

Is the Value Premium a Puzzle?

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September, 2006

Abstract

This paper provides an economic explanation of the value premium, differences in price/dividend ratios of value and growth assets and variance-covariance structure of their realized returns within the long-run risks model of Bansal and Yaron (2004). Consistent with time-series properties of observed cash-flow data, value firms exhibit higher exposure to low-frequency fluctuations in aggregate consumption than growth firms do. This is the key input that allows the model to justify the magnitude of the historical value premium. Furthermore, heterogeneity in systematic risks across firms helps account for the violation of the CAPM and C-CAPM, resolving the puzzle.

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1 Introduction

One of the well-established features of financial data is the fact that firms with high book-to-market ratios (commonly referred to as value firms) tend to consistently deliver higher returns than firms with low book-to-market ratios (or growth firms). This finding, known as the value premium, turns out to be quite robust to alternative definitions of value, and, in contrast to the size effect, does not disappear over time. The latter observation naturally calls for a risk-based interpretation – it is reasonable to believe that investors engaged in the value strategy are exposed to some systematic risks, and the value premium is simply a reward required for risk-bearing. Although appealing, this argument is strongly rejected if these fundamental risks are measured by the commonly-used CAPM betas (see Fama and French (1992, 1993)). Empirically, the dispersion in market risks between value and growth stocks is too small to generate sizable spread in average returns, making the value premium a puzzle. It is further confronted by the poor performance of the consumption-based CAPM (Mankiw and Shapiro (1986)).

This paper offers an economic explanation of the value premium puzzle. I introduce value and growth portfolios into a general equilibrium model that features long-run consumption risks and show that it can successfully account for the differences in their expected returns and valuation ratios, variances and covariances of asset returns, as well as time-variation in their risk premia. Specifically, I provide a fundamental explanation for the scale and the joint transitional density of the two assets within the long-run risks model of Bansal and Yaron (2004) and show that the model goes a long way towards resolving the puzzle — it quantitatively accounts for both the observed magnitude of the value premium and empirical failure of the CAPM and C-CAPM.

The existing empirical literature has usually studied cross-sectional and time-series dimensions of financial data in isolation. On the one hand, the works of Fama and French (1992, 1993), Jagannathan and Wang (1996), Lettau and Ludvigson (2001), Campbell and Vuolteenaho (2004), Parker and Julliard (2005), Lettau and Wachter (2005), Jagannathan and Wang (2005)¹ have focused on measuring risk exposures (i.e., betas) and applying them to the cross-section of mean returns to explain the differences in risk premia. On the other hand, Kandel and Stambaugh (1991), Campbell and Cochrane (1999), Barberis, Huang, and Santos (2001), Menzly, Santos, and Veronesi (2004), and Bansal and Yaron (2004) have been mainly interested in understanding the time-series behavior of asset markets. The

¹See Cochrane (2005) for an updated survey of the cross-sectional literature.

novel aspect of this paper is to explore the ability of the general equilibrium model to simultaneously account for both cross-sectional and time-series puzzles of asset pricing data. In this sense, the approach taken here is related to the two recent papers by Hansen, Heaton, and Li (2005), and Santos and Veronesi (2005), who likewise analyze pricing implications of general equilibrium models for the cross-section of book-to-market sorted portfolios.²

This paper is based on the model of Bansal and Yaron (2004). This choice has been primarily motivated by the empirical evidence in Bansal, Dittmar, and Lundblad (2001, 2005), Hansen, Heaton, and Li (2005), and Bansal, Dittmar, and Kiku (2005) that highlights the importance of long-run properties of assets' cash flows for understanding the risk-return relation in financial markets. Long-run risks in the model are captured by a small but highly persistent component that governs the evolution of consumption growth. In addition to long-run growth risks, the model allows for time-variation in the conditional volatility of consumption. Firms in this economy are distinguished by the exposure of their dividends to low- and high-frequency shocks in consumption, and news about future economic uncertainty. A complementary ingredient in the model is time-non-separable preferences of Epstein and Zin (1989) type that break the link between agents' attitude towards smoothing consumption over time and across different states of nature. This separation plays an important role as it makes the marginal rate of substitution depend not only on consumption growth (as in the standard power utility case), but also on the forward-looking return on the aggregate wealth portfolio. Consequently, predictable variations in all sources of systematic risks have a significant bearing for the implied dynamics of asset returns and, as I show, allow us to quantitatively account for numerous silent features of value and growth data under reasonable configurations of investors' preferences.

What drives the value premium in the model? As argued in Bansal and Yaron (2004), in the Epstein-Zin economy, risks related to long-term growth lead to large reactions in stock prices and, hence, entail a significant risk compensation. Assets' valuations and risk premia, therefore, by and large depend on the amount of low-frequency risks embodied in assets' cash flows. I document that in the data, value firms are highly exposed to long-run consumption shocks. Growth firms, on the other hand, are mostly driven by short-lived fluctuations

²There are, however, a number of important differences between the present and the above-mentioned works. Although Santos and Veronesi (2005) pose a very similar set of questions, they address it from a perspective of a very different, habit-based, model. Hansen, Heaton, and Li (2005), on the other hand, rely on the model similar to the one considered here but confine their attention to a specification of preferences in the region where the elasticity of intertemporal substitution is close to unity and ignore possible variations in discount rates. Their main focus is on issues pertaining to the measurement of stochastic growth components in the data and characterization of the long-run risk-return tradeoff.

in consumption and risks related to future economic uncertainty. Consequently, value firms exhibit higher elasticity of their price/dividend ratios to long-run consumption news (relative to growth assets) and have to provide investors with high ex-ante compensation.

To evaluate the model's ability to quantitatively capture various features of value and growth equities, I solve it numerically using the quadrature-based method of Tauchen and Hussey (1991). I show that once time-series dynamics of aggregate and asset-specific cash flows are calibrated so as to match the observed annual data on consumption and dividends, the model is able to successfully account for both time-series and cross-sectional properties of assets' prices and returns. In particular, the model generates the value premium of about 5.3% per annum that is fairly comparable to 6% in the data. In the model, as in the data, both the CAPM and C-CAPM fail to justify the spread in average returns — the model-implied market and consumption betas of value stocks, on average, are lower than those for growth firms. Importantly, the model is able to simultaneously replicate the value-growth spread in Sharpe ratios (0.34 versus 0.20), differences in their price/dividend ratios (24.7 for value versus 39.8 for growth), high persistence in assets' valuations (the first-order autocorrelation of price/dividend ratios varies between 0.8 and 0.9), and high volatilities of assets' returns (of about 20-30% per annum). In addition, the model reproduces long-horizon return predictability, countercyclical variation in the value premium, and largely accounts for the high contemporaneous correlation between value and growth returns.

The rest of the paper is organized as follows. The next section presents an overview of the stylized empirical features of value and growth firms' data. Section 3 provides details of the long-run risks model and highlights its intuition. The choice of preferences and time-series parameters is discussed in Section 4. Section 5 summarizes asset pricing implications of the model. Finally, Section 6 provides concluding remarks.

2 Empirical Evidence

This section reviews the historical performance of high and low book-to-market firms and summarizes the time-series dynamics of value and growth portfolios. I focus on the long-term behavior of financial markets, employing for this reason the longest available set of data that spans the period from 1929 to 2003.

2.1 Data Construction

Asset market data consist of annual observations on value-weighted real returns and cash-flows for portfolios sorted by book-to-market ratios, as well as for the aggregate stock market. I construct 5 portfolios on a monthly basis as in Fama and French (1993), using data from the Center for Research in Securities Prices (CRSP) and the Compustat database. The book-to-market ratio is calculated as book equity at the last fiscal year end of the prior calendar year divided by market equity at the end of December of the previous year. Following Fama and French, I define book equity as the stockholders' equity, plus balance sheet deferred taxes and investment tax credit, minus the book value of preferred stock. Depending on availability, redemption, liquidation or par value are used for the book value of preferred stock. Portfolios are formed for NYSE, AMEX and NASDAQ stocks at the end of June of each year using NYSE breakpoints. For each portfolio, I construct the per-share dividend series as in Campbell and Shiller (1988b) and Bansal, Dittmar, and Lundblad (2001, 2005), extracting dividend yields for a given portfolio, y_{t+1} , using CRSP returns with and without dividends. Portfolio dividends are created as $D_{t+1} = y_{t+1}V_t$, where the value of the portfolio, V_t , is computed using the price gain series h_{t+1} , as $V_{t+1} = h_{t+1}V_t$ and $V_0 = 100$. Monthly returns and dividends are time-aggregated to an annual frequency and converted to real quantities using the personal consumption deflator. Empirical findings discussed below are fairly robust to an alternative measure of payouts that adjusts dividends by share repurchases. Therefore, in what follows, I only report evidence based on the former, i.e., cash dividend series. I focus on cash flows and returns of two portfolios with opposite book-to-market characteristics — firms in the bottom quintile that are referred to as *growth* firms, and firms in the top book-to-market quintile that are correspondingly referred to as *value* firms.

The 90-day T-bill is used as a measure of the return on the riskless asset. The real rate of interest is constructed by subtracting a 12-month moving average of inflation from the observed nominal rate. Treasury and inflation data are taken from the CRSP dataset. Finally, I construct the growth rate of aggregate consumption using seasonally adjusted data on real per capita consumption of nondurables and services from the NIPA tables available from the Bureau of Economic Analysis. Consumption data, as well as all asset pricing data, are sampled on an annual basis.

