The Equity Premium in Brock’s Asset Pricing Model

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Abstract

In this paper we combine dynamic programming methods with projection methods for solving stochastic growth models. As an application of these methods, we solve Brock’s asset pricing model with a variety of parameterizations. We focused on finding parameterizations that result in an equity premium that is high relative to the variation in consumption.

We show (both analytically and numerically) that the equity premium can be higher in a production based asset pricing model than it is in the consumption based asset pricing model, even when the real output level is the same in both models.

Key words: Computational economics, projection methods, asset pricing models, stochastic growth models.

1 Introduction

The equity premium puzzle that was raised by Mehra and Prescott (1985) stems from the fact that for no reasonable parameterizations of the Lucas (1978) asset pricing model is the theoretical equity premium as large as the

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empirically observed equity premium. As they discovered, the Lucas model
does not have sufficient flexibility to predict the extent of the equity premium.
It does predict that there is an equity premium, but it is insufficiently large to
be compatible with data. The Brock (1982) asset pricing model is rich enough
to predict a far more substantial equity premium. It gives pause for thought
that if Mehra and Prescott had used Brock’s model in their seminal article,
the subsequent literature on the equity premium puzzle might have been less
prolific and less contentious.\textsuperscript{1} Referring to the equity premium and the risk
free rate puzzles, Kocherlakota (1996) points out that “. . . there is now a vast
literature that seeks to resolve these two puzzles.” As Kocherlakota describes
in that review of the literature, a number of alternate models\textsuperscript{2} have been
developed to explain the equity premium puzzle. We do not criticize those
models.\textsuperscript{3} Many of the effects that are captured in those models are important
in the modeling of human behavior. Our point is that it is not necessary to
change the assumption on preferences to get a higher equity premium. It is
sufficient to include production processes in the model.\textsuperscript{4,5}

In this paper we have two basic points to make. First, there are parameteriza-
tions of the Brock model that have equity premia that are (1) more consistent
with empirical evidence than those that were found by Mehra and Prescott in
their solution of the Lucas asset pricing model;\textsuperscript{4} and that are (2) consistent
with empirical values for utility and production parameters. Second, the val-
ues of all relevant financial variables in the model are functions of the output
level.\textsuperscript{7} The values of the equity premium that are reported in empirical re-
search are averages over time which means that the values have been averaged
over the business cycle. However, one of the strong results from the Brock
asset pricing model is that one should find that the equity premium is much
higher at the bottom of a business cycle than it is at the top of the business
cycle.\textsuperscript{8}

In section 5 we present some scaling results that show, in part, why Brock’s
model with production leads to a higher equity premium than a consumption
based model, or even a single firm model. What we show is that, along with
systematic shocks, there must be idiosyncratic shocks that alter the marginal
products of the firms differently from each other.\textsuperscript{9} Otherwise, as we show in
section 5 the model reduces to a one firm model, and the equity premium is
comparable to those reported in Mehra and Prescott (1985) for their consump-
tion based asset pricing model. In section 4 we show how we model systematic
and idiosyncratic shocks so that the (random) marginal products of the firms
differ in each state.
1.1 A Parameterization of the Brock APM

In Brock (1979) and Brock (1982) it is shown how the stochastic economic growth model can be used to solve for the asset prices in a production based economy. However, there is only one parameterization for which a closed form solution exists for this model, so we have to rely on numerical methods for solutions for the other cases. The advantage of numerical methods, as Judd (1995) points out, is that we can often solve for a much broader class of cases than is possible with analytical methods.

In this study we use that solution and explore the parameter space for solutions to the model that, to a certain extent, fit some of the stylized facts of asset markets. Many of the stylized facts (such as those that Cooley and Prescott (1995) report) relate to economic growth. In our model there is no labor and no population to grow, so we examine those results that do not relate directly to issues of economic growth. In particular, the equity premium puzzle is not related to the growth of the economy.

In this paper we explore the parameter space with a primary focus of presenting the results for values of the annual discount factor of $\beta$ ranging from 0.95 to 0.99, and the relative risk aversion coefficient of $\gamma$ ranging from $-1$ to $-4$. These are typical values based on US data.

In section 5.4 we also compare the formulæ for the asset prices and equity premia in both the Brock and Lucas asset pricing models. One of the conclusions is that if the asset pricing functions and the investment functions are linear in the level of output, then there is no difference in the equity premia in the two models. However, as we show with our numerical results in section 4, there are parameterizations of the Brock model for which the equity premia are higher than those of the Lucas model.

2 The Growth Model

In this section we borrow heavily from Brock (1979). The essential elements of the growth model are:
\[
V(y_0) = \max_{\{c_t,x_t\}} \mathbb{E} \left[ \sum_{t=0}^{\infty} \beta^t u(c_t) \right]
\]  
\hspace{1cm} (2.1)

subject to:  
\[x_t = \sum_{i=1}^{N} x_{it} \]  
\hspace{1cm} (2.2)

\[y_{t+1} = \sum_{i=1}^{N} f_i(x_{it}, \xi_t) \]  
\hspace{1cm} (2.3)

\[c_t + x_t = y_t \]  
\hspace{1cm} (2.4)

\[c_t, x_{it} \geq 0 \]  
\hspace{1cm} (2.5)

\[y_0 \text{ given} \]  
\hspace{1cm} (2.6)

Where:

\begin{itemize}
  \item \( \beta \) discount factor on future utility
  \item \( u \) per period utility function of consumption
  \item \( c_t \) consumption at date \( t \)
  \item \( y_t \) output at date \( t \)
  \item \( x_t \) capital stock at date \( t \)
  \item \( f_i \) production function of process \( i \)
  \item \( x_{it} \) capital allocated to process \( i \) at date \( t \)
  \item \( \xi_t \) random shock
\end{itemize}

For a description and interpretation of the model see Brock (1982). The main assumptions for this model are:

(A1) the utility function, \( u \), is concave, increasing and twice continuously differentiable;

(A2) the production functions, \( f_i \), are concave, increasing, twice continuously differentiable, and satisfy the Inada conditions;

