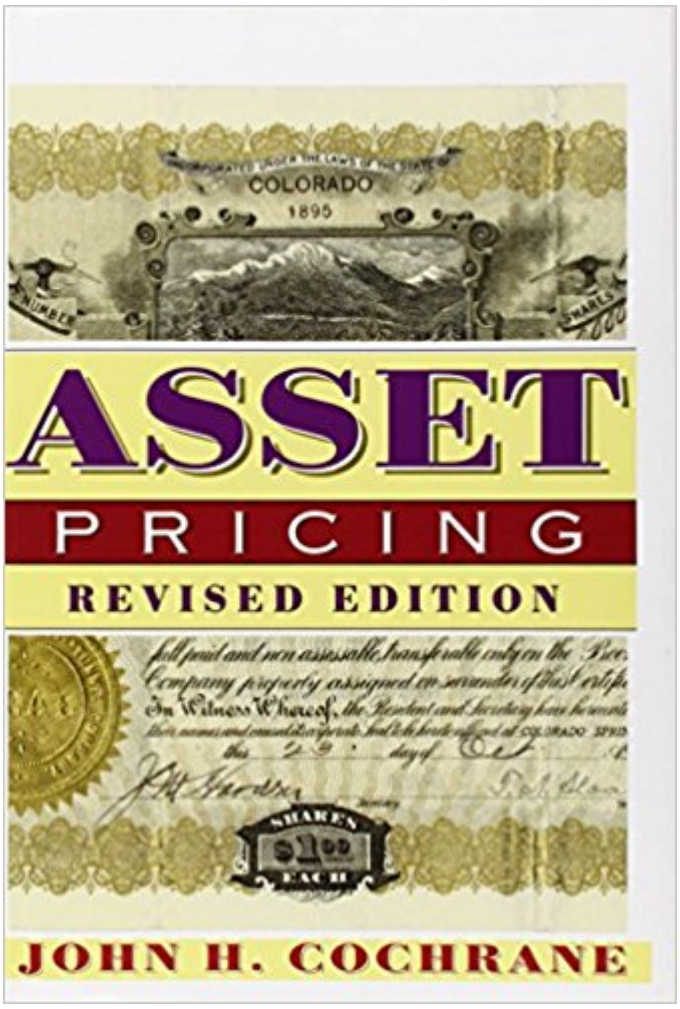
Asset Pricing



Synopsis

Winner of the prestigious Paul A. Samuelson Award for scholarly writing on lifelong financial security, John Cochrane's Asset Pricing now appears in a revised edition that unifies and brings the science of asset pricing up to date for advanced students and professionals. Cochrane traces the pricing of all assets back to a single idea--price equals expected discounted payoff--that captures the macro-economic risks underlying each security's value. By using a single, stochastic discount factor rather than a separate set of tricks for each asset class, Cochrane builds a unified account of modern asset pricing. He presents applications to stocks, bonds, and options. Each model--consumption based, CAPM, multifactor, term structure, and option pricing--is derived as a different specification of the discounted factor. The discount factor framework also leads to a state-space geometry for mean-variance frontiers and asset pricing models. It puts payoffs in different states of nature on the axes rather than mean and variance of return, leading to a new and conveniently linear geometrical representation of asset pricing ideas. Cochrane approaches empirical work with the Generalized Method of Moments, which studies sample average prices and discounted payoffs to determine whether price does equal expected discounted payoff. He translates between the discount factor, GMM, and state-space language and the beta, mean-variance, and regression language common in empirical work and earlier theory. The book also includes a review of recent empirical work on return predictability, value and other puzzles in the cross section, and equity premium puzzles and their resolution. Written to be a summary for academics and professionals as well as a textbook, this book condenses and advances recent scholarship in financial economics.

Book Information

Hardcover: 568 pages

Publisher: Princeton University Press; Revised edition (January 23, 2005)

Language: English

ISBN-10: 0691121370

ISBN-13: 978-0691121376

Product Dimensions: 6.5 x 1.6 x 9.2 inches

Shipping Weight: 2 pounds (View shipping rates and policies)

Average Customer Review: 3.9 out of 5 stars 47 customer reviews

Best Sellers Rank: #74,523 in Books (See Top 100 in Books) #3 inÃ Â Books > Business & Money > Management & Leadership > Pricing #56 inÃ Â Books > Textbooks > Business &

Finance > Investments & Securities #160 inÃ Â Books > Textbooks > Business & Finance > Finance

Customer Reviews

Co-Winner of the 2001 Paul A. Samuelson award"This is a brilliant and useful book, well-deserving of the TIAA-CREF Samuelson Award. . . . The clever intuition and informal writing style make it a joy to read. Like a star athlete does with the sport, Cochrane makes it look easier than it really is."--Journal of Economic Literature