2.2 The Value Premium in the Data

One of the most robust features of financial data is the finding that value firms, on average, have higher returns than growth firms. Figure 1 visualizes this evidence by plotting the spread in realized returns on high and low book-to-market portfolios. It can be seen that over the course of the last 74 years, the value strategy delivered superior returns about 70% of the time. Numerically, the value effect is illustrated in the top panel of Table I, which reports descriptive statistics for returns, cash-flow growth rates, and logarithms of price/dividend ratios of the two portfolios along with their robust standard errors.³ The first column of the table shows that growth firms, on average, offer about 8% to investors (comparable to that for the market portfolio), whereas value stocks yield an impressive 14% per annum. The difference in average returns or the *value premium* is about 6% over the sample period. Value investing seems to be somewhat riskier in the traditional sense as the standard deviation of value stocks exceeds that for growth stocks. Even though, value stocks provide a much better deal to investors in terms of average compensation per unit of risks as measured by the Sharpe ratio. The ratio of average excess return to standard deviation is equal to 0.43 for value versus 0.34 for growth stocks.⁴

What causes such a remarkable difference in mean returns on value and growth stocks? It is sensible to argue that high book-to-market firms are subject to some systematic risks, and the extra premium is the appropriate compensation required by value investors. This interpretation, however, finds no empirical support within standard asset pricing paradigms. In particular, the CAPM states that the difference in mean returns should be entirely accounted for by the difference in market risks measured by the covariation of asset returns with the market portfolio. There is, however, too little dispersion in market betas of value and growth assets (in our sample, both are virtually the same, around 1) to justify the observed magnitude of the value premium. The consumption-based CAPM developed in Breeden (1979) and Grossman and Shiller (1981) similarly fails to explain the value-growth spread, as well as variation in risk premia across a wider asset menu (see, for example, Mankiw and Shapiro (1986), Campbell (1996), and Lettau and Ludvigson (2001)).

The violation of traditional asset pricing models in the cross-section of book-to-market sorted assets has spurred extensive academic research during the last two decades. Earlier works include Fama and French (1992, 1993, 1996) who argue that the spread in returns on

³Robust standard errors are calculated using the Newey-West variance-covariance estimator with 8 lags.

⁴This measure of relative performance, however, may be very misleading as it does not account for the composition of idiosyncratic and systematic risks in assets' returns.

high and low book-to-market firms proxies for some common source of risks not captured by the CAPM betas and use it as a risk-factor to explain the variation in risk premia across a broader set of assets. Their view was subsequently challenged by Daniel and Titman (1997) who show that an alternative, characteristics-based explanation is equally consistent with the observed asset pricing data. Lakonishok, Shleifer, and Vishny (1994) also depart from a risk-based premise, arguing that the value strategy delivered an extra reward in the past because naive market participants appeared to be overly optimistic about long-term growth of low book-to-market assets relative to value stocks. This conclusion, however, is hard to reconcile with the fact that the value anomaly has persisted for such a long time. It seems quite unlikely that growth investors have systematically failed in their forecasts of future growth differences between low and high book-to-market firms. Consequently, empirical research that followed has tried to restore the validity of the risk-based argument. This literature relies on either conditional versions of traditional models as in Jagannathan and Wang (1996) and Lettau and Ludvigson (2001), the ICAPM premise (Campbell and Vuolteenaho (2004)), a duration-based explanation (Lettau and Wachter (2005)), or simply on risk measures that allegedly are more robust to measurement errors in consumption data and slow adjustment of consumption decisions to economic news (Jagannathan and Wang (2005), Parker and Julliard (2005)). A number of recent studies highlight the role of low-frequency properties of assets' cash flows in explaining the cross-sectional risk-return tradeoff. Relying on different specifications for the joint dynamics of aggregate consumption and assets' dividends, Bansal, Dittmar, and Lundblad (2001, 2005), Hansen, Heaton, and Li (2005), and Bansal, Dittmar, and Kiku (2005) find that value firms exhibit much higher exposure to persistent consumption risks than firms with low book-to-market characteristics; consequently, value firms have to compensate investors for the extra long-run risk bearing. This paper is primarily motivated by these empirical findings.

2.3 P/D Ratios: Levels and Variance Decomposition

Although the existing cross-sectional literature provides valuable insights about the origins of the value premium, it does not address other dimensions of value and growth data that are just as important for investment decision-making as is the spread in average returns.

One of the pronounced features of the data is the difference in value and growth valuations.⁵ As Table I shows, even though value firms, on average, have quite high growth of

⁵Throughout the paper, the term “valuation” refers to the ratio of asset prices to dividends.

their cash flows, they usually sell at prices that are fairly low relative to current dividends. The mean of the log price/dividend ratio of value stocks is equal to 3.25, while that for growth assets is significantly higher, of about 3.61.⁶ It is often argued in the literature⁷ that growth firms are highly exposed to discount-rate variation since their cash flows are delayed more into the future. This argument implies that price/dividend ratios of low book-to-market firms should be much more sensitive to variation in future expected returns than valuations of high book-to-market firms. The data, however, do not strongly support this view. In fact, the percentage of variation in price/dividend ratios due to variation in future expected returns is very similar across the two portfolios — it is estimated at 0.39 (SE=0.27) and 0.32 (SE=0.20) for growth and value firms respectively. The decomposition is performed as in Cochrane (1992). Specifically, for a given asset, the fraction of variance of the log price/dividend ratio that comes from the variation in future expected returns is estimated by $\sum_{j=1}^J \varrho^j \frac{Cov(\log(P_t/D_t), -r_{t+1+j})}{Var(\log(P_t/D_t))}$, where the discount factor $\varrho = 1/[1 + \bar{r}]$, and the lag length, J , is set to 15 years.

2.4 Second Moments of Assets' Returns

It is known from the volatility literature (see Shiller (1981), LeRoy and Porter (1981)) that prices are highly volatile relative to fundamentals. For example, as shown in the top panel of Table I, the sample standard deviation of value and growth returns varies from 20% to almost 30%, whereas the volatility of dividend growth rates is about half as low — of around 14% for growth and 18% for value firms. Another pertinent aspect of the data is the finding that the unconditional correlation in ex-post assets' returns substantially exceeds that in assets' cash-flow growth rates. In particular, the correlation between growth rates of dividends of high and low book-to-market firms is about 32% compared to 75% for returns.

2.5 Time-Varying Premia

Much empirical literature has documented that the premium on the market tends to be higher in recessions than during economic booms. There is, in fact, ample evidence that aggregate stock returns are forecasted by variables that either describe current or predict future

⁶In terms of levels, the average price/dividend ratio is about 27.6 and 43.2 for value and growth firms respectively.

⁷See, for example, Lettau and Wachter (2005).

economic activity (see Keim and Stambaugh (1986), Fama and French (1989), Campbell (1991, 1996) among others). The spread in expected returns on value and growth portfolios displays similar countercyclical fluctuations, especially in the post-war period. Figure 2 illustrates this evidence by plotting expected returns on value-minus-growth strategy along with the realized volatility of consumption. The latter is measured by the 3-year moving average of squared residuals from an AR(1) process fitted to consumption growth data. The value premium is constructed by regressing the spread in realized returns on value and growth firms on lagged price/dividend ratios and dividend growth rates of the two stocks. In order to facilitate the comparison, the measure of consumption uncertainty is rescaled so that it has the same mean and standard deviation as the value premium.⁸ Notice that excluding several episodes in the 1950-60's, the spread in expected returns increases during "bad" times — when the uncertainty about consumption growth is high. On the other hand, during times of low economic uncertainty, investors seem to reverse their expectations of the relative performance of growth and value firms. The correlation between the value premium and the volatility of consumption for the post-war period is about 40%. For comparison, the corresponding correlation for the market risk premium, constructed in an analogous way, is about 37%.

3 The Long-Run Risks Model

To provide a rational explanation for the above-listed stylized features of value and growth data, I adopt the long-run risk model of Bansal and Yaron (2004). The model is built on Epstein and Zin (1989) preferences. These are a generalization of the standard time-separable utility that relaxes the link between risk aversion and the elasticity of intertemporal substitution of a representative investor. Below, I will discuss the importance of this separation; in short, it allows the model to assign distinct nontrivial prices to different sources of systematic risks. Another key ingredient of the model is the assumption that growth rates in the economy are driven by a small but highly persistent component. Shocks to this expected growth component are risks that investors fear the most — although quantitatively small, they have a long-lasting, near permanent effect on future levels of consumption. The amount of low-frequency risks embodied in assets' cash flows, therefore, is a major determinant of compensation in financial markets. In addition, to capture predictable

⁸The pre-war data are not utilized in the estimation in order to purge the impact of few outliers in the first decade of the sample on the forecasted value premium.

variations in the observed risk premia, Bansal and Yaron assume a GARCH-type process for the conditional volatility of consumption and dividend growth rates.

3.1 Epstein-Zin Preferences

The intertemporal marginal rate of substitution (IMRS) in the Epstein-Zin economy is given by

$$M_{t+1} = \delta^\theta (C_{t+1}/C_t)^{-\theta/\psi} R_{c,t+1}^{\theta-1}, \quad (1)$$

where C_t is consumption of a representative agent, $R_{c,t}$ is the return on all invested wealth, $0 < \delta < 1$ reflects the agent's time preferences, γ is the coefficient of risk aversion, $\theta = \frac{1-\gamma}{1-\frac{1}{\psi}}$, and ψ is the elasticity of intertemporal substitution (IES). The equilibrium price of any security i is derived through the standard Euler equation:

$$E_t[M_{t+1}R_{i,t+1}] = 1. \quad (2)$$

Taking the logarithm of (1), the stochastic discount factor can be written as

$$m_{t+1} \equiv \log(M_{t+1}) = \theta \ln \delta - \frac{\theta}{\psi} \Delta c_{t+1} + (\theta - 1)r_{c,t+1}, \quad (3)$$

where Δc_t is consumption growth defined as the first difference of the log consumption, and $r_{c,t} \equiv \log(R_{c,t+1})$. Notice that, in contrast to the time-separable utility, the IMRS of Epstein-Zin preferences depends on the endogenous return on the agent's wealth.⁹ This return represents the return on an asset that delivers aggregate consumption as its dividends each time period. Its distribution, therefore, is determined by the time-series dynamics of consumption growth. Consequently, in the Epstein-Zin setting, predictable variations in all state variables that govern the evolution of consumption over time will affect the current level of marginal utility and will be priced in equilibrium.

3.2 Cash-Flow Growth Rates

It is assumed that the conditional distribution of consumption and dividend growth rates varies over time. Specifically, predictable fluctuations in growth rates are governed by an

⁹In the case of power utility, $\gamma = \frac{1}{\psi}$. Consequently $\theta = 1$, the second term in (3) disappears and the IMRS is solely determined by consumption growth.