(A3) the stochastic process \( \{\xi_t\} \) is independent and identically distributed;

The first order conditions\(^{13}\) for the intertemporal maximization are:

\[ u'(c_{t-1}) = \beta \mathbb{E}_{t-1} [u'(c_t) f_i'(x_{it}, \xi_t)] \]  
\hspace{1cm} (2.7)

and the transversality condition is:

\[ \lim_{t \to \infty} \beta^t \mathbb{E}_0 [u'(c_t)x_t] = 0. \]  
\hspace{1cm} (2.8)

Equation (2.7) is the one that is used to derive a numerical solution to the growth model. Since the problem given by equations (2.1) to (2.6) is time stationary the optimal levels of \( c_t, x_t, \) and \( x_{it} \) are functions of the output level
\( y_t \), and can be written as:

\[
\begin{align*}
    c_t &= c(y_t) \\
    x_t &= h(y_t) \\
    x_{it} &= h_i(y_t)
\end{align*}
\] (2.9)

The first two functions in equation (2.9) can be expressed in terms of the individual firm investment functions:

\[
\begin{align*}
    h(y) &= \sum_{i=1}^{N} h_i(y) \quad (2.10) \\
    c(y) &= y - h(y) \quad (2.11)
\end{align*}
\]

Given these functions, one can then define next period’s output, given the current level of output, \( y \), and the shock, \( \xi \):

\[
Y(y, \xi) = \sum_{i=1}^{N} f_i(h_i(y), \xi) .
\] (2.12)

A numerical solution to this problem are policy functions (2.9) that satisfy

\[
u'(c(y)) = \beta E \left[ u'(c(Y(y, \xi))) f_i'(h_i(Y(y, \xi)), \xi) \right]
\] (2.13)

for \( i = 1, \cdots, N \) and for all \( y \) and for which the transversality condition (2.8) holds. Fortunately, the transversality condition does not have to be directly verified. A bounded solution to equation (2.13) satisfies the transversality condition.\(^\text{14}\) Further details are in Akdeniz and Dechert (1997).

### 3 An Asset Pricing Model

The asset pricing model in Brock (1982) has its roots in the models of Brock and Mirman (1972) and Lucas (1978). In particular, Brock also solves for the rational expectations equilibrium. The difference between the Brock (1982) and Lucas (1978) models is that former includes production. By incorporating the shocks in with the production processes, Brock’s model has the sources of uncertainty in the asset prices directly tied to economic fluctuations in output levels (and hence in profits).

There is one representative consumer whose preferences are given in equation (2.1). There are \( N \) different firms. Firms rent capital from the consumers at
the rate $r_{it}$ to maximize their profits:

$$\pi_{i,t+1} = f_i(x_{it}, \xi_t) - r_{it} x_{it} \quad (3.1)$$

Each firm rents capital given $\xi_t$. Here $r_{it}$ denotes the interest rate on capital in industry $i$ at date $t$ and is determined within the model. Asset shares are normalized so that there is one perfectly divisible equity share for each firm. Ownership of the share in firm $i$ at date $t$ entitles the consumer to the firm's profits at date $t$. It is also assumed (as in Lucas (1978)) that the optimum levels of asset prices, capital, consumption and output form a rational expectations equilibrium.

The Model:

The representative consumer takes asset prices, profits and rents as given and solves the following problem:

$$\max \ E \left[ \sum_{t=0}^{\infty} \beta^t u(c_t) \right] \quad (3.2)$$

subject to:

$$c_t + x_t + P_t \cdot Z_t \leq \pi_t \cdot Z_{t-1} + P_t \cdot Z_{t-1} + r_{t-1} \cdot x_{t-1} \quad (3.3)$$

$$c_t, Z_t, x_{it} \geq 0 \quad (3.4)$$

$$r_{it} = f'_i(x_{it}, \xi_t) \quad (3.4)$$

$$\pi_{it} = f_i(x_{i,t-1}, \xi_{t-1}) - f'_i(x_{i,t-1}, \xi_{t-1}) x_{i,t-1} \quad (3.5)$$

where:

- $P_{it}$ price of one share of firm $i$ at date $t$
- $Z_{it}$ number of shares of firm $i$ owned at date $t$
- $\pi_{it}$ profits of firm $i$ owned at date $t$

The details of the model are in Brock (1982). The first order conditions are:

$$P_{it} u'(c_t) = \beta E_t [u'(c_{t+1}) (\pi_{i,t+1} + P_{i,t+1})] \quad (3.6)$$

and

$$u'(c_t) = \beta E_t [u'(c_{t+1}) f'_i(x_{i,t+1}, \xi_{t+1})] \quad (3.7)$$
from which we get the prices for the assets. In addition the transversality conditions

\[
\lim_{t \to \infty} \beta^t E_0 \left[ u'(c_t) \sum_{i=1}^{N} P_{it} Z_{it} \right] = 0 \quad (3.8)
\]

\[
\lim_{t \to \infty} \beta^t E_0 [u'(c_t) x_t] = 0. \quad (3.9)
\]

are needed to fully characterize the optimum. Brock (1979) shows that there is a duality between the growth model (2.1) – (2.6) and the asset pricing model (3.2) – (3.5), and that the solution to the growth model is also the solution to the asset pricing model. Once the growth model is solved, the asset pricing functions can be solved for by equation (3.6). As for the transversality condition, Judd (1992) points out that it implies that we are looking for the bounded solution\(^\text{15}\) to the growth model.

