SIMON FRASER UNIVERSITY
Department of Economics

Econ 482 — Prof. Kasa
Asset Pricing — Fall 2003

FINAL EXAM - December 9, 2003

Answer the following questions True, False, or Uncertain. Briefly explain your answers. No credit without explanation. (5 points each).

1. If markets are efficient, then stock prices follow random walks.

2. Conditional linear factor models are untestable.

3. A portfolio could be conditionally mean-variance efficient, but *not* unconditionally mean-variance efficient.

4. Idiosyncratic risk increases the equity premium.

5. Favorable news about future dividends increases stock prices.

The following questions are short answer. Clarity will be rewarded.

6. (25 points). People often find that the traditional CAPM "fits the data" better than the consumption-based CAPM. Why study the consumption-based CAPM then? Why not just use the regular CAPM? What's the value-added of the consumption-based CAPM?

7. (25 points). In class we discussed two recent attempts to explain the "equity premium puzzle". One was Campbell and Cochrane's 'habit persistence' model. The other was Constantinides and Duffie's idiosyncratic risk model. Briefly describe the key features of these two theories. Why are they able to explain the puzzle? What are their strengths and weaknesses?

8. (25 points). In the popular press, the stock market is often described as a 'casino', where people are trying to place winning bets and avoid losing bets. In his article entitled "Portfolio Advice for a Multifactor World", Cochrane argued that a better metaphor would be that people are buying and selling insurance policies. What did he mean by this? Briefly discuss its portfolio implications. How do they differ from the case where the stock market is viewed as a casino?