AR(1) process x_t , while fluctuations in their second moments are driven by a common variance component σ_t^2 . Let Δd_t denote the growth rate of a given asset's cash flows. The joint dynamics of consumption and dividend growth rates is described as follows,

$$\begin{aligned}
\Delta c_{t+1} &= \mu_c + x_t + \sigma_t \eta_{t+1} \\
\Delta d_{t+1} &= \mu + \phi x_t + \varphi \sigma_t u_{t+1} \\
x_{t+1} &= \rho x_t + \varphi_x \sigma_t \epsilon_{t+1} \\
\sigma_{t+1}^2 &= \sigma^2(1 - \nu) + \nu \sigma_t^2 + \sigma_w w_{t+1} \\
\eta_{t+1}, u_{t+1}, \epsilon_{t+1}, w_{t+1} &\sim iid N(0, 1),
\end{aligned} \tag{4}$$

where μ_c and μ are average growth rates of consumption and dividends, respectively.¹⁰ For simplicity, all shocks are assumed to be orthogonal to each other, except I allow for the contemporaneous correlation between news in realized growth rates of consumption and dividends, which is denoted by $\alpha \equiv Corr(\eta_t, u_t)$. The two state variables, x_t and σ_t^2 , determine the dynamics of the conditional mean and variance of consumption growth, and φ_x and σ_w allow us to calibrate the amount of predictable variation in these moments. Parameter ϕ in the dividend growth equation reflects the degree of leverage on the expected consumption growth, while φ captures the exposure of cash flows to volatility, as well as realized shocks in consumption.

3.3 Solving for Equilibrium Asset Prices

Given the endowment nature of the economy, finding solutions for price/consumption and price/dividend ratios is sufficient to describe equilibrium stock prices and returns. I solve for valuation ratios of consumption- and dividend-paying assets numerically using the quadrature-based method proposed by Tauchen and Hussey (1991). The idea of the method is to approximate the dynamics of the state variables with a discrete Markov chain (details are provided in the Appendix). Asset valuations for each pair of $\{x_t, \sigma_t^2\}$ are then derived by exploiting the Euler condition. The process for the expected growth component is discretized using a 30-point Gauss-Hermite quadrature, and the volatility of consumption growth is assumed to take on 4 possible values.

¹⁰It should be noted that dividend streams of individual firms do not aggregate to the agent's consumption; the discrepancy arises due to labor income and other sources of non-financial wealth.

To highlight the model's intuition, I first discuss some key analytical expressions for the implied moments of asset returns. Quantitative implications of the model based on numerical solutions are presented afterwards.

3.4 Model Intuition

3.4.1 Assets' Valuations

As shown in Bansal and Yaron (2004), approximate analytical solutions for the model can be obtained by recognizing that the log of the price/consumption ratio is approximately linear in the state variables:

$$z_{c,t} \equiv P_t/C_t = A_{c,0} + A_{c,1}x_t + A_{c,2}\sigma_t^2 . \quad (5)$$

The solution coefficients can then be derived by exploiting the Campbell and Shiller (1988b) approximation for the continuously compounded wealth return,

$$r_{c,t+1} = \kappa_{c,0} + \Delta c_{t+1} + \kappa_{c,1}z_{c,t+1} - z_{c,t} , \quad (6)$$

where $\kappa_{c,0}$ and $\kappa_{c,1}$ are constants of linearization, together with the log-linear equivalent of the Euler equation,

$$E_t[\exp(m_{t+1} + r_{c,t+1})] = 1 . \quad (7)$$

In particular,

$$A_{c,1} = \frac{1 - \frac{1}{\psi}}{1 - \kappa_{c,1}\rho} , \quad A_{c,2} = (1 - \gamma) \left(1 - \frac{1}{\psi}\right) \left[\frac{1 + \left(\frac{\kappa_{c,1}\varphi x}{1 - \kappa_{c,1}\rho}\right)^2}{2(1 - \kappa_{c,1}\nu)} \right] . \quad (8)$$

It follows then that the effect of the expected growth component, x_t , on the valuation ratio is positive ($A_{c,1} > 0$) as long as the IES parameter, ψ , is greater than one. Further, if both the IES and risk aversion are greater than one, an increase in economic uncertainty will lower asset valuations. This scenario is consistent with the empirical evidence in Bansal, Khatchatrian, and Yaron (2005) that asset prices fall during times of high consumption uncertainty, which will motivate the choice of preference parameters in the simulation exercise below. Solution coefficients for the valuation ratio of a dividend-paying asset can be derived

analogously.¹¹

3.4.2 Systematic Risks and Their Pricing

The solution in (8) allows us to express the innovation in the pricing kernel in terms of the underlying consumption risks,

$$m_{t+1} - E_t[m_{t+1}] = -\Lambda_\eta \sigma_t \eta_{t+1} - \Lambda_\epsilon \sigma_t \epsilon_{t+1} - \Lambda_w \sigma_w w_{t+1} , \quad (10)$$

where:

$$\begin{aligned} \Lambda_\eta &= \gamma \\ \Lambda_\epsilon &= \left(\gamma - \frac{1}{\psi} \right) \left[\frac{\kappa_{c,1} \varphi_x}{1 - \kappa_{c,1} \rho} \right] \\ \Lambda_w &= (1 - \gamma) \left(\gamma - \frac{1}{\psi} \right) \left[\frac{\kappa_{c,1} \left(1 + \left(\frac{\kappa_{c,1} \varphi_x}{1 - \kappa_{c,1} \rho} \right)^2 \right)}{2 (1 - \kappa_{c,1} \nu)} \right]. \end{aligned} \quad (11)$$

There are three systematic shocks in the economy that, in general, command different risk compensations as shown in (11). The first risk comprises news about the realized growth rate of consumption, η_t . I will refer to these shocks as *short-run* risks since their effect on growth rates is purely transient. In contrast, the impact of expected growth rate shocks extends far beyond the current level of consumption — today’s news about expected growth rates will affect both short- and long-term consumption decisions of the agent. These risks, therefore, are labeled *long-run* risks. Finally, risks related to fluctuations in economic uncertainty are referred to as *volatility* risks.

Notice that, if preferences are constrained to the standard power utility (that sets $\gamma = \frac{1}{\psi}$), risks related to long-term growth and fluctuating economic uncertainty are not reflected in the innovation in the pricing kernel. Shocks in x_t and σ_t^2 still affect valuation ratios, however, in equilibrium, they do not carry a separate risk compensation. By breaking the link between risk aversion and intertemporal substitution, non-expected utility preferences of Epstein and

¹¹In particular,

$$A_{d,1} = \frac{\phi - \frac{1}{\psi}}{1 - \kappa_{d,1} \rho} \quad \text{and} \quad A_{d,2} = \frac{(1 - \theta) A_{c,2} (1 - \kappa_{c,1} \nu) + 0.5 [H_1 + H_2]}{1 - \kappa_{d,1} \nu} , \quad (9)$$

where $H_1 = \gamma^2 + \varphi^2 - 2\gamma\varphi\alpha$, $H_2 = \left[\left((\theta - 1) \kappa_{c,1} A_{c,1} + \kappa_{d,1} A_{d,1} \right) \varphi_x \right]^2$, and $\kappa_{d,1}$ is the parameter of log-linearization for the asset’s return.

Zin allow the model to assign nontrivial distinct prices to all sources of risk. Intuitively, in the time-additive setting, agents are indifferent to when the uncertainty about future consumption is resolved — in essence, they have the same preferences towards all systematic risks, independent of their intertemporal nature. In sharp contrast, investors' concerns in the Epstein and Zin economy critically depend on the time-series properties of various consumption risks. In particular, if $(\gamma - \frac{1}{\psi}) > 0$, agents are highly concerned with long-run growth risks, i.e., risks realized far into the future. The price of low-frequency consumption risks for this configuration of preference parameters, therefore, is positive. Moreover, if the duration of these risks is sufficiently high, the magnitude of the long-run risks compensation may far exceed that for short-run fluctuations in consumption.

3.4.3 Equity and Value Premia in the Model

Given that asset returns and the IMRS are conditionally log-normal, the risk premium on an asset is determined by the conditional covariation of the asset return with the pricing kernel,

$$E_t[r_{t+1} - r_{f,t}] + \frac{\sigma_{r,t}^2}{2} = -Cov_t(m_{t+1}, r_{t+1}) , \quad (12)$$

where $r_{f,t}$ is the risk-free rate, and the second term on the left-hand side is a Jensen's inequality adjustment. Using the solution for the price/dividend ratio, the premium can be expressed in terms of the loadings on each risk factor (the betas) and the corresponding risk prices,

$$E_t[r_{t+1} - r_{f,t}] + \frac{\sigma_{r,t}^2}{2} = \beta_\eta \Lambda_\eta \sigma_t^2 + \beta_\epsilon \Lambda_\epsilon \sigma_t^2 + \beta_w \Lambda_w \sigma_w^2 , \quad (13)$$

where assets' betas with respect to the three risks are determined endogenously by preferences and parameters underlying time-series dynamics of consumption and cash-flow growth rates:

$$\begin{aligned} \beta_\eta &= \varphi \alpha , \\ \beta_\epsilon &= \kappa_{d,1} A_{d,1} \varphi x , \\ \beta_w &= \kappa_{d,1} A_{d,2} . \end{aligned} \quad (14)$$

Expression (13) highlights the importance of the stochastic nature of consumption uncertainty — given that assets' betas are constant, time-variation in the conditional volatility of consumption is the only channel that allows the model to generate time-variation in risk premia.

Let V and G label value and growth stocks, respectively. Using (13), the value premium can be approximately expressed as,

$$E_t[R_{V,t+1} - R_{G,t+1}] \simeq (\beta_{V,\eta} - \beta_{G,\eta})\Lambda_\eta\sigma_t^2 + (\beta_{V,\epsilon} - \beta_{G,\epsilon})\Lambda_\epsilon\sigma_t^2 + (\beta_{V,w} - \beta_{G,w})\Lambda_w\sigma_w^2. \quad (15)$$

Equations (14) and (15) allow us to analyze the contribution of different risks to the cross-sectional spread in risk premia. Notice first that the difference in dividend exposures to short-run risks translates one-for-one into the difference in expected returns, as $\beta_{V,\eta} - \beta_{G,\eta} = \varphi_V\alpha_V - \varphi_G\alpha_G$. In contrast, the cross-sectional heterogeneity in cash-flow loadings on the expected growth component is amplified by the persistence of long-run risks: $\beta_{V,\epsilon} - \beta_{G,\epsilon} \approx \frac{\phi_V - \phi_G}{1 - \rho} \varphi_x$. Even if news about future expected growth in the economy is small ($\varphi_x \ll 1$) but highly persistent (ρ close to 1), a modest difference in dividend exposures to long-run consumption risks may be transmitted into quite a sizeable spread in expected returns. On top of this, the difference in expected rewards for long-run risk-bearing is magnified through the price channel as the price of low-frequency consumption risks, Λ_ϵ , also increases in the permanence parameter ρ .