Other assets can be included in this model. Assets that are in zero net supply in equilibrium do not affect the real side of the model, and so the solution does not change. For example, we can introduce one period discount bonds into the model. If the bond pays $1 (with probability one) at date \(t + 1\), then the equilibrium price of the bond, \(B_{t,t+1}\), at date \(t\) must satisfy

\[
u'(c_t) B_{t,t+1} = \beta E_t [u'(c_{t+1})]
\]

or

\[
B_{t,t+1} = \frac{\beta E_t [u'(c_{t+1})]}{u'(c_t)} \quad (3.10)
\]

This, then, defines the one period risk free rate of return in period \(t\) as \(1/B_{t,t+1}\). In similar fashion we can introduce an \(n\) period discount bond that pays $1 (with probability one) at date \(t + n\).\(^\text{16}\)

Since (in equilibrium) there is 1 share of each asset, the equally weighted market portfolio is:

\[
M_t = \sum_{i=1}^{N} P_{it}
\]

and the dividends (profits) are:

\[
\pi_t = \sum_{i=1}^{N} \pi_{it}.
\]
Define the return on each asset by:

\[ R_{it} = \frac{p_{i,t+1} + \pi_{i,t+1}}{p_{it}} \]

and the (equally weighted) return on the market portfolio by:

\[ R_{Mt} = \frac{M_{t+1} + \pi_{t+1}}{M_t}. \]

From the first order condition (3.6), the return on each asset satisfies:

\[ u'(c_t) = \beta E [u'(c_{t+1})R_{it}] \]

which is the efficiency condition from the growth model. By summing equation (3.6), we get that the return on the market portfolio satisfies:

\[ u'(c_t) = \beta E [u'(c_{t+1})R_{Mt}] \]

and so it too is efficient. (This is one of the hypotheses of the CAPM, which in this model is a consequence of the optimizing behavior of the consumer.\textsuperscript{17})

Now define the profit and output functions by:

\[ \pi_i(y, \xi) = f_i(h_i(y), \xi) - h_i(y)f_i'(h_i(y), \xi) \] \hfill (3.11)

\[ Y(y, \xi) = \sum_{i=1}^{n} f_i(h_i(y), \xi) \] \hfill (3.12)

and the asset pricing functions by:

\[ p_i(y)u'(c(y)) = \beta E [u'(c(Y(y, \xi))) (p_i(Y(y, \xi)) + \pi_i(y, \xi))] \] \hfill (3.13)

for \( i = 1, \ldots, n \). Once we have the pricing functions\textsuperscript{18} we next define the return functions

\[ R_i(y, \xi) = \frac{p_i(Y(y, \xi)) + \pi_i(y, \xi)}{p_i(y)} \] \hfill (3.14)

\[ R_M(y, \xi) = \frac{\sum_{i=1}^{n} [p_i(Y(y, \xi)) + \pi_i(y, \xi)]}{\sum_{i=1}^{n} p_i(y)} \] \hfill (3.15)
as well as the one period risk free bond price

\[ B(y) = \frac{\beta E[u'(c(Y(y, \xi)))]}{u'(c(y))} \] (3.16)

As these formulæ make clear, the expected return on assets, \( E[R_i(y, \xi)] \), the expected return on the (equally weighted) market portfolio, \( E[R_M(y, \xi)] \), and the bond price, \( B(y) \), are all functions of the output level, \( y \). The equity premium in this model is given by

\[ e(y) = E[R_M(y, \xi)] - \frac{1}{B(y)} . \] (3.17)

In order to study the term structure of interest rates in this model define the following recursion:

\[
G_0(y) = u'(c(y)) \\
G_{n+1}(y) = E[u'(c(Y(y, \xi)))G_n(Y(y, \xi))] \quad n = 0, 1, \ldots
\]

Then the \( n \) period risk free bond price when the output level is \( y \) is

\[ \frac{G_n(y)}{u'(c(y))} \] (3.18)

In the next section we will explore the nature of the relationship of these functions in terms of the output level, \( y \).

4 A Numerical Solution

Except for a very special case of the utility and production functions, there is no closed form solution for the optimal investment functions. In order to analyze the properties of the solutions to the asset pricing model we must use numerical techniques instead. Akdeniz and Dechert (1997) report the technical details of the numerical solution which we will not repeat here. In this study we use that solution and explore the parameter space for solutions to the model that, to a certain extent, fit some of the stylized facts of asset markets. Our primary focus will be on the equity premium and the term structure of interest rates that come out of the Brock asset pricing model.

Akdeniz (2000) and Akdeniz and Dechert (1997) showed that CAPM results do hold in the model, but with the proviso that they depend on the level of
I.e., an asset’s beta is not constant over time, but fluctuates with the level of output. Furthermore, at each level of output the market portfolio (which is efficient in this model) is on the security market line (at that level of output).

In section 4.3 we report the results of simulations using the numerical solution for the model. In keeping with the results found by Akdeniz and Dechert, one of the important features to note is that the equity premium sharply depends on the level of output. In the tables, for each value of $\gamma$ and $\beta$ there are five values of the equity premium which, reading down the table, occur for low, below average, average, above average and high output levels.

4.1 Computational Details

We use the projection method to solve equation (2.13) for the coefficients of the policy functions

$$h_i(y) = \sum_{j=0}^{m} a_{ij} T_j(y) \quad (4.1)$$

where $T_j(y)$ is the $i$th Chebyshev polynomial shifted to the interval which is the support of the invariant measure, $[y_{\min}, y_{\max}]$. One of the steps is to use Newton’s method to solve for the coefficients, $\{a_{ij}\}$. Since Newton’s method is only locally convergent, we need a good initial set of values for these coefficients. In Judd (1992) good results were obtained by choosing a linear approximation that passes through the origin and the steady state. In the model in this paper we are dealing with the multi firm stochastic case, and need an alternative procedure. We chose to first create a deterministic model by taking the expected value of the firm’s production functions. For this deterministic model, we can readily solve for the steady state levels of capital for each firm. It turns out that the linear approximations of the policy functions which passes through the origin and the steady states are not good enough in general to get Newton’s method to converge. So, by using the value function for this deterministic case, we also computed the derivative of the policy functions at the steady state and used linear approximations at the steady state as an initial point for the Newton routine. See Figure 1 for a pictorial representation of this method. As long as the values $y_{\min}$ and $y_{\max}$ are reasonably close to the deterministic steady state, the Newton method converges for this initialization. The values of $y_{\min}$ and $y_{\max}$ then have to be determined by trial and error.
4.2 Systematic and Idiosyncratic Shocks

For firm production functions we use Cobb–Douglas functional forms with depreciation. Total output in state \( s \) and period \( t \) and is:

\[
y_{s,t+1} = \sum_{i=1}^{n} \left[ \theta_{is} x_{it}^{\alpha_{is}} + (1 - \delta_{is}) x_{it} \right]
\]  

