show that individuals are still indifferent to the timing of taxation but the government is not. Under back-loaded taxation, the government implicitly owns a share of all retirement accounts and is effectively paying investment fees on this share, something it avoids under front-loaded taxation. We estimate this to cost the government $14 billion per year. We then ask whether this result holds in general equilibrium, where fees as a percent of AUM are allowed to vary. The answer depends both on the nature of the cost function for asset management services, and on the nature of market competition, but we find that the result will in general continue to hold: back-loaded taxation is more expensive for the government and produces a

larger asset-management industry. Finally, we use the general equilibrium model to examine welfare implications. In a rough calibration of the model, we find that this increase in the size of the asset management industry reduces consumer welfare.

Wednesday 19 July

20.30 – 21.00

Room: Bern

"The Financial Intermediation Premium in the Cross Section of Stock Returns"

Presenting author: Tatyana Marchuk (Goethe University Frankfurt)

Abstract: This paper documents a significant risk premium for financial intermediation risk in the cross section of equity returns. Firms that borrow from highly levered financial intermediaries have on average 4% higher expected returns relative to firms with low-leverage lenders. This difference cannot be attributed to differences in firm characteristics and is driven by firms' exposure to the financial sector. The dispersion in the leverage of financial intermediaries in the debt market forecasts the growth of macroeconomic aggregates. To shed light on the underlying mechanism behind the intermediation risk, I provide a tractable model with state-dependent borrowing costs.

20.30 – 21.00

Room: Zürich

"Dealer Inventory and the Cross-Section of Corporate Bond Returns"

Presenting author: Nils Friewald (NHH Norwegian School of Economics and CEPR)

Abstract: Inventory models of dealership markets imply that intermediaries reduce their exposure to inventory risk by offering prices different from fundamental values. Therefore, inventory levels should affect asset prices and thus returns. We explore the cross-sectional relation between US corporate bond inventories and returns. Our findings provide strong support for the asset pricing implication of inventory models, that is, the risk-adjusted return of a high-minus-low inventory-sorted portfolio is 21 basis points per week. Furthermore, we examine several drivers of the inventory risk premium; for example, we emphasize the importance of inventory risk sharing in pricing bonds.

ESSFM 2017 Asset Pricing Informal Evening Sessions

21.00 – 21.30

Room: Bern

"The Pricing Kernel Puzzle in Forward Looking Data"

Presenting author: Jens Carsten Jackwerth (University of Konstanz)

Abstract: The pricing kernel puzzle concerns the locally increasing empirical pricing kernel, which is inconsistent with a risk-averse representative investor in a single period, single state variable setting. Some recent papers worry that the puzzle is caused simply by the mismatch of backward looking subjective and forward looking risk-neutral distributions of index returns. By using a novel test and forward looking information only, we generally confirm the existence of a u-shaped pricing kernel puzzle in the S&P 500 options data. The evidence is weaker for tests against an alternative with a risk-neutral investor and for longer horizons.

21.00 – 21.30

Room: Zürich

"Preventing Controversial Catastrophes"

Presenting author: Steven Baker (University of Virginia)

Abstract: In a market-based democracy, we model different constituencies that disagree regarding the likelihood of economic disasters. Costly public policy initiatives to reduce or eliminate disasters are assessed relative to private alternatives presented by financial markets. Demand for such public policies falls as much as 40% with disagreement, and crowding out by private insurance drives most of the reduction. As support for disaster-reducing policy jumps in periods of disasters, it may be optimal for policy-makers to propose disaster-reducing policies after disasters occur. In some scenarios constituencies may even demand policies oriented to increase disaster risk if these policies introduce speculative opportunities.

ESSFM 2017 Asset Pricing Informal Evening Sessions

21.30 – 22.00

Room: Bern

"Sparse expectations: A unified theory of expectations and implications for asset pricing"

Presenting author: Ansgar Walther (Warwick University)

Abstract: We propose an equilibrium model of asset price fluctuations that arise from sparse, imperfect expectations. In our model, forward-looking agents optimally balance the precision of their forecasts versus their robustness by relying on simplified, constrained-optimal representation of the economy. Our model reconciles extrapolation with the under-response to new information commonly found in macroeconomic forecast data in a unified framework. We document how sparse, imperfect expectations create asset prices that are excessively volatile, predictable, and prone to booms and busts.

21.30 – 22.00

Room: Zürich

"The Time-Varying Risk of Macroeconomic Disasters"

Presenting author: Julien Penasse (University of Luxembourg)

Abstract: The rare disasters model of asset prices suggests stock market variations reflect persistent fluctuations in the probability of a large decline in consumption. This paper estimates this probability from macroeconomic data alone, using a dataset of 42 countries over more than a century. We find that disaster risk is volatile and persistent, strongly correlates with the dividend-price ratio, and forecasts stock returns. Our evidence suggests that disaster risk can rationalize the equity premium and risk-free rate puzzles, the excess volatility puzzle, and the predictability of aggregate stock market returns by the dividend-price ratio. A variable disaster model calibrated with our risk estimates confirms these results under standard assumptions. While former works support the plausibility of disaster risk hypothesis, we provide direct evidence that disaster risk can rationalize price fluctuations.