3.4.4 Second Moments and Cross-Moments of Asset Returns

Predictable variations in systematic risks have an important bearing on the implied properties of second moments and cross-moments of asset returns. If consumption and cash-flow growth were i.i.d., the model would produce constant volatilities of equity returns simply equal to volatilities of dividend growth rates. Similarly, cross-sectional correlations in asset returns would exactly match correlations in asset's cash-flow growth. Both outcomes, however, are fairly inconsistent with the stock market data. First, there is by now vast, irrefutable evidence of time-variation in conditional volatilities of financial returns (see, for example, Bollerslev, Chou, and Kroner (1992)). Second, as discussed in Section 2.4, empirical second moments and cross-moments of asset returns are significantly higher than the corresponding moments of dividend growth rates. These features of the data are easily accommodated once the i.i.d. assumption is relaxed. While persistent changes in expected growth rates allow the model to resolve the volatility and partially address the cross-correlation puzzles, the channel of fluctuating economic uncertainty is required to further justify high cross-sectional correlations in asset returns and account for the time-varying volatility of stock returns. The intuition behind the first effect is revealed by expression (9). Shocks to the persistent expected growth component lead to a significant revision in agents'

expectations of future economic growth and, consequently, result in large elasticity of stock prices with respect to growth rate news. Further, time-varying uncertainty about future growth prospects introduces an additional common source of risks in asset prices leading to more pronounced co-movements in ex-post assets' returns.

4 Calibration of the Model

To examine the ability of the model to quantitatively account for various phenomena of value, growth and market prices and returns, I solve it numerically for a chosen configuration of preference and time-series parameters.

I calibrate the model at a monthly frequency but evaluate its implications for the time-averaged annual data. This approach is consistent with the calibration exercises in Bansal and Yaron (2004), Campbell and Cochrane (1999) and Kandel and Stambaugh (1991), who likewise aim to match various features of annual data but assume that the decision interval of the agent is one month.¹² I simulate 74×12 months of artificial consumption and dividend data (growth rates and levels) from the model. This corresponds to 74 years in the targeted sample discussed in Section 2.1. Simulated monthly observations are then aggregated to an annual frequency to calculate the implied annual moments of interest. I repeat this exercise 1000 times and report the empirical distribution of the estimated statistics.

The calibration of preferences is similar to Bansal and Yaron (2004). In particular, time-discount factor of the agent is set to 0.999, risk aversion and elasticity of intertemporal substitution are set to 10 and 1.5 respectively.¹³ Values of time series parameters, reported in Table II, are chosen so as to capture various aspects of observed consumption and dividend data. I first motivate the choice of parameters that describe time-series dynamics

¹²To avoid the effect of time-aggregation, one might prefer to test the model using the data sampled on the same frequency as the assumed decision interval of the agent. This, however, is not feasible as monthly data for the pre-1959 aggregate consumption are not available. Furthermore, the strong seasonality of monthly dividends makes data sampled on a finer than an annual basis less desirable.

¹³The magnitude of the IES parameter has long been a subject of controversy in the financial literature. Hansen and Singleton (1982), Attanasio and Vissing-Jørgensen (2003), and Guvenen (2005) estimate it above 1, whereas Hall (1988) and Campbell (1999) advocate for much lower values of intertemporal substitution. However, as argued in Bansal and Yaron (2004), Hall and Campbell's estimates may suffer a significant downward bias since their models ignore possible fluctuations in the conditional volatility of consumption. Further, as revealed by solution (8), small values of the IES parameter would imply a negative response of the price of consumption claim to good growth prospects, and coupled with the risk aversion coefficient above 1, would lead to a positive elasticity of prices with respect to volatility shocks. To rule out these counterintuitive and counterfactual outcomes, the IES parameter is chosen to be greater than 1.

of consumption growth and then provide details and empirical validation for the calibration of the cross-section of assets' cash flows.

4.1 Consumption Growth

4.1.1 Motivation and Empirical Support

It is quite common in the literature to assume that consumption growth is simply an i.i.d. process (e.g., Campbell and Cochrane (1999), Barberis, Huang, and Santos (2001)). This paper departs from the i.i.d. assumption and argues that long-run predictability of growth rates is essential for the model to quantitatively replicate a wide spectrum of time-series and cross-sectional asset market phenomena. It is, therefore, legitimate to ask whether the presumption of time-varying expected growth rates is consistent with the observed data. This issue has been carefully examined in a number of recent studies including Bansal and Yaron (2000), Hansen, Heaton, and Li (2005), and Bansal, Gallant, and Tauchen (2004). Exploring different econometric techniques, these papers provide pervasive empirical evidence that there is indeed an important low-frequency component that helps account for the variation in realized growth of consumption. This is illustrated in Figure 3 that plots two estimates of the spectral density of consumption growth: a parametric one, constructed by fitting an ARMA(1,1) process to the observed data (thin line),¹⁴ and a more flexible non-parametric estimate based on the Bartlett kernel (thick line). If consumption growth were i.i.d., the spectral density would be constant across all the frequencies. Figure 3, however reveals that the spectral density of consumption growth exhibits a pronounced peak at frequencies close to zero. In fact, the contribution to the sample variance of consumption growth of low-frequency component is several times larger than the contribution of fluctuations at higher (business cycles) frequencies. The i.i.d. assumption is further rejected in Bansal and Yaron (2004), and Bansal, Khatchatrian, and Yaron (2005), who document time-variation in realized volatility of consumption growth and show that it is significantly predicted by past price/dividend ratios.¹⁵ Taken together, this evidence suggests that specification of consumption growth that incorporates long-run predictability in the first two moments provides a much more adequate description of the underlying transitional dynamics of consumption data than does a simplistic i.i.d. model.

¹⁴An ARMA(1,1) specification is nested in (4) as a special case when $\eta_t \equiv \epsilon_t$.

¹⁵Earlier evidence on time-varying volatility of consumption growth is presented in Kandel and Stambaugh (1990).

4.1.2 Calibration of Consumption Growth

The dynamics of monthly consumption in equation (4) is calibrated so that the implied moments of annual growth rates match the corresponding statistics of actual consumption data. I set the unconditional mean and standard deviation of monthly growth rates equal to 0.0015 and 0.0064, respectively. The conditional mean of consumption growth is assumed to be fairly persistent ($\rho = 0.98$), but the amount of predictable variation in consumption growth is quite small ($\varphi_x = 0.032$). In particular, this configuration implies that, on a monthly basis, the variation in expected consumption growth accounts for less than 3% of the overall variation in realized consumption growth. I further assume that the volatility of consumption growth changes slowly over time by setting the autoregressive coefficient in the variance dynamics to 0.99. Finally, I choose σ_w so as to approximately match the volatility of volatility of annual consumption growth. It should be pointed out, though, that this parameter is quite difficult to calibrate since the variation in the conditional volatility of consumption is hardly detectable once that data are time-averaged to an annual frequency.¹⁶

4.1.3 Implied Consumption Dynamics

To assess how well the calibrated model is able to capture time-series properties of annual consumption data, Table III presents the empirical distribution of various annual statistics computed from the simulated data. To facilitate the comparison, the first two columns report the corresponding statistics estimated from the actual data along with their robust standard errors. As the table shows, the distribution of the first two moments of consumption growth is well centered around data estimates. In particular, the volatility of consumption growth implied by the model is 2.16% compared to 2.20% in the data. The first and the second-order autocorrelations of annual consumption growth in the sample are about 0.44 and 0.16, respectively. Both values are easily replicated by the model. Higher order serial correlations are statistically negligible in both the data and simulations.

4.2 Dividend Growth

I consider a small cross-section of assets consisting of growth and value stocks. To reiterate, I use terms “growth” and “value” to refer to the extreme (low and high) book-to-market

¹⁶Overall, the calibration of consumption growth is consistent with Bansal and Yaron (2004), and Bansal, Gallant, and Tauchen (2004).

sorted portfolios. In addition, in order to evaluate the model’s implications for the standard CAPM betas and to ensure that it can account for the equity premium, I also calibrate the dynamics of the aggregate market portfolio.¹⁷ I first report the chosen parameter values and evaluate the implied moments of annual dividend growth rates. After that, I will discuss in detail empirical evidence that motivates the calibration of firms’ cash flows.

4.2.1 Calibration of Dividend Growth Rates

The calibration, details of which are provided in the bottom panel of Table II, is performed so as to match key unconditional moments of annual growth rates, as well as to replicate the degree of consumption leverage of assets’ dividends identified in the data. The unconditional means of monthly growth rates, μ ’s, are chosen to ensure that implied annual average growth rates match their data counterparts. The loading on the expected growth component, ϕ , is calibrated at 2.6 for growth stock, 6.2 for value stock and 2.8 for the market. The two remaining parameters, φ and α , govern the exposure of dividends to high-frequency consumption risks and risks arising from fluctuating economic uncertainty. I assign a somewhat higher value to φ_{Growth} (= 8.4) and correspondingly lower values to φ_{Value} (= 7.4) and φ_{Market} (= 7.5). The correlation between realized consumption and dividend news is set to 0.27, 0.15 and 0.55 for growth, value and the market portfolios, respectively. As shown below, the choice of α ’s allows the model to replicate sample correlations in annual growth rates of consumption and assets’ cash flows. Finally, to adequately capture the correlation in realized growth rates across assets, I allow for the contemporaneous correlation in idiosyncratic dividend news. The correlation between dividend shocks orthogonal to realized news in consumption is set to 0.20 for growth and value assets, 0.80 for growth and the market portfolio, and 0.45 for value and aggregate market.¹⁸

¹⁷As explained in Section 2.1, the calibration is performed with respect to the *per-share* dividend series. These do not account for equity repurchases and issuances and, therefore, may be very different from aggregate payouts. Consequently, assets’ per-share dividends do not sum up to those of the market. For the same reason, average growth rates of per-share dividends may vary across portfolios. This, however, does not necessarily imply that a firm with the highest mean growth overtakes the whole economy in the long run as the construction of the per-share dividend series ignores the dynamics of firms’ capital. See Bansal and Yaron (2005) for a detailed discussion of the differences between per-share and aggregate dividends.