(4.2)

where \( n \) is the number of firms. For the numerical work below, we took the depreciation terms to be deterministic, and so

\[
\delta_{is} = \delta_i \quad i = 1, \ldots, n
\]

In order to model both systematic shocks as well as idiosyncratic shocks we constructed the \((\alpha_{is}, \theta_{is})\) parameters as follows. First, construct a partition of the state space, \( \{\Omega_j\} \) for \( j = 1, \ldots, m \), and select capital levels, \( k_1 < k_2 < \cdots < k_m \), one for each partition. Next, select values of \( \alpha_{is} \). These can be chosen at random, or they can be chosen to fit a pattern based on stylized facts. Then the parameters \( \theta_{is} \) are chosen so that

\[
\theta_{is} = \delta_{i} k_{j}^{1 - \alpha_{is}} \quad s \in \Omega_j
\]

This implies that for all the firms, \( i \),

\[
\theta_{is} k_{j}^{\alpha_{is}} + (1 - \delta_i) k_j = k_j \quad \forall s \in \Omega_j
\]
holds for all \( j = 1, \ldots, m \). A visual example of the effect of this parameterization is in Figure 2.

4.3 Numerical Results

In this section we will present some results from simulation studies of the solution to Brock’s asset pricing model with various parameterizations. The examples will show that there are values of the parameters of the model that give values of excess returns (at the median level of output) in excess of 5%.

First, we present some results that show that the equity premium can be quite large, even for some fairly reasonable values of the parameters. In the examples, the parameter values are for a model with three firms and eight states of uncertainty. For these examples, the range of utility parameters are \( \beta = 0.95, 0.97, 0.99 \), and \( \gamma = -1.0, -2.0, -3.0, -4.0 \).

The resulting values of the equity premium are listed in Tables 2 – 14. The first column in the tables are levels of the invariant distribution of output. The second column is the excess return on the market portfolio, and the remaining columns are the excess returns on the individual firm shares. Each table caption shows the particular values of \( \gamma \) and \( \beta \), and also the value of the standard deviation of consumption, \( \sigma_c \).

Typical results for the term structure of interest rates are given in Tables 15 and 16. Notice that the interest rates depend on the output level, with high interest rates associated with low output levels, and low rates (negative) with high levels. The one period interest rates are the risk free rates that are used
to measure the equity premium.

Figures 3 – 14 show the consumption levels for a simulation of the model for 120 periods. Notice in both the tables and the figures how the standard deviation of consumption, $\sigma_c$, falls as $\gamma$ decreases, while the equity premium increases.\textsuperscript{28}

4.4 Comparative Dynamics

The impact of depreciation on the results can be substantial. For the three firm model above with depreciation levels increased by 1\% for each firm in each state we get in increase in the equity premium at all levels of output. The results are in Table 10 and should be compared with the results in Table 9. As can be seen from these results, a change in depreciation has a substantial impact on the equity premium. Arguably, in the US economy depreciation rates have increased in the past 20 years. There is more rapid replacement of high technology capital which has become an ever increasing proportion of the US capital stock. This is certainly one of the testable hypotheses of this model.

5 Scaling and Uncertainty

In this section we present some scaling results that hold for this model. We will show an invariance principle for two types of scalings: one where the productivity parameters, $\theta_{i,s}$, are scaled, and one where the economy is expanded by replication. We then show the impact of uncertainty in multiplicative models, and why our parameterization of the Brock model produces the results that we have presented in this paper. We also show the precise difference between the asset prices and the equity premia in the Lucas and Brock asset pricing models.
5.1 Scaling by Replication

Let the solution to the one firm problem:

$$\max E \left[ \sum_{t=0}^{\infty} \beta^t u(c_t) \right]$$

$$c_t + x_{t+1} = y_t \quad t = 0, 1, \ldots$$

$$y_t = f(x_t, \xi_t) \quad t = 1, 2, \ldots$$

be $x_t = h(y_t)$. Now consider the following two firm problem:

$$\max E \left[ \sum_{t=0}^{\infty} \beta^t u(c_t) \right]$$

$$c_t + x_{1,t+1} + x_{2,t+1} = y_t \quad t = 0, 1, \ldots$$

$$y_t = f(x_{1,t}, \xi_t) + f(x_{2,t}, \xi_t) \quad t = 1, 2, \ldots$$

where the two production functions both have the same functional form as in the one firm case. Since the utility function is a concave function of consumption, and the production function is a concave function of input, from the first order conditions it is the case that the optimal investments in the two firms satisfy

$$x_{1,t} = x_{2,t}$$

Let us call this common value $z_t$. Thus the solution to the two firm problem is equivalent to

$$\max E \left[ \sum_{t=0}^{\infty} \beta^t u(c_t) \right]$$

$$c_t + 2z_{t+1} = y_t \quad t = 0, 1, \ldots$$

$$y_t = 2f(z_t, \xi_t) \quad t = 1, 2, \ldots$$
Now define

\[ \tilde{c}_t = \frac{1}{2} c_t \quad \tilde{y}_t = \frac{1}{2} y_t \]

and this equivalent problem becomes

\[
\max \mathbb{E} \left[ \sum_{t=0}^{\infty} \beta^t u(2\tilde{c}_t) \right]
\]

\[ \tilde{c}_t + z_{t+1} = \tilde{y}_t \quad t = 0, 1, \ldots \]

\[ \tilde{y}_t = f(z_t, \xi_t) \quad t = 1, 2, \ldots \]