ESSFM 2017 Asset Pricing Informal Evening Sessions

Thursday 20 July

20.30 – 21.30

Room: Bern

"Asset pricing with endogenously uninsurable tail risks"

Presenting author: Hengjie Ai (University of Minnesota)

Abstract: This paper studies asset pricing in a setting where idiosyncratic risks in labor productivities are uninsurable due to limited commitment. Firms provide insurance to workers using long-term contracts but neither side can commit to these relationships. Under the optimal contract, sufficiently adverse shocks to worker productivity are uninsured. In general equilibrium, exposure to down-side tail risks results in higher risk premia, more volatile returns and variation of returns across firms. The risk sharing patterns are also consistent with the observed cross-sectional heterogeneity in earnings and wealth sensitivities to aggregate shocks.

20.30 – 21.00

Room: Zürich

"Limits of Arbitrage under the Microscope: Evidence from detailed Hedge Fund Transaction Data"

Presenting author: Bastian von Beschwitz (Federal Reserve Board)

Abstract: We exploit detailed transaction and position data for a sample of long-short equity hedge funds to document new facts about the trading activity of sophisticated investors. We find that the initiation of both long and short positions is associated with significant abnormal returns, suggesting that the hedge funds in our sample possess investment skill. In contrast, the closing of long and short positions is followed by return continuation, implying that hedge funds close their positions too early and leave money on the table." As we demonstrate with a simple model, this behaviour can be explained by hedge funds being (risk) capital constrained and facing position monitoring costs. Consistent with our model, we document that the return continuation following closing orders is more pronounced when these constraints become more binding (e.g., after negative fund returns or increases in volatility).

ESSFM 2017 Asset Pricing Informal Evening Sessions

21.00 – 21.30

Room: Bern

"Limited Participation and Local Currency Sovereign Debt"

Presenting author: Kirill Shakhnov (EIEF)

Abstract: Emerging markets governments increasingly rely on local currency denominated debt. Despite this recent development, the markets for foreign and local currency debts exhibit a substantial degree of segmentation. This paper investigates the causes and the consequences of market segmentation for debt prices and debt issuance. First, we show that deviations from the covered interest rate parity condition between local and foreign currency denominated debt are related to market segmentation. Second, we show that the demand for local currency debt from foreign investors is persistent and increases after an improvement in the relative credit rating vis-a-vis foreign currency denominated debt. We propose a simple model of partially segmented markets that replicates the observed empirical regularities. The model predicts that the covered interest rate parity hold only for perfectly integrated markets.

21.00 – 21.30

Room: Zürich

 "Market Power and Price Informativeness"

Presenting author: Savitar Sundaresan (Imperial College London)

Abstract: Levels and concentration of institutional equity ownership have been growing steadily over the last few decades raising concerns of potential market instability. We study theoretically the consequences of changes in ownership structure for informational content of prices, on average and across assets with different characteristics. Our framework is a general equilibrium portfolio-choice model with endogenous information acquisition and market power. We show that, in the cross section, an increase in institutional (informed) ownership increases price informativeness, and an increase in concentration of ownership leads to lower informativeness. The policy experiments of changing ownership structure indicate a non-monotonic relationship between the levels and concentration of ownership and price informativeness. We conclude that any policy targeting ownership structure should factor in its effects on welfare through price informativeness.

ESSFM 2017 Asset Pricing Informal Evening Sessions

21.30 – 22.00

Room: Bern

"Asset Pricing with Large Investors"

Presenting author: Alberto Teguia (Swiss Finance Institute)

Abstract: We derive closed form expressions for equilibrium asset prices and liquidity in an economy populated by a finite number of large, strategic, risk averse investors. The model allows for arbitrary risk preferences, any number of assets, and an arbitrary distribution of asset payoffs. In equilibrium, assets are priced according to the standard consumption Euler equation plus a correction term accounting for market illiquidity (price impact), linked to an endogenous measure of systemic risk that puts a large weight on low consumption states. Wealth effects imply that price impact is generally asymmetric, which leads to the emergence of endogenous systemic assets: That is, assets whose sell-off triggers large moves in all security prices. Market liquidity is non-monotonic in funding liquidity and may decrease in the number of investors. In the presence of liquidity shortage, price impact becomes negative and gives rise to an illiquidity premium in asset prices.

21.30 – 22.00

Room: Zürich

"Extrapolative Beliefs in the Cross-Section: What can We learn from the Crowds?"

Presenting author: Xing Huang (Michigan State University)

Abstract: Using novel data from a crowdsourcing platform for ranking stocks, we investigate how individuals form their beliefs about future stock returns. In each contest on the platform, competitors are asked to rank 10 stocks according to their expected performance (% gain) over the course of the contest (usually 1 week). These rankings allows us to investigate how investors form return expectations on individual stocks in the cross-section. Preliminary results show that individuals extrapolate from past returns, with more weight on more recent returns. Interestingly, the consensus rankings negatively predict future stock returns — longing the quintile with lowest rankings and shorting the quintile with highest rankings generates 0.734% weekly return. The return predictability is not driven by the well-known short-term return reversal, but is consistent with the asset pricing implications of extrapolative beliefs.