¹⁸It should be noted that the number of targeted data moments is much higher than the total number of calibrated time-series parameters.

4.2.2 Implied Dynamics of Assets' Cash Flows

Table IV reports the implied moments of time-averaged dividend growth rates along with their counterparts computed from the data. Overall, the model has no difficulties in capturing time-series properties of annual growth rates. There is one exception, however. The model generates somewhat excessive serial correlation in growth rates, especially for value stocks. High first-order autocorrelation emerges as a result of the assumed high loading of value dividends on the persistent growth component. The conditional variation in x is quite small, so that the amount of predictable variation in monthly cash-flow growth is almost negligible. In particular, the implied predictability of monthly growth rates (i.e., R^2) is equal to about 1.7% for value stock and essentially zero for the other two assets. However, once the data are aggregated to lower frequencies, the effect of realized dividend news diminishes due to its transitory nature, whereas the impact of long-lasting expected growth shocks strengthens, leading to a much more pronounced predictability of time-averaged growth rates. A modification of dividend growth dynamics that allows for time-dependencies in realized dividend innovations may help the model lower the degree of serial correlation in simulated annual data. This, however, would require the introduction of an additional state variable. Notice that, although the first-order autoregressive parameters for growth and value stocks are not matched on average, their point estimates are still within the 95% confidence interval of the empirical distribution implied by the model. All the other moments are matched quite well, including the correlation between cash-flow and consumption growth rates. The model reproduces the same consumption-dividend correlation pattern as in the data with the market portfolio having the highest correlation, followed by value and growth assets. In addition, the model is able to match cross-sectional sample correlations of assets' growth rates. As illustrated in Table V, cash flows of growth and market portfolios move quite closely over time — the correlation coefficient between their growth rates is about 80% in the data and in the model. In contrast, cash-flows of value firms are much less related to the time series of market and growth dividends. The correlation between value-market and value-growth growth rates is 50% and about 30%, respectively.

4.2.3 Risks Exposures: Motivation and Empirical Support

This section discusses the heterogeneity in intertemporal risk properties of value and growth cash flows. I document that in the data, value firms exhibit higher exposure to persistent consumption news, whereas growth firms load more strongly on short-run and discount-rate

risks. I further show that the calibration of assets' cash flows in the model takes into account this important empirical evidence.

Long-Run Risk Exposures

I measure the exposure of a firm's dividends to long-run consumption risks by the projection coefficient from regressing cash-flow growth rates on the moving average of lagged consumption growth, i.e.,

$$\Delta d_t = d_0 + \tilde{\phi} \sum_{k=1}^K \Delta c_{t-k} + \varepsilon_t . \quad (16)$$

Consumption growth is smoothed over the previous two years ($K = 2$) in order to capture risks related to low-frequency (rather than short-term) fluctuations in consumption. Regression results, reported in the top panel of Table VI, show that cash flows of value stocks are tightly linked to persistent fluctuations in aggregate consumption, whereas dividends paid by growth firms show virtually no long-run relation with consumption. The point estimate for high book-to-market stocks is equal to 2.16 compared to -0.38 for low book-to-market firms. This pattern is consistent with the evidence in Bansal, Dittmar, and Lundblad (2001, 2005), Hansen, Heaton, and Li (2004), and Bansal, Dittmar, and Kiku (2005), who similarly find that the amount of low-frequency (or permanent) consumption risks increases in the book-to-market characteristic.

Although the economic story behind this empirical finding cannot be offered within this endogenous economy, one possible interpretation may arise from the differences in the capital structure of low and high book-to-market firms. It is quite natural to think of value firms as mature, physical capital-intensive firms. As such, value firms contribute a lot to aggregate quantities, such as income and consumption, and fundamentally determine the long-run evolution (thus, long-run risk) at the aggregate level. The capital structure of growth firms, on the other hand, is tilted towards intangible capital, whose risk is largely dominated by firm-specific factors that do not necessarily reflect the current state of the economy. Consequently, growth firms are expected to exhibit much smaller exposure to persistent consumption fluctuations. Alternatively, the cross-sectional heterogeneity in aggregate risks could emerge inside production economies with nonlinear adjustment costs as argued in Kyle (2004) and Zhang (2005). In particular, Zhang (2005) considers an economy where firms face higher cost of reducing than expanding capital. In his model, costly reversibility limits the ability of value firms to adjust their cash flows to technological shocks. Dividends paid out by value firms, therefore, strongly covary with aggregate output. Growth firms, on the

other hand, are less constrained in smoothing their dividends over time as they have more incentives to invest than disinvest, and expanding capital is relatively cheap. Consequently, their dividends have much lower exposure to aggregate shocks.

The leverage parameter ϕ for growth, value and market assets in the model is chosen so as to capture the documented cross-sectional dispersion in long-run risk exposures. The Model panel of Table VI reports projection coefficients from equation (16) estimated using time-averaged simulated data. Long-run risk loadings implied by the model exhibit the same cross-sectional pattern and magnitude as in the data, confirming the calibration of this dimension of firms' dynamics.

Short-Run and Volatility Risks

The bottom panel of Table VI shows cash-flow exposures to short-run consumption risks and risks related to fluctuating economic uncertainty. These loadings are estimated by the correlation coefficient between residuals from regression (16) and contemporaneous innovations in consumption. The latter are computed by filtering consumption growth data through an AR(1) process. As expected in the data, and in the model, the market portfolio has the highest exposure to realized consumption shocks. Cash flows of value and growth firms seem to be less sensitive to contemporaneous news in consumption. This is not surprising as innovations in individual asset dividends are also driven by idiosyncratic news not related to aggregate consumption news. Between the two, growth firms have somewhat higher exposure to innovation risks. In the model, the innovation correlation for growth and value firms is centered around 0.33 and 0.28, respectively, which is quite comparable to 0.37 and 0.30 estimated in the data.

5 Asset Pricing Implications

Table VII presents key asset pricing implications of the model — expected returns, standard deviations and log price/dividend ratios for value and growth firms. In addition, it reports the corresponding statistics for the aggregate stock market portfolio.

5.1 The Unconditional Value Premium

The average return on growth stocks implied by the model is about 6.1%, while for value stocks it is about 11.4% per annum. Consequently, the model-implied value premium is about 5.3%, which is fairly comparable to 6.1% observed in the data. Further, consistent with empirical evidence, the model implies that value firms have higher Sharpe ratio than do firms with low book-to-market characteristics. In particular, the Sharpe ratio, across simulations, averages about 0.34 for value stocks versus only 0.20 for growth assets.

What drives the value premium in the model? As discussed in Section 3, assets are subject to three types of systematic risks. Risks that investors dislike the most and, therefore, demand higher reward for, are risks related to the long-run growth in the economy. Consequently, the risk premium on any asset is largely determined by its exposure to low-frequency fluctuations in consumption. Consistent with the data, value stocks in the model load more strongly on the persistent growth component, and, therefore, have to provide investors with high ex-ante compensation. In contrast, growth firms have higher exposure to realized consumption news and risks related to fluctuating economic uncertainty. This, however, does not quantitatively outweigh the effect of low-frequency risks. As discussed in Bansal (2004), the magnitude of prices assigned to short-run and volatility shocks is much lower than that for slow-moving fluctuations in consumption. This is quite intuitive. First, investors require quite modest compensation for transitory consumption risks since these do not alter growth prospects in the economy. Second, an increase in economic uncertainty raises the cost of capital and lowers asset valuations (as future cash flows are now discounted at a higher rate). The decrease in wealth, however, gets partially compensated by improved future opportunities. As the result of these offsetting forces, the volatility-risk premium does not quantitatively exceed that for low-frequency risks in consumption.

The contribution of each source of risk to the value premium can be roughly quantified using the approximate analytical solutions. I find that about 85% of the value spread is attributed to the value-growth dispersion in long-run consumption risks, about -10% is due to the difference in loadings on short-run risks, and the remaining 25% is due to the dispersion in volatility risks.¹⁹ Thus, it is the differential exposure to low-frequency consumption risks that plays the key role in accounting for the extra premium on value relative to growth stocks.

¹⁹In other words, the overall value premium can be approximately decomposed as $5.3\% \approx -0.6\% + 4.6\% + 1.3\%$, where the three components represent the contribution of short-, long-run and volatility risk, respectively (see equation (15)).

5.2 Valuations of Value and Growth Firms

The bottom panel of Table VII shows that the model is also able to capture the observed differences in assets' price/dividend ratios. Consistent with the data, growth stocks, on average, have significantly higher ratios of prices to fundamentals than value stocks. The mean of the log valuation ratio across simulations is about 3.61 for growth stocks and only 3.25 for value stocks. Notice that, in the model as in the data, value firms, on average, have substantially higher growth rate of dividends than the other two assets. Value strategies, however, are perceived by investors as quite risky, especially in the long run, since cash flows of value firms are tightly linked to persistent fluctuations in consumption. The future expected flow of their dividends is therefore discounted at a relatively high rate leading to low present values. Investing in growth firms, on the other hand, is considered less risky as the variation of their cash flows is dominated by idiosyncratic and transient news rather than long-lasting aggregate shocks. Hence, investors are willing to buy growth stocks at prices that are fairly high relative to current dividends, even despite their low average growth.

As in the data, the model-implied price/dividend ratios are highly persistent. The first-order autocorrelation coefficient ranges from 0.78 for value asset to 0.89 for growth and market equities. The variation in assets' valuation ratios in the model is mostly driven by the variation in expected cash-flow growth rather than discount rates. In particular, the fraction of variance of price/dividend ratios due to fluctuations in expected returns, on average, is equal to about 0.18 for growth and 0.22 for value stocks. Although these are somewhat lower than the corresponding quantities in the data, these statistics should be treated with great caution as their standard deviations across simulations are very large, as well as is the uncertainty in data estimates.