Note the similarity with the one firm problem at the beginning of this section. Now this is as far as we can push the scaling result, and we see that indeed enlarging the economy by replication will have, in general, an impact on the result. However, for the parameterization in this paper the utility function is of the form \( u(c) = c^\gamma \) and so

\[
\mathbb{E} \left[ \sum_{t=0}^{\infty} \beta^t u(2\tilde{c}_t) \right] = \mathbb{E} \left[ \sum_{t=0}^{\infty} \beta^t 2^{\gamma} \tilde{c}_t^\gamma \right] = 2^{\gamma} \mathbb{E} \left[ \sum_{t=0}^{\infty} \beta^t u(\tilde{c}_t) \right]
\]

and so for this utility function, the two firm problem has the same solution as

\[
\max \mathbb{E} \left[ \sum_{t=0}^{\infty} \beta^t u(\tilde{c}_t) \right]
\]

\[ \tilde{c}_t + z_{t+1} = \tilde{y}_t \quad t = 0, 1, \ldots \]

\[ \tilde{y}_t = f(z_t, \xi_t) \quad t = 1, 2, \ldots \]

Thus, the optimal policy functions are the same as for the one firm case which means that the equity premium (among other things) is invariant to scaling by replication.
5.2 Scaling the $\theta_{t,s}$ Parameters

Consider scaling the productivity parameters, $\theta_{t,s}$, as follows:

$$\tilde{\theta}_{t,s} = A^{\alpha_{t,s} - 1} \theta_{t,s}$$

where $A > 0$. The total output is

$$y = \sum_{i} \left[ \tilde{\theta}_{t,s} x_{t,s}^{\alpha_{t,s}} + (1 - \delta_{t,s}) x_{t,s} \right]$$

$$= \sum_{i} \left[ A^{\alpha_{t,s} - 1} \theta_{t,s} x_{t,s}^{\alpha_{t,s}} + (1 - \delta_{t,s}) x_{t,s} \right]$$

$$= \sum_{i} \left[ A^{-1} \theta_{t,s} (Ax_{t,s})^{\alpha_{t,s}} + (1 - \delta_{t,s}) Ax_{t,s} \right]$$

By multiplying both side of this last equality by $A$ we get:

$$Ay = \sum_{i} \left[ \theta_{t,s} (Ax_{t,s})^{\alpha_{t,s}} + (1 - \delta_{t,s}) Ax_{t,s} \right]$$

Therefore, if we scale the dynamic optimization equation,

$$Ac_t + Ax_{t+1} = Ay_t$$

and follow the reasoning above for the case that the utility function is of the form $u(c) = c^\gamma$, we readily see that the solution will be invariant to this rescaling as well.

5.3 The Real Impact of Production Uncertainty

Consider the Bellman equation for the growth model (2.1)

$$V(y) = \max_{\{x_i\}} \left\{ u \left( y - \sum_{i=1}^{n} x_i \right) + \beta \mathbb{E} \left[ V \left( \sum_{i=1}^{n} f_i(x_i, \Xi) \right) \right] \right\}$$
for which the first order conditions are:

\[ u'(y - \sum_{i=1}^{n} x_i) = \beta \mathbb{E}\left[V'(\sum_{i=1}^{n} f_i(x_i, \Xi)) f_j(x_j, \Xi)\right] \quad j = 1, \ldots, n \]

which in turn implies that for all \( j \) and \( k \),

\[ \mathbb{E}\left[V'(\sum_{i=1}^{n} f_i(x_i, \Xi)) f_j'(x_j, \Xi)\right] = \mathbb{E}\left[V'(\sum_{i=1}^{n} f_i(x_i, \Xi)) f_k'(x_k, \Xi)\right] \quad (5.1) \]

From this, it is clear that if the uncertainty is multiplicative, so that \( f_i(x_i, \xi) = \xi f_i(x_i) \), then for all firms

\[ f_i'(x_i) = f_j'(x_j) \quad (5.2) \]

Thus, the marginal products of all firms are equal, regardless of the shock. So uncertainty only affects the overall level of output, and not the disaggregated investment decisions. Put another way, under these conditions we can construct a technology set that depends only on the level of aggregate savings, and not on the risk preferences of the consumer. For a given level of investment, \( x \), solve equation (5.2) subject to \( \sum x_i = x \), and define

\[ f(x) = \sum_{i=1}^{n} f_i(x_i) \]

Then we can reduce the problem to a one firm problem with the (random) production function, \( \Xi f(x) \). In this case, there is very little equity premium unless other factors are adjusted or taken into account, e.g., a very high degree of relative risk aversion, habit persistence in consumption, etc.

Finally let us look at a special case of the parameterization that we have chosen: the total output from equation (4.2) is of the special form

\[ y_{s,t+1} = \sum_{i=1}^{n} f_i(x_i, \xi) = \sum_{i=1}^{n} \left[ \theta_s^\alpha x_{it}^\alpha + (1 - \delta_t)x_{it} \right] . \]

Notice that the \( \alpha_i \) and \( \delta_i \) parameters are not random, and the \( \theta_s \) shock is
common to all firms. In this case equation (5.1) can be rewritten as

$$\alpha_j x_j^{\alpha_j - 1} - \alpha_k x_k^{\alpha_k - 1} = (\delta_k - \delta_j) \frac{E \left[ V' \left( \sum_i \left[ \Theta x_i^{\alpha_i} + (1 - \delta_i) x_i \right] \right) \right]}{E \left[ V' \left( \sum_i \left[ \Theta x_i^{\alpha_i} + (1 - \delta_i) x_i \right] \right) \right]} \Theta \] (5.3)

Note that the ratio on the right hand side of this equation is a function of $x = \sum x_i$ (as well as the particular form of the utility function). Call this term

$$\zeta_u(x) = \frac{E \left[ V' \left( \sum_i \left[ \Theta x_i^{\alpha_i} + (1 - \delta_i) x_i \right] \right) \right]}{E \left[ V' \left( \sum_i \left[ \Theta x_i^{\alpha_i} + (1 - \delta_i) x_i \right] \right) \right]} \Theta \]$$

where the subscript $u$ emphasizes the dependence on the particular utility function. Then equation (5.3) is:

$$\alpha_j x_j^{\alpha_j - 1} - \alpha_k x_k^{\alpha_k - 1} = (\delta_k - \delta_j) \zeta_u(x) \] (5.4)

Now if $\delta_k = \delta_j$, then we have the same situation as above. There is a single technology that we can construct which is independent of the utility function. The shocks do not impact the marginal product of the technology in a significant way. Even without the equality of depreciation rates, equation (5.4) shows that what matters is the level of investment, $x$, and not the distributional aspects of the shock.

