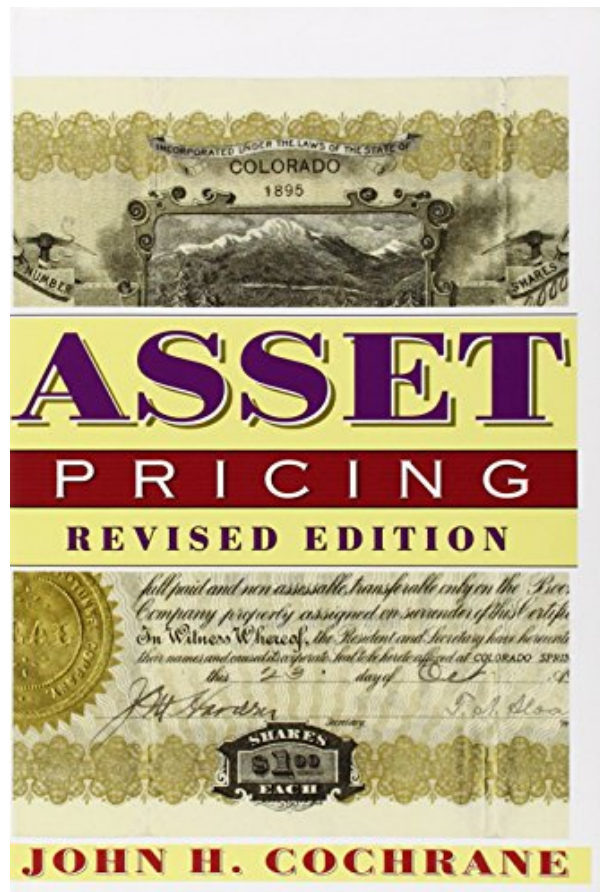
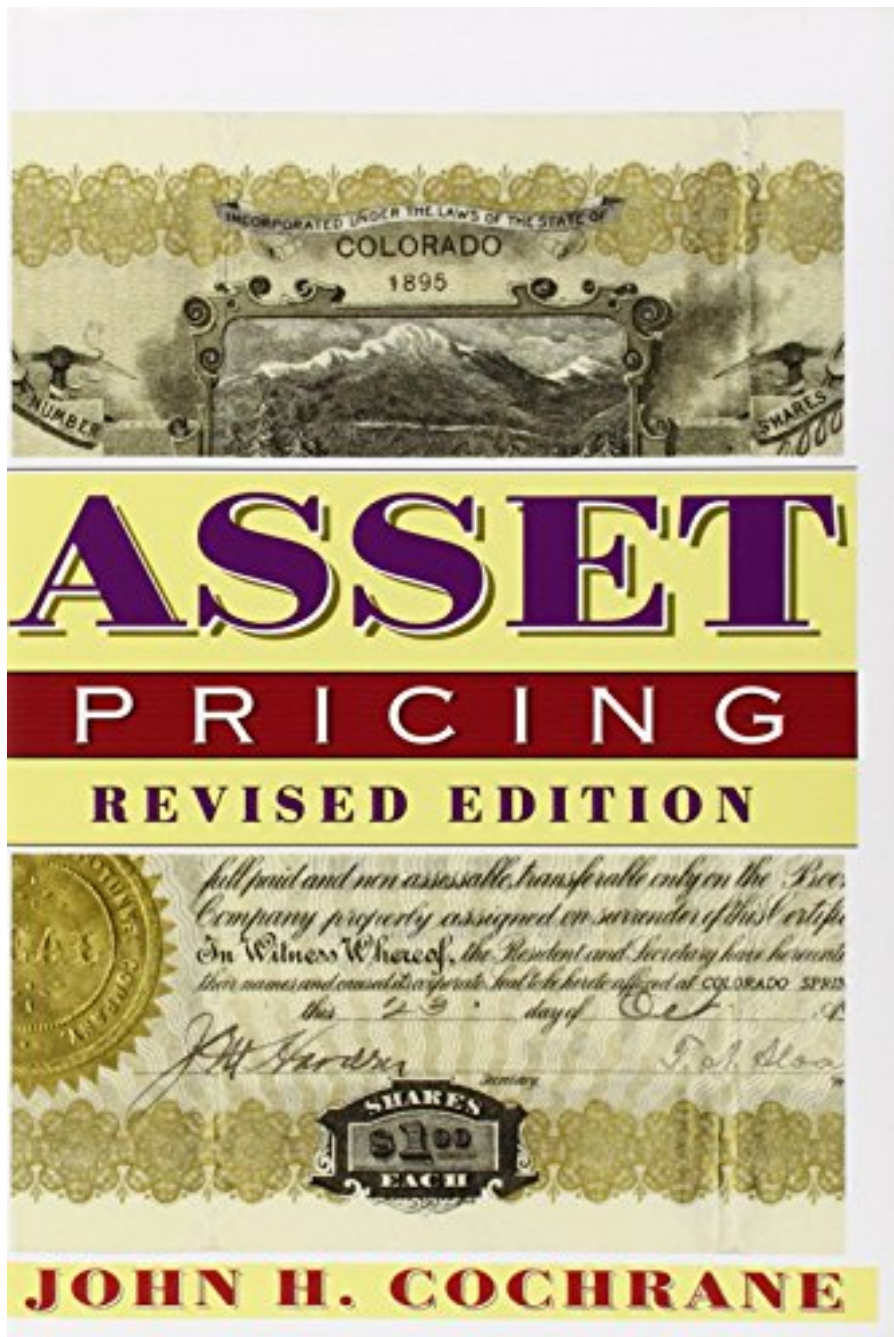


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Winner of the prestigious Paul A. Samuelson Award for scholarly writing on lifelong financial security, John Cochrane's *Asset Pricing* now appears in a revised edition that unifies and brings the science of asset pricing up to date for advanced students 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.

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- Asset Pricing Revised

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Good book but falls short of a Great Text Book

By RK

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 abstruse 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.

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By Amazon Customer

excellant book!

54 of 57 people found the following review helpful.

The Practitioner's Portable Ph.D.

By Craig W. French

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 Château 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.

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