5.3 Violation of the CAPM and C-CAPM

In the model, as in the data, both the CAPM and the C-CAPM fail to explain the difference in risk premia on value and growth assets. The model-implied market beta of value stocks, on average, is lower than that for growth stocks. Similarly, high book-to-market firms have lower correlation of their returns with contemporaneous consumption growth relative to growth firms. Table VIII reports the ratio of the CAPM betas of value and growth firms, $\beta_{\text{Value}}/\beta_{\text{Growth}}$, and the corresponding ratio of their consumption betas. Both quantities fall well below one; the first equals 0.92, while the second is about 0.85. What allows the model

to encompass the violation of the standard betas? As discussed above, the risk premium on an asset is determined by the asset's betas with respect to the three consumption risks (short-run, long-run risks and risks related to fluctuating economic uncertainty), each one of which carries a separate compensation. Once the model is compressed to a one-factor model, such as the CAPM or C-CAPM, this important risk pricing information gets entirely distorted. While the risk premium arises largely as a reward for long-run risks bearing, a single risk-measure is dominated by high-frequency properties of assets' cash flows and, therefore, fails to account for the cross-sectional differences in average returns.²⁰

5.4 Volatilities and Correlations of Assets' Returns

The model also correctly predicts the spread in return volatilities as shown in Table VII. The standard deviation of low book-to-market returns is about 10% smaller than that for firms with high book-to-market characteristics; the implied volatility of the market portfolio matches that in the data.

As discussed in Section 2.4, the correlation in realized value and growth returns is significantly larger than the correlation in assets' dividend growth rates. This also holds for value-market and growth-market pairs of assets. Table IX examines the model's ability to account for these differences in correlation structures of firms' cash flows and returns. The contemporaneous correlation between high and low book-to-market returns in the model is centered around 44%. Although this is much smaller than 75% in the data, the model makes an important step towards capturing the gap between dividend and return dynamics in the cross-section. Recall that inside the model, the correlation in cash-flow growth rates of value and growth firms is about 30%. This figure is amplified to a significantly higher 44%. Similarly, the model-implied correlations between value-market and growth-market returns are larger than correlations in their dividend growth rates. This magnification is primarily carried through the channel of time-varying economic uncertainty. Predictable shifts in future discount rates introduce an additional source of common variation in asset prices, inducing higher covariation in ex-post returns across assets.

²⁰Recently, Santos and Veronesi (2005) argue that a representative agent model based on habit-formation preferences is also able to generate the violation of the CAPM. Indeed, the CAPM formally does not hold in their set-up (due to general equilibrium restrictions imposed on the market risk premium), however, the model-implied market betas still line up with average returns. In fact, the CAPM betas inside their model account for quite a sizable portion of the cross-sectional variation in mean returns, which is hard to reconcile with the lacking performance of the CAPM in the data.

5.5 Conditional Value Premia

The long-run risks model implies that the value premium (as well as the market-equity premium) rises during times of high economic uncertainty and shrinks in “good” times. In order to quantitatively assess this implication, I simulate 1000 years of monthly data, aggregate this artificial sample to an annual frequency and use it to estimate the volatility of consumption growth and the value premium in the same way as has been done in Section 2.5 for the observed data. Specifically, I fit an AR(1) process to annualized consumption growth and construct a measure of realized consumption volatility by averaging the AR(1) squared residuals over the previous 3 years. The value premium is estimated by regressing the value-growth spread in simulated annual returns on lagged price/dividend ratios and dividend growth rates of the two assets. Figure 4 plots the model-implied value premium along with the implied volatility of consumption. Consistent with empirical evidence illustrated previously in Figure 2, the model-implied spread between expected returns on value and growth firms exhibits countercyclical fluctuations. The correlation between the value premium and realized consumption volatility in the model is equal to 36%. For the market-equity premium this correlation is about 32%. Both numbers are quite close to the post-war data estimates — 40% and 37% for the value and aggregate equity premia, respectively.

5.6 Predictability Evidence

Price/dividend ratios in the model are negatively related to future asset returns, especially at long investment horizons. This is in line with empirical evidence on return predictability in Campbell and Shiller (1988b, 1988a), Fama and French (1988) and Hodrick (1992). The left set of columns of Table X reports estimated projection coefficients and adjusted- R^2 's from regressing 1- and 5-year ahead returns on the log of current price/dividend ratios for each asset. The two right columns present the corresponding estimates averaged over simulated samples. The model-implied slope coefficients are negative and increase in magnitude as the horizon lengthens. As in the data, the predictive power of price/dividend ratios seems to improve with the horizon. The magnitude of both R^2 and regression coefficients in the model, though, is somewhat smaller than in the data. However, given the high degree of uncertainty in point estimates and R^2 's, I find that the model performs quite well in

addressing this dimension of the data.²¹

6 Conclusions

To summarize, this paper emphasizes the importance of intertemporal, specifically long-run, properties of assets' cash flows for understanding various stylized features of asset market data along both time-series and cross-sectional dimensions. The empirical investigation focuses on two stocks — value and growth portfolios, and relies on the model of Bansal and Yaron (2004) that incorporates long-run consumption risks within the Epstein-Zin utility specification. I show that when growth rate dynamics are calibrated so as to fit the time-series behavior of consumption and firms' cash flows, the model is able to quantitatively replicate differences in average returns, price/dividend and Sharpe ratios of value and growth firms, the high premium on the market and the low risk-free rate, high volatilities and correlations of stock returns, as well as to capture countercyclical variation in the market-equity and value premia.

I argue that the value premium is largely driven by the cross-sectional differences in long-run consumption risks in assets' cash flows. In the model, as in the data, value firms exhibit high exposure to low-frequency fluctuations in aggregate consumption, and, therefore, have to provide investors with high ex-ante compensation. Growth firms, on the other hand, carry a significantly smaller premium as their cash flows are less sensitive to persistent aggregate risks. The paper thereby provides a rational explanation of the observed value premium, which traditional CAPM and C-CAPM frameworks have failed to accomplish. Importantly, I show that the model is able to accommodate the empirical failure of the standard betas, resolving the puzzle.

²¹As already shown in Bansal and Yaron (2004), the model does an excellent job in capturing the dynamics of the overall equity market and the riskless asset. In particular (see Table VII), the average return on the market portfolio over the risk-free rate, in the model, is about 6% per annum, which is reasonably close to the observed market premium. The average risk-free rate across simulations is about 1.58% and the model-implied volatility of the interest rate is about 0.90%, compared to 1.22% in the data. Both the mean and the volatility of the risk-free rate depend on the elasticity of intertemporal substitution. Increasing the IES would help further lower the level of the interest rate; however, it would also decrease its variability. The chosen value of the IES parameter seems a reasonable compromise between these two ends.

Appendix: Quadrature Approximation

The model is solved using the method of Tauchen and Hussey (1991), based on a discrete approximation of the conditional density of a continuous stochastic process. To illustrate the method, consider a continuous random variable y with the law of motion given by the density $f(y|x)$ conditional on the observed history of y ,

$$1 = \int f(y|x)dy , \quad (17)$$

where x denotes the set of conditioning values. The objective is obtain an “equivalent” discrete representation of y . Consider the following transformation of (17),

$$1 = \int f(y|x)dy = \int \frac{f(y|x)}{\omega(y)} \omega(y)dy , \quad (18)$$

where ω is some strictly positive weighting function. This integral can now be approximated with a finite sum,

$$1 \approx \sum_{k=1}^N \frac{f(y_k|x)}{\omega(y_k)} w_k = \sum_{k=1}^N \pi(y_k|x) , \quad (19)$$

where y_k and w_k are the nodes and the weights of an N -point quadrature rule for the density $\omega(y)$, and

$$\pi(y_k|x) = \frac{f(y_k|x)}{\omega(y_k)} w_k . \quad (20)$$

The nodes and weights are chosen in such a way that the approximation is exact when the function $F(y|x) \equiv \frac{f(y|x)}{\omega(y)}$ is a polynomial of order $(2N - 1)$. Notice that expression (19) implies that $\pi(y_k|x)$ is an estimate of the transitional probability from the current state $x = \{y_j\}$ to state y_k . However, since the quadrature is just an approximation, $\pi(y_k|x)$ may not necessarily sum up to 1. To facilitate the interpretation, Tauchen and Hussey (1991) propose re-normalizing $\pi(y_k|x)$,

$$\tilde{\pi}(y_k|x) = \frac{\pi(y_k|x)}{s(x)} , \quad s(x) = \sum_{k=1}^N \pi(y_k|x) , \quad (21)$$

so that $\sum_{k=1}^N \tilde{\pi}(y_k|x) = 1$. This now allows us to interpret $\{y_k, \tilde{\pi}(y_k|x)\}_{k=1}^N$ as a Markov chain that approximates the continuous process y .

The accuracy of the approximation hinges on several important issues. The first one involves the weighting function ω . Although different alternatives are plausible, in the empirical work I use $\omega(y) = f(y|\bar{y})$, where \bar{y} is the unconditional mean of the process. As argued in Tauchen and Hussey (1991) this choice, in general, allows to achieve a high quality of approximation. Another pertinent issue concerns the choice of N . There is, however, no common rule as to how many grid points

to use to attain a desired level of accuracy. The optimal N depends on dynamic properties of the process that is discretized and should be chosen in each case individually.

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Table I
Summary Statistics

Panel A: MEANS / VOLATILITIES

	Returns		Div. Growth		Log(P/D)
	Mean	StDev	Mean	StDev	Mean
Growth	7.81 (1.98)	20.2 (2.00)	0.68 (1.25)	13.9 (2.24)	3.61 (0.18)
Value	13.88 (1.74)	29.9 (4.34)	3.63 (3.06)	18.1 (2.69)	3.25 (0.12)
Market	8.56 (1.79)	20.1 (2.23)	0.85 (0.95)	10.9 (2.41)	3.34 (0.13)

Panel B: CORRELATIONS

	Returns			Dividend Growth		
	Growth	Value	Market	Growth	Value	Market
Growth	1			1		
Value	0.75 (0.05)	1		0.32 (0.17)	1	
Market	0.95 (0.01)	0.87 (0.04)	1	0.80 (0.09)	0.53 (0.10)	1

Table I presents descriptive statistics for returns, dividend growth rates and logarithms of price/dividend ratios on value and growth firms, and the aggregate stock market. Value firms represent companies in the highest book-to-market quintile of all NYSE, AMEX and NASDAQ firms. Growth firms correspond to the lowest book-to-market quintile. Returns are value-weighted, price/dividend ratios are constructed by dividing the end-of-year price by the cumulative annual dividend, growth rates are constructed by taking the first difference of the logarithm of dividend series. All data are annual, expressed in real terms, and cover the period from 1930 to 2003. Panel A reports means and standard deviations. Panel B presents the correlation structure of returns and cash-flow growth rates for the three stocks. Robust standard errors, reported in parentheses, are calculated using the Newey-West variance-covariance estimator with 8 lags.