What these results show is that for the case that there is only systematic shocks and no idiosyncratic shocks, the model behaves as a one firm model. What our numerical results show is that the presence of idiosyncratic shocks along with systematic shocks matter in the sense that the equity premium is higher when there are more sources of idiosyncratic shocks.29

5.4 Brock vs Lucas Asset Prices

Consider the difference in the asset prices that are generated by the Lucas (1978) model and the Brock (1982) model. In particular, consider a consumption process, $\{c_t\}$, that is generated by the model in sections 2 and 3, and then compare the asset prices that are generated by the Lucas with the same consumption process.
In the Lucas model all output is consumed \((c_t = y_t)\) and the asset price sequence, \(\{\tilde{P}_{it}\}\), satisfies
\[
\tilde{P}_{it}u'(c_t) = \beta E_t \left[ u'(c_{t+1}) \left( c_{t+1} + \tilde{P}_{t+1} \right) \right] \tag{5.5}
\]

Using the notation of section 3, let
\[
\tilde{M}_t = \sum_i \tilde{P}_{it}
\]
and sum equation (5.5) over the firms to get
\[
\tilde{M}_t u'(c_t) = \beta E_t \left[ u'(c_{t+1}) \left( c_{t+1} + \tilde{M}_{t+1} \right) \right] \tag{5.6}
\]

Sum equation (3.6) over the firms to get the market price sequence
\[
M_t u'(c_t) = \beta E_t \left[ u'(c_{t+1}) \left( \pi_{t+1} + M_{t+1} \right) \right] \tag{5.7}
\]
\[
= \beta E_t \left[ u'(c_{t+1}) \left( y_{t+1} - \sum_i f_i'(x_{it}, \xi_t) x_{it} + M_{t+1} \right) \right] \tag{5.8}
\]
\[
= \beta E_t \left[ u'(c_{t+1}) \left( c_{t+1} + M_{t+1} \right) \right]
+ \beta E_t \left[ u'(c_{t+1}) x_{t+1} \right] - u'(c_t) x_t \tag{5.9}
\]

where we have use equations (2.2) and (2.7) to get equation (5.9). A comparison of equations (5.6) and (5.9) shows that for these asset prices to have the same value then

\[
u'(c_t) x_t = \beta E_t \left[ u'(c_{t+1}) x_{t+1} \right]
\]

must hold. However, this is not a necessary condition.

Next, look at the appendix in (Brock, 1982, pages 36–39), and consider his equation (A5.12) summed over the firms. The market value of the firms satisfies
\[ u'(c_t)V_t = E_t \left[ u'(c_{t+1}) \left( y_{t+1} - x_{t+1} + V_{t+1} \right) \right] = E_t \left[ u'(c_{t+1}) \left( c_{t+1} + V_{t+1} \right) \right] \] (5.10)

which is precisely the Lucas formula for the market value of the firms! Heuristically, the only thing that matters to the consumer is his/her total wealth, which in the main part of the Brock article is \( M_t + x_t \), since s/he owns the firms and the capital stock that the firms rent. In the appendix of the Brock article, the firms own the capital stock so the consumer’s wealth is \( V_t \). It should be the case that \( V_t = M_t + x_t \). Here’s a proof.

Compute the difference,

\[ \tilde{M}_t - M_t = \beta E_t \left[ \frac{u'(c_{t+1})}{u'(c_t)} \left( c_{t+1} + \tilde{M}_{t+1} - y_{t+1} \right) + f'(x_t, \xi_t)x_t - M_{t+1} \right] \] (5.12)

\[ = \beta E_t \left[ \frac{u'(c_{t+1})}{u'(c_t)} \left( \tilde{M}_{t+1} - M_{t+1} \right) \right] \]

\[ - \beta E_t \left[ \frac{u'(c_{t+1})}{u'(c_t)} \left( x_{t+1} - f'(x_t, \xi_t)x_t \right) \right] \] (5.13)

\[ = \beta E_t \left[ \frac{u'(c_{t+1})}{u'(c_t)} \left( \tilde{M}_{t+1} - M_{t+1} \right) \right] \]

\[ - \beta E_t \left[ \frac{u'(c_{t+1})}{u'(c_t)} \left( x_{t+1} - x_t \right) \right] + x_t \] (5.14)

Rearrange the terms in equation (5.14) to get

\[ \tilde{M}_t - M_t - x_t = \beta E_t \left[ \frac{u'(c_{t+1})}{u'(c_t)} \left( \tilde{M}_{t+1} - M_{t+1} - x_{t+1} \right) \right] \] (5.15)

By transversality, the left hand side must be zero, so

\[ \tilde{M}_t = M_t + x_t \] (5.16)
We can follow the same line of argument to get the relationship between the asset prices of the individual firms,

\[ \tilde{P}_{it} = P_{it} + x_{it} \] (5.17)

We now have the difference between Lucas and Brock asset prices. Next, the equity premium in the two models is

\[ \tilde{e}_t = E_t \left[ \frac{\tilde{M}_{t+1}}{\tilde{M}_t} \right] - \frac{1}{B_{t,t+1}} \] (5.18)

\[ e_t = E_t \left[ \frac{M_{t+1}}{M_t} \right] - \frac{1}{B_{t,t+1}} \] (5.19)

where the bond price, \( B_{t,t+1} \), is given by equation (3.10). Compute the difference in the equity premia and use equation (5.16) to get

\[ \tilde{e}_t - e_t = E_t \left[ \frac{\tilde{M}_{t+1}}{\tilde{M}_t} - \frac{M_{t+1}}{M_t} \right] \] (5.20)

\[ = E_t \left[ \frac{\tilde{M}_{t+1} + x_{t+1} - M_{t+1}}{M_t + x_t} \right] \] (5.21)

\[ = E_t \left[ \frac{M_t x_{t+1} - M_{t+1} x_t}{M_t (M_t + x_t)} \right] \] (5.22)

\[ = \left( \frac{x_t}{M_t + x_t} \right) E_t \left[ \frac{x_{t+1}}{x_t} - \frac{M_{t+1}}{M_t} \right] \] (5.23)

Now equation (5.23) is quite interesting. For example, when the optimal investment functions and the pricing functions are all linear in output, \( y \), then

\[ \frac{x_{t+1}}{x_t} = \frac{y_{t+1}}{y_t} = \frac{M_{t+1}}{M_t} \]

in which case,

\[ \tilde{e}_t - e_t = 0 \]
This is the case when \( u(c) = \ln(c) \) and \( f_i(x, \xi) = \xi A_i x^\alpha \). So it is no wonder that this whole literature has taken the view that “production does not add anything” to the equity premium. However, for models where the policy and pricing functions are not linear, equation (5.23) is not in general zero, and so there is a difference in the equity premia in the two models, in spite of the fact that the real side is the same in both models!