"An excellent survey of asset pricing theory and applications from the modern viewpoint of stochastic discount factors and their associated geometry. This book was already a classic among finance scholars and on Ph.D. syllabi when it circulated in the form of class notes. It will also prove highly useful to practitioners who seek an in-depth introduction to these tools."--Yacine Aït-Sahalia, Princeton University "This is a beautiful book that uses the elegant simplicity of the stochastic discount factor to present a general theory of the pricing of stocks, bonds, and derivatives and a practical approach to estimating particular models derived from the general theory. It will help experts in the field to consolidate their knowledge and beginners to appreciate the unity of asset pricing theory. Cochrane uses his mastery of the subject to present it in a clear and compelling manner that is easily accessible."--Michael Brennan, Anderson School, University of California, Los Angeles "This is an impressive treatise of very high quality. It is a serious scholarly monograph, of interest to those who are working to advance financial theory, and it can also serve as a textbook in an advanced finance course. It is thoughtful, inductive, and comprehensive."--Robert J. Shiller, author of Irrational Exuberance "This is a sparkling, intuitive, makes-it-look-easier-than-it really-is, gem of a book . . . Cochrane’s focus is the classical asset pricing models of frictionless markets and rational expectations. But the lessons learned are relevant in many empirical contexts. Cochrane’s clever intuition and easy, informal writing style make the book a joy to read."--Wayne Ferson, Boston College "This book represents an exciting step forward in the exposition of financial economics. The last twenty years of finance research have advanced and enriched the field, and textbook treatments have lagged behind these developments. This text will replace the previous generation of books and should have a broad market. It is written in an informal, almost breezy style that will appeal to students and is divided into small, easily digested chapters. . . . The book moves easily between discrete-time and continuous-time models. This is an excellent thing as it encourages students to see beyond the

formalism to the underlying economics. I strongly recommend it as an advanced finance text."--John Y. Campbell, coauthor of The Econometrics of Financial Markets

This is a good book; it packs a lot of material but lacks something. Now, this something is hard to figure out from an initial glimpse. When you look at some of the material; you fail to see it easily (understand it) from the book. Then, upon further reflection you comprehend what the author is trying to convey, and realize that the book could have said it (presented the material) better. Two other books that were mentioned to me were by Costis Skiadas and Darrell Duffie; I have not read those books and hence cannot compare. Perhaps this book is the best available in the field; perhaps the material or the topics themselves are abtruse and hard. This means that this field is still in need of a classic reference book. Whenever I read any text book and it falls short of excellent exposition and clear connection with the readers (may well be due to the limitations of the reader which is why they are using a text book) ... I always feel that James Hamilton (of Time Series Analysis fame) should give lessons to others on how to write text books... that would serve society and this field immensely.

excellant book!

Given the innumerable finance books available, I find myself constantly trying to separate the wheat from the chaff (and, sadly, finding a whole lot more of the latter than the former). John Cochrane’s Asset Pricing (2001, Princeton University Press) is not only wheat, but also perhaps the most finely milled flour baked to perfection into one’s favorite dessert, served with a chilled glass of ChÃƒÆ’Ã Â¢teau d’Yquem. Cochrane identifies his target audience as "economics and finance Ph.D. students, advanced MBA students, or professionals with similar background". Residing in the third camp, I can say from this point of view that this book could have been subtitled, "the Practitioner’s Portable Ph.D." Academic researchers, students, and practitioners of finance should all value Cochrane’s Asset Pricing enough to own a copy.Asset Pricing is extremely readable, as Cochrane stresses economic intuition over formal proofs. The book is structured into four parts: 1) asset pricing theory; 2) asset pricing models; 3) options and interest rates; 4) an empirical survey. Cochrane begins powerfully, introducing us to the notion that the consumption-based asset pricing equation, given by an investor’s first-order conditions, is the central formulation in asset pricing; market-based models simply consider the market returns specified in the consumption models to be exogenously determined free parameters. Cochrane emphasizes that all factor models are derived