Table II
Model Parameters

PREFERENCES					
δ	γ	ψ			
0.999	10	1.5			

CONSUMPTION					
μ	ρ	φ_x	σ	ν	σ_w
0.0015	0.98	0.032	0.0064	0.99	0.0000017

DIVIDENDS				
	μ_i	ϕ_i	φ_i	α_i
Growth	0.0009	2.6	8.4	0.27
Value	0.0019	6.2	7.4	0.15
Market	0.0012	2.8	7.5	0.55

Table II reports the chosen configuration of preferences: the time-discount factor δ , the coefficient of risk aversion γ , the elasticity of intertemporal substitution ψ , along with time-series parameters of the model:

$$\begin{aligned} \Delta c_{t+1} &= \mu_c + x_t + \sigma_t \eta_{t+1} \\ x_{t+1} &= \rho x_t + \varphi_x \sigma_t \epsilon_{t+1} \\ \sigma_{t+1}^2 &= \sigma^2(1 - \nu) + \nu \sigma_t^2 + \sigma_w w_{t+1} \\ \Delta d_{i,t+1} &= \mu_i + \phi_i x_t + \varphi_i \sigma_t u_{i,t+1} \\ \alpha_i &= Cov(\eta, u_i) \\ i &= \{Growth, Value, Market\} \end{aligned}$$

The calibration of preferences and consumption dynamics is similar to Bansal and Yaron (2004).

Table III
Consumption Growth Dynamics

Statistic	— Data —	— Model —
$E[\Delta c]$	1.96 (0.32)	1.86 (0.64)
$\sigma(\Delta c)$	2.20 (0.45)	2.16 (0.48)
$AC(1)$	0.44 (0.12)	0.43 (0.12)
$AC(2)$	0.16 (0.15)	0.20 (0.15)

Table III reports various moments of annual consumption growth implied by the model and from the data. $E[\Delta c]$ and $\sigma(\Delta c)$ are the mean and the volatility of consumption growth, $AC(1)$ and $AC(2)$ are the 1st and 2nd-order autocorrelation coefficients. Consumption data, taken from the BEA, are real, annual per-capita expenditure of nondurables and services that cover the period from 1930 to 2003. Growth rates are constructed by taking the first difference of the logarithm of consumption. Robust standard errors of data estimates, reported in parentheses, are calculated using the Newey-West variance-covariance estimator with 8 lags. Model-implied statistics are based on 1000 simulated samples, each with 74×12 monthly observations, aggregated to an annual frequency. The entries in the Model column represent means and standard deviations (in parentheses) of the corresponding statistics across simulations.

Table IV
Dividend Growth Rates Dynamics

Asset	Statistic	— Data —	— Model —
Growth	$E[\Delta d]$	0.68 (1.25)	1.05 (2.63)
	$\sigma(\Delta d)$	13.9 (2.24)	14.1 (3.37)
	$AC(1)$	0.08 (0.14)	0.19 (0.13)
	$Corr(\Delta c, \Delta d)$	0.33 (0.14)	0.33 (0.13)
Value	$E[\Delta d]$	3.63 (3.06)	2.38 (3.83)
	$\sigma(\Delta d)$	18.1 (2.69)	15.2 (3.15)
	$AC(1)$	0.06 (0.16)	0.29 (0.14)
	$Corr(\Delta c, \Delta d)$	0.42 (0.06)	0.38 (0.13)
Market	$E[\Delta d]$	0.85 (0.95)	1.51 (2.50)
	$\sigma(\Delta d)$	10.9 (2.41)	13.2 (3.36)
	$AC(1)$	0.18 (0.13)	0.20 (0.13)
	$Corr(\Delta c, \Delta d)$	0.59 (0.16)	0.57 (0.10)

Table IV reports various moments of annual dividend growth of value and growth firms, and the aggregate market implied by the model and from the data. $E[\Delta d]$ and $\sigma(\Delta d)$ are the mean and the volatility of dividend growth, $AC(1)$ is the 1st-order autocorrelation, and $Corr(\Delta c, \Delta d)$ denotes the correlation between dividend and consumption growth rates. Value firms represent companies in the highest book-to-market quintile of all NYSE, AMEX and NASDAQ firms. Growth firms correspond to the lowest book-to-market quintile. Consumption data, taken from the BEA, are per-capita expenditure of nondurables and services. All data are annual, expressed in real terms, and cover the period from 1930 to 2003. Growth rates are constructed by taking the first difference of the logarithm of dividend and consumption series. Robust standard errors of data estimates, reported in parentheses, are calculated using the Newey-West variance-covariance estimator with 8 lags. Model-implied statistics are based on 1000 simulated samples, each with 74×12 monthly observations, aggregated to an annual frequency. The entries in the Model column represent means and standard deviations (in parentheses) of the corresponding statistics across simulations.

Table V
Cross-Correlations in Dividend Growth Rates

	Data			Model		
	Growth	Value	Market	Growth	Value	Market
Growth	1			1		
Value	0.32 (0.17)	1		0.31 (0.14)	1	
Market	0.80 (0.09)	0.53 (0.10)	1	0.80 (0.06)	0.50 (0.16)	1

Table V reports pair-wise correlations between dividend growth rates of value and growth firms, and the aggregate market implied by the model and from the data. Value firms represent companies in the highest book-to-market quintile of all NYSE, AMEX and NASDAQ firms. Growth firms correspond to the lowest book-to-market quintile. The data are annual, expressed in real terms, and cover the period from 1930 to 2003. Growth rates are constructed by taking the first difference of the logarithm of dividend series. Robust standard errors of data estimates, reported in parentheses, are calculated using the Newey-West variance-covariance estimator with 8 lags. Model-implied statistics are based on 1000 simulated samples, each with 74×12 monthly observations, aggregated to an annual frequency. The entries in the Model panel represent means and standard deviations (in parentheses) of the corresponding statistics across simulations.

Table VI
Risks Exposures

Panel A

DIVIDEND EXPOSURES TO LONG-RUN RISKS

Asset	— Data —	— Model —
Growth	-0.38 (1.34)	1.01 (1.41)
Value	2.16 (1.44)	2.43 (1.29)
Market	0.66 (1.20)	1.19 (1.35)

Panel B

DIVIDEND EXPOSURES TO INNOVATION RISKS

Asset	— Data —	— Model —
Growth	0.37 (0.14)	0.33 (0.14)
Value	0.30 (0.07)	0.28 (0.13)
Market	0.58 (0.15)	0.53 (0.11)

Table VI presents risk exposures of value and growth firms, and the aggregate market estimated from the data along with the corresponding estimates implied by the model. Panel A reports estimated projection coefficients from regressing the growth rate of dividends on the two-year moving average of past consumption growth, i.e.,

$$\Delta d_t = d_0 + \tilde{\phi} \sum_{k=1}^2 \Delta c_{t-k} + \varepsilon_t.$$

Panel B presents the correlation between dividend innovations from the above regression with the contemporaneous news in consumption growth, computed by fitting an AR(1) process to consumption growth. Value firms represent companies in the highest book-to-market quintile of all NYSE, AMEX and NASDAQ firms. Growth firms correspond to the lowest book-to-market quintile. Consumption data, taken from the BEA, are per-capita expenditure of nondurables and services. All data are annual, expressed in real terms, and cover the period from 1930 to 2003. Growth rates are constructed by taking the first difference of the logarithm of dividend and consumption series. Robust standard errors of data estimates, reported in parentheses, are calculated using the Newey-West variance-covariance estimator with 4 lags. Model-implied statistics are based on 1000 simulated samples, each with 74×12 monthly observations, aggregated to an annual frequency. The entries in the Model column represent means and standard deviations (in parentheses) of the corresponding estimates across simulations.

Table VII
Asset Pricing Implications

Statistic	Asset	— Data —		— Model —	
$E(R)$	Growth	7.81	(1.98)	6.07	(2.91)
	Value	13.88	(1.74)	11.36	(4.30)
	Market	8.56	(1.79)	7.53	(2.69)
	Risk-free	0.91	(0.39)	1.58	(0.01)
$\sigma(r)$	Growth	20.2	(2.00)	21.5	(4.90)
	Value	29.9	(4.34)	29.0	(6.13)
	Market	20.1	(2.23)	20.1	(4.35)
	Risk-free	1.22	(0.31)	0.90	(0.01)
$E(pd)$	Growth	3.61	(0.18)	3.65	(0.06)
	Value	3.25	(0.12)	3.10	(0.15)
	Market	3.34	(0.13)	3.24	(0.07)

Table VII presents asset pricing implications of the model for value and growth firms, and the aggregate market along with corresponding statistics computed from the data. $E(R)$, $\sigma(r)$ and $E(pd)$ denote expected returns, volatilities of returns and means of the log price/dividend ratios respectively. Value firms represent companies in the highest book-to-market quintile of all NYSE, AMEX and NASDAQ firms. Growth firms correspond to the lowest book-to-market quintile. All data are annual, expressed in real terms, and cover the period from 1930 to 2003. Returns are value-weighted, price/dividend ratios are constructed by dividing the end-of-year price by the cumulative annual dividend. Robust standard errors of data estimates, reported in parentheses, are calculated using the Newey-West variance-covariance estimator with 8 lags. Model-implied statistics are based on 1000 simulated samples, each with 74×12 monthly observations, aggregated to an annual frequency. The entries in the Model column represent means and standard deviations (in parentheses) of the corresponding statistics across simulations.

Table VIII
CAPM and C-CAPM in the Model

$\frac{\beta_{\text{Value}}}{\beta_{\text{Growth}}}$	
CAPM	C-CAPM
0.92	0.85

Table VIII presents the model-implied ratio of the CAPM betas of value and growth stocks, and the corresponding ratio for the consumption-based CAPM betas computed using a sample of 1000 annual observations simulated from the model.