6 Conclusion

In this paper, numerical results point to the fact that by including production directly into the model we can obtain equity premia that are more consistent with US data than can be had from models that are based on consumption alone.

It is also clear from both the data and simulations, that the typical application of Brock’s asset pricing model has a number of shortcomings that need to be addressed before it might become a widely accepted basis for macro economic research.\(^{30}\) From a macro economic point of view, one shortcoming is that the model does not include growth. While one can view it as a “detrended” model, most macro economists build growth into their models, and would expect to see it in this one as well. Another problem with the model can be seen from Figures 15 and 16.\(^{31}\) Market prices and profits do not follow the patterns in these figures. One reason for this is the iid nature of the shocks over time. To the extent that random shocks is a reasonable model for the fluctuations in output, surely there is substantial serial correlation in them. This means that Brock’s model should, at the very least, use a Markov model for the systematic shocks.\(^{32}\) These shortcomings are not inherent in Brock’s model, but are rather complications which add to the computational complexity of implementing a numerical solution of the model. This explains, in part, why the model has not been extensively used.
References


Geweke, J., June 1999. Computational experiments and reality, University of Iowa.


Endnotes

1 They based their decision, in part, on Mehra (1984), and in part on their experience with production models. In Mehra and Prescott (1985) they write, “If we had been successful in finding an economy which passed our not very demanding test, as we expected, we planned to add capital accumulation and production to the model using a variant of Brock’s (1979, 1982) … general equilibrium stationary structures and to perform additional tests.” Although they make no mention of the technical difficulties in solving Brock’s model, it is likely that this was also a reason for their not having done so. Neither the algorithms nor the hardware used to produce the results in Akdeniz and Dechert (1997) were available then.

2 Among others, are the models on habit formation, such as Constantinides (1990), Campbell and Cochrane (1999), Boldrin et al. (2001), to cite a few. See also Campbell (2001) and the references there. McGrattan and Prescott (June 2001) show how taxes can account for both the growth in equity values as well as for the equity premium. In an earlier dynamic model of regulation and taxation, Brock and Turnovsky (1981) derived the impact of government policy on asset values. In a paper that has applications well beyond the equity premium puzzle, Weitzman (September 2004) argues that the modeling should be forward looking in the sense that “…the correct interpretation requires not frequentist objective estimates of the past mean and variance, but rather Bayesian subjective estimates of the future mean and variance.” (Emphasis in the original.)

3 Geweke (June 1999) does raise the point that “The benefits of an analytically rigorous economic theory will be realized only when harnessed to the same high standards for measurement.” He found that “The posterior distribution for the mean of the risk free rate and the equity premium supports values consistent with …dynamic stochastic general equilibrium models designed to address this question.”

4 In referring to Brock’s asset pricing model, Black (1995) remarked, “If we add non-separable utility, adjustment costs for moving capital from one sector to another, human capital, and a few other features, we will have a model of the kind I favor.” This kind of model would indeed include many useful components that would make the results more realistic. Nevertheless, as we show in this paper, including production alone is sufficient to get the size of the equity premium that Mehra and Prescott were looking for.

5 Campbell (2001) makes the comment that “Models with production also help one to move away from the common assumption that stock market dividends equal consumption …” and he goes on to conclude that “…it
will ultimately be more satisfactory to derive both dividends and consumption within a general equilibrium model.” This is, of course, what Brock does in his asset pricing model.

In that study the consumer’s discount factor and risk aversion parameter were varied and the highest equity premium they found was 0.35 percent. In our study we focus most of our attention on keeping the values of the discount factor and risk aversion parameter consistent with empirical results.

This property was emphasized in Akdeniz and Dechert (1997) and Akdeniz (2000) where it was shown that the asset prices are a function of the output level.

In the introduction to their paper, Campbell and Cochrane (1999) state, “…standard business cycle models utterly fail to reproduce the level, variation, and cyclical co-movement of equity premia.” As we show in this paper, Brock’s APM does in fact reproduce the cyclical co-movement of equity premia with the level of output.

The same conclusion that idiosyncratic shocks have an impact was reported in Turnovsky and Bianconi (October 2003) and Saito (1998).

The special case is for a logarithmic utility function, and Cobb–Douglas firms, where the value of the output elasticity (with respect to the input) is common to all firms.

In our work we use $u(c) = (c^{\gamma} - 1)/\gamma$ for the utility function. In some of the studies cited, it is specified as $u(c) = (c^{1-\gamma} - 1)/(1 - \gamma)$, and so our value of $\gamma = -1$ would correspond to $\gamma = 2$ in those models.

Campbell and Cochrane (1999) use a value of $\gamma = 2.00$ (which would correspond to a value of $-1.00$ in our formulation. Since there is no universal value for the relative risk aversion parameter, we present results for several values of $\gamma$.

We assume that $x_{it} > 0$ wp 1. If not then the Kuhn–Tucker type conditions in Brock (1979) must be used. In our numerical studies we used functional forms that include a Cobb–Douglas term, so our assumption is satisfied.

See Judd (1992) and Judd (1998) for the solution to the one firm growth model and the argument about the transversality condition.

The optimal solution remains in a bounded interval: $0 < a < y_t < b < \infty$ for all $t$.