as specializations of the consumption-based model, using extra variables to proxy marginal utility.In Part 1, Cochrane covers the field from the Law of One Price, to the mean-variance frontier, to the CCAPM, the CAPM, ICAPM and APT, covering both discrete- and continuous-time, as well as market- and consumption-oriented approaches. Cochrane begins with a simple concept: that price equals discounted payoff, and claims that this is the core of all asset pricing theory. I found this section to neatly clarify my understanding and perspective of these models. Cochrane argues effectively for the use of contingent-claims budget constraints as our lens rather than the traditional mean-variance frontiers and beta models: "...it has seemed that there are several different asset pricing theories: expected return-beta for stocks, yield-curve models for bonds, arbitrage models for options. In fact all three are just cases of p = E(mx)." Cochrane makes clear in his theorems of chapter 4 that the Law of One Price guarantees the existence of a discount factor, and the lack of pure arbitrage implies that the discount factor must be positive. Furthermore, the absence of arbitrage is the result of a positive discount factor, which is the natural result of any sort of utility maximization. Cochrane provides proofs of these relationships for both complete and incomplete markets. I also learned something new (to me) in Chapter 8: in addition to the famous Roll (1977) critique, which states that testing the CAPM using empirical data is impossible because the wealth portfolio is not observable, there is another basic but profound critique due to Hansen and Richard (1987), regarding the conditional versus unconditional CAPMs, which asserts that tests of the CAPM are doomed since the conditioning information of the agents is not observable.Part 2 introduces us to The Generalized Method of Moments (GMM) approach to free parameter selection, distribution estimation, and model evaluation. GMM is quite powerful and is becoming increasingly popular in empirical studies; one recent example of applied GMM can be found in Andrew Lo's 2002 paper "The Statistics of Sharpe Ratios" (FAJ 58(4)). Cochrane provides the background and methodology for implementing the GMM approach of Hansen and Singleton (1982). Cochrane also covers time-series and cross-sectional (OLS and GLS) regressions for testing linear factor models, with a special emphasis on the Fama-MacBeth (1973) procedure, as well as Maximum Likelihood, which is a special case of GMM, and closes the section with examples of Monte Carlo and bootstrap simulations. Chapter 16, "Which Method?", highlights both Cochrane's pragmatism and masterful intuition of the subject (which is evident throughout the book); I especially enjoyed his brief commentary on statistical philosophy here.In Part 3, Cochrane covers option pricing and term structure of interest rate models. Two chapters (17 and 18) is hardly enough to do justice to options pricing, which is better served by a complete text such as Cox and Rubinstein's "Options Markets" or Hull's "Options, Futures, and Other Derivatives", but given the limited space, Cochrane does an

impressive job, using the Law of One Price to describe put-call parity, arbitrage bounds, early exercise rules for American options, and the Black-Scholes and Feynman-Kac solutions as well as real options. Chapter 19 is devoted to bond pricing. Cochrane covers bond basics, yield curves, and term structure models. The Cox-Ingersoll-Ross (1985) model and the Vasicek (1977) models are shown to be special cases of the affine class of term structure models, and Cochrane derives all three. He also provides a nice review of the literature of both affine and non-affine models, including as Constantinides' 1992 closed-form solution and many others.Part 4 provides a well-written survey of the empirical work in the field, specifically on time-series predictability, cross-sectional models and equity premium puzzles, and new variations on the consumption-based models. Cochrane also provides an introduction to continuous-time stochastic processes in the Appendix, which succinctly covers Brownian motion, time-series diffusions and Ito's lemma. Most chapters include several problems at the end, a nice addition for readers who really want to dig in and explore asset pricing directly. Although solutions are not provided in the book, Cochrane's website,[...]offers them via e-mail to teachers using Asset Pricing as a class text. The website also offers a preview of the book through page 50, which encompasses the Contents, Preface, and chapters 1 and 2 in their entirety. The website also contains an important errata page describing more than 160 equation typos and errors, additions and clarifications to the manuscript.Cochrane's experience as editor of the Journal of Political Economy shines through in his clear writing style, and his students at Chicago's GSB, where he is Theodore O. Yntema Professor of Finance, are lucky indeed if this book is any indication of his teaching ability. Asset Pricing is not a book to be missed.

This is a great book. Professor John Cochrane is great educator, he can makes involved material look easy without simplifying the subject. After 450 pages you still ask for more. Great literature both for academia and practitioners

I love this book. It is very well written and complex ideas are explained in a very clear way.

Upon recommendation by a friend of the author, I ordered this book through . I read the entire book from cover to cover in a month. I am onto my second pass through the book.Cochrane organizes pricing theories from CAPM to APT to derivative pricing, all of which I have learned through disparate sources, around a central theme: consumption based pricing theory. Then he goes on explaining the equivalence among these pricing theories, and indicate situations where these theories may best be used.The author balances the theory with equal emphasis on empirical

studies, from estimation methods to common pricing models, especially the Fama-French model. He also shares with us intuitive discussions of value factors, forecasting power of dividend/price ratios and the puzzling momentum factors.What is especailly good about this book, I found, at least for myself, is how the author manages a casual style without losing rigor and focus. The author in 500+ pages review as well as explore vast amount of financial literature and present it to us in a clear and unified fashion. Another aspect I particularly like is that the author probably has students or people without finance ph.d.s in mind when he explains common but potentially confusing terminologies used in different segments of academic research.Cochrane sketches out proofs for most of theorems and corollaries. Perhaps it is not the purpose of this book, and should not be required of it as such, that detail proofs be provided. Those can be found in references listed at the end of the book.Overall I highly recommend this book to people who are interested in asset pricing theories as well as practice. Minimal advanced mathematics is sufficient, such as calculus and linear algebra.

I took a Finance Ph.D. - level Asset Pricing course that used this book along with other sources and I’m quite happy with it. In particular, I enjoyed Ch 21 "Equity Premium puzzle and Consumption-Based Models". Some Matlab code for Campbell-Cochrane model is still available on my website (click on my name above).

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