Table IX
Cross-Correlations in Realized Returns

	Data			Model		
	Growth	Value	Market	Growth	Value	Market
Growth	1			1		
Value	0.75 (0.05)	1		0.44 (0.13)	1	
Market	0.95 (0.01)	0.87 (0.04)	1	0.82 (0.06)	0.60 (0.11)	1

Table IX reports pair-wise correlations between realized returns on value and growth firms, and the aggregate market implied by the model and from the data. Value firms represent companies in the highest book-to-market quintile of all NYSE, AMEX and NASDAQ firms. Growth firms correspond to the lowest book-to-market quintile. Returns are value-weighted. The data are annual, expressed in real terms, and cover the period from 1930 to 2003. Robust standard errors of data estimates, reported in parentheses, are calculated using the Newey-West variance-covariance estimator with 8 lags. Model-implied statistics are based on 1000 simulated samples, each with 74×12 monthly observations, aggregated to an annual frequency. The entries in the Model panel represent means and standard deviations (in parentheses) of the corresponding statistics across simulations.

Table X
Predictability of Asset Returns

Asset	Horizon	Data		Model		
		\hat{b}	\bar{R}^2	\hat{b}	\bar{R}^2	
Growth	1	-0.07	(0.047)	0.03	-0.00	0.00
	5	-0.33	(0.145)	0.22	-0.17	0.08
Value	1	-0.13	(0.062)	0.05	-0.05	0.01
	5	-0.41	(0.087)	0.21	-0.19	0.09
Market	1	-0.07	(0.057)	0.02	-0.07	0.01
	5	-0.42	(0.158)	0.23	-0.38	0.14

Table X presents predictability evidence for 1- and 5-year returns on value and growth firms, and the aggregate stock market from the data and from the model. The entries correspond to the estimated projection coefficients and adjusted- R^2 s from regressing future multi-horizon returns on the log of the current price/dividend ratios, i.e.,

$$r_{t+1} + \dots + r_{t+h} = b_0 + b \log(P_t/D_t) + e_{t,t+h},$$

where h denotes the forecasting horizon in years. Value firms represent companies in the highest book-to-market quintile of all NYSE, AMEX and NASDAQ firms. Growth firms correspond to the lowest book-to-market quintile. All data are annual, expressed in real terms, and cover the period from 1930 to 2003. Returns are value-weighted, price/dividend ratios are constructed by dividing the end-of-year price by the cumulative annual dividend. Robust standard errors of data estimates, reported in parentheses, are calculated using the Newey-West variance-covariance estimator with 8 lags. Model-implied statistics are based on 1000 simulated samples, each with 74×12 monthly observations, aggregated to an annual frequency. The entries in the Model column represent means of the estimates across simulations.

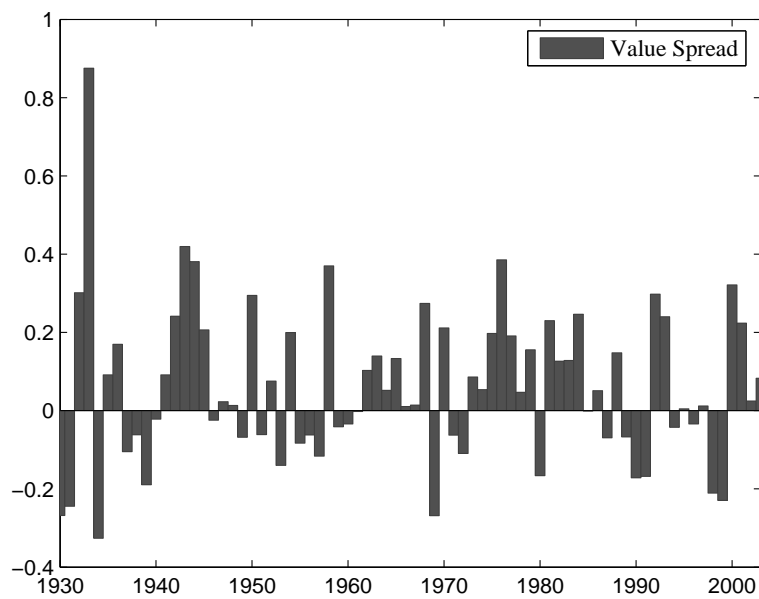


Figure 1. Spread in Realized Returns

Figure 1 plots the spread in realized returns on value and growth firms. Value firms represent companies in the highest book-to-market quintile of all NYSE, AMEX and NASDAQ firms. Growth firms correspond to the lowest book-to-market quintile. Returns are value-weighted, annual and cover the period from 1930 to 2003.

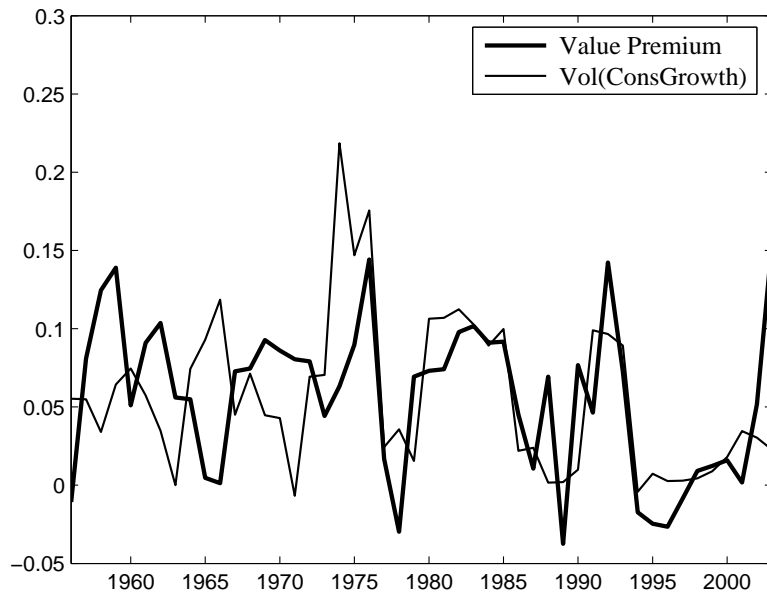


Figure 2. Value Premium and Economic Uncertainty

Figure 2 plots the value premium along with the realized volatility of consumption. The latter is measured by the 3-year moving average of squared residuals from an AR(1) process fitted to consumption growth data. The value premium is constructed by projecting the spread in realized returns on value and growth stocks on lagged price/dividend ratios and dividend growth rates of the two stocks. Consumption volatility is rescaled so that it has the same mean and standard deviation as the value spread. Value firms represent companies in the highest book-to-market quintile of all NYSE, AMEX and NASDAQ firms. Growth firms correspond to the lowest book-to-market quintile. Consumption data, taken from the BEA, are per-capita expenditure of nondurables and services. All data are annual, expressed in real terms, and cover the period from 1952 to 2003.

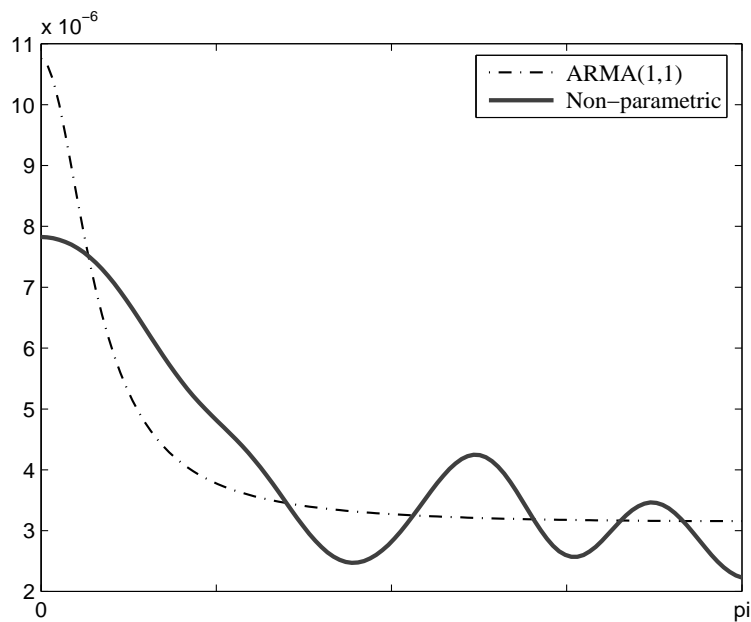


Figure 3. Spectral Density of Consumption Growth

Figure 3 plots the spectral density for consumption growth implied by an ARMA(1,1) model, and a non-parametric estimate based on the Bartlett kernel. Consumption data, taken from the BEA, are real, annual per-capita expenditure of nondurables and services that cover the period from 1930 to 2003. Growth rates are constructed by taking the first difference of the logarithm of consumption.

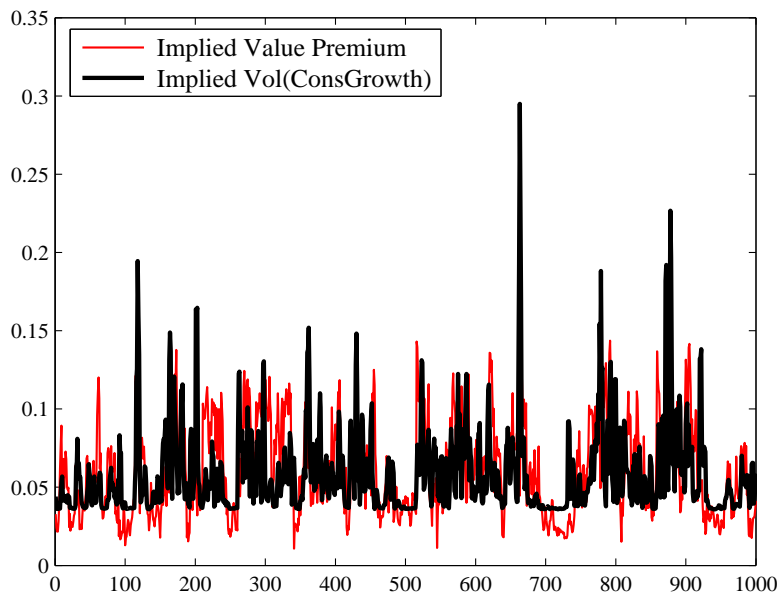


Figure 4. Model-Implied Value Premium and Economic Uncertainty

Figure 4 plots the value premium along with the realized volatility of consumption growth, estimated as described in the footnote to Figure 2 using a sample of 1000 annual observations simulated from the model.