Discussion on Buss, Uppal, and Vilkov (2018): "Financial Innovation and Asset Prices"

Lu Zhang[1]

[1]The Ohio State University
and NBER

UBC Summer Finance Conference
July 27, 2018

What's the impact of financial innovation on asset prices?

Traditional view: Financial innovation facilitates risk sharing, reducing risk and risk premiums

This paper: With heterogeneous beliefs, financial innovation increases risk and risk premiums

With common briefs, when a new asset arrives, investors switch to a well diversified portfolio, reducing risk and risk premiums

With heterogeneous beliefs:

- Inexperienced investors' portfolios remain concentrated in traditional assets, due to parameter uncertainty and learning about the new asset's expected dividend growth rate, giving rise to a more volatile SDF
- Experienced investors' portfolios remain tilted toward the new asset, and their SDF volatility declines only slowly

The net effect is to increase risk and risk premiums

3 comments, which come with free disposal

Not expecting qualitative mechanisms to change, though results could be made more (quantitatively) persuasive

In an endowment economy, basically 2 ways to obtain a high equity premium: long-run risks and/or disasters

A high consumption growth volatility of 3.73% per annum yields a high equity premium, without long-run risks or disasters, making the interpretation of learning and briefs a bit difficult

Learning and disagreeing about hard-to-measure long-run risks or disaster probability, size, and duration would put the paper on a more solid ground, conceptually and quantitatively

Comment 2

(Non)stationarity of the learning effect, a comment on the broader literature

Inexperienced investors learn about the expected dividend growth of the new asset: Given a long enough sample, would investors eventually learn the truth to make the learning effect disappear?

More generally, such a learning economy is non-stationary; one has to take a stand on time

While straightforward to pinpoint when financial innovation hits in the model, much less clear in the data

Could adopt a regime switching dividend growth model, and let investors learn about the probabilities of the hidden states

Financial innovations are likely heterogeneous too

Mortgage-back securities clearly increased risk and risk premiums

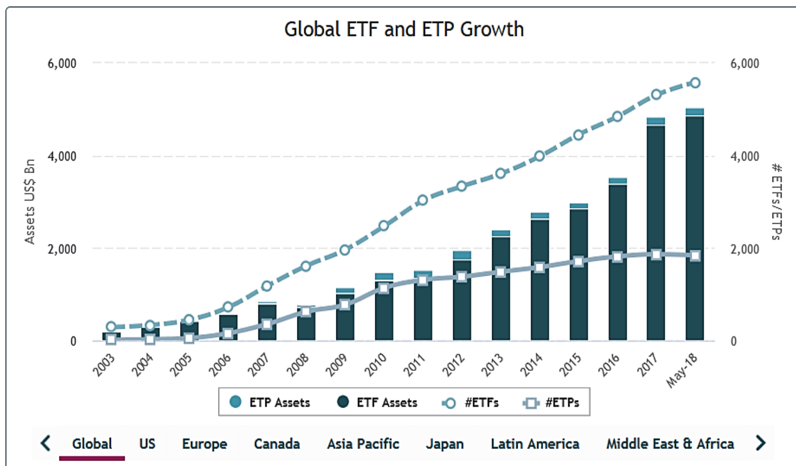
Though the innovation itself started in the 1970s, I think

The "experienced" investors (e.g., Bear, Lehman, AIG) were likely surprised too by the Crisis

Was that financial innovation welfare-improving? Probably. . .

Comment 3

Factor investing? Risk and risk premiums seem to have been declining, so far



Source: ETFGI data sourced from ETF/ETP sponsors, exchanges, regulatory filings, Thomson Reuters/Lipper, Bloomberg, publicly available sources, and data generated in-house.

Conclusion

Thought-provoking paper on a very important topic

Intuitive insights

Can probably improve the quantitative execution

More broad discussion on practical implications