In an analogous way one can also derive the price of an Arrow–Debreu
security, i.e., an asset that pays $1 if state $i$ occurs at date $t$ and $0$ otherwise.

\[^{17}\text{See Akdeniz and Dechert (1997) and Akdeniz (2000) for more details on this issue.}\]

\[^{18}\text{Solving equation (3.13) is easier than it might appear: these equations are linear in the functions $p_i$. The details are in Akdeniz and Dechert (1997).}\]

\[^{19}\text{The special case is for a logarithmic utility function, $u(c) = \log(c)$, and for Cobb–Douglas firms, $f_i(x, \xi_i) = \xi_i x^\alpha$, where the value of $\alpha$ is common to all firms. In this case the optimal investment policy functions are linear in output, $\hat{x}_i(y) = \gamma_i y$.}\]

\[^{20}\text{Basically, equation (2.13) is solved for the policy functions, $h_i(y)$, and then equation (3.13) is solved for the pricing functions, $p_i(y)$.}\]

\[^{21}\text{As pointed out by Campbell and Cochrane (1999), “… the slope of the conditional mean-variance frontier … changes through time with a business cycle pattern …” This is precisely what Akdeniz (2000) shows in the context of Brock’s APM.}\]

\[^{22}\text{The tables are based on the long run distribution of output. The levels used in the tables are the 10, 30, 50, 70 and 90\textsuperscript{th} percentiles.}\]

\[^{23}\text{See Akdeniz and Dechert (1997) for complete details. Also see Judd (1992) and Judd (1998) for a further description of the technique as applied to problems in economic analysis.}\]

\[^{24}\text{Actually, we are solving for polynomial approximations to the policy functions.}\]

\[^{25}\text{In that article, a deterministic growth model with a single firm was analyzed.}\]

\[^{26}\text{In order to determine the support of the invariant distribution of output we need to solve $y = \min_\xi Y(y, \xi)$ and $y = \max_\xi Y(y, \xi)$ for the crossing points on the 45 degree line. See equation (2.12) for the definition of $Y(y, \xi)$.}\]

\[^{27}\text{See Tables 15 and 16 for some corresponding risk free rates in the columns labeled $t = 1$.}\]

\[^{28}\text{This is of course a standard observation: as the consumer becomes increasingly risk averse, he smooths intertemporal consumption more and demands higher rates of return on risky assets.}\]

\[^{29}\text{Turnovsky and Bianconi (October 2003) also find that idiosyncratic shocks play an important role in the risk premium on capital. E.g., on page 27, “If}\]

27
the reduction in aggregate risk is accompanied by an approximate doubling
in the reduction of idiosyncratic risk from 0.15 to 0.10, then the gains from
the stabilization of the aggregate risk increase to between 1.3% to 2.8%,
depending upon the degree of risk aversion.” And on page 29 they state, “In
the presence of idiosyncratic risk, the mean return on capital and the savings
rate are both nonmonotonically related to the degree of risk aversion.” In
other work, Saito (1998) examined the effect of idiosyncratic shocks on the
risk free rate of return, and found that “Assuming an empirically reasonable
magnitude of idiosyncratic shocks (σₜ), we have shown that the prediction of
risk-free rates is improved considerably.” (Page 775.)

30 Although the model is widely cited, the only numerical solution is the one in
Akdeniz and Dechert (1997) which was also used in Akdeniz (2000). Judd
(1992) has a solution for the Brock and Mirman (1972) model.

31 Figures 15 and 16 show the price and profit series for the market portfolio,
while Figures 17 and 18 show the percentage changes in the two series.

32 Notice that Brock’s model with iid shocks does exhibit serial correlation in
the output and consumption processes. This is due to the “spillover” effects
of savings. I.e., when output is high, a greater fraction of it is used as
investment, which somewhat insulates the economy from a bad shock in the
next period. A Markov series for the shocks would emphasize this effect and
produce longer intervals between peaks and troughs in output. Also, the
effect of crashes being steeper than recoveries can be incorporated with
Markov shocks, but not with iid shocks. See Danthine and Donaldson (1986)
for a model of asset prices where the shocks are modeled as a Markov
process in the output series, Yₜ.
## Tables and Figures

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Table 1
Parameter Values of the 3 Firms
Table 2
Equity Premia at $\gamma = -1.0$ $\beta = 0.95$ $\sigma_c = 0.0927$
<table>
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Table 4
Equity Premia at $\gamma = -1.0$ $\beta = 0.99$ $\sigma_c = 0.0755$
\[ P \{ Y < y \} \] | Market | Firm 1 | Firm 2 | Firm 3  \\
---|---|---|---|---
10% | 7.85% | 8.13% | 8.28% | 7.35% \\
30% | 6% | 6.17% | 6.33% | 5.66% \\
50% | 4.95% | 5.07% | 5.23% | 4.68% \\
70% | 3.89% | 3.97% | 4.12% | 3.68% \\
90% | 2.65% | 2.7% | 2.83% | 2.5% \\

Table 5  
Equity Premia at \( \gamma = -2.0 \ \beta = 0.95 \ \sigma_c = 0.0815 \)
\[
P\{Y < y\}
\]

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<tr>
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<td>4.09%</td>
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</tr>
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<td>3.13%</td>
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<tr>
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<td>2.06%</td>
<td>2.07%</td>
<td>2.17%</td>
<td>1.98%</td>
</tr>
</tbody>
</table>

Table 6
Equity Premia at $\gamma = -2.0 \ \beta = 0.97 \ \sigma_c = 0.0708$
<table>
<thead>
<tr>
<th>$\mathbb{P}{Y &lt; y}$</th>
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<th>Firm 1</th>
<th>Firm 2</th>
<th>Firm 3</th>
</tr>
</thead>
<tbody>
<tr>
<td>10%</td>
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<td>5.02%</td>
</tr>
<tr>
<td>30%</td>
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<td>4.11%</td>
<td>4.17%</td>
<td>4.03%</td>
</tr>
<tr>
<td>50%</td>
<td>3.37%</td>
<td>3.38%</td>
<td>3.44%</td>
<td>3.32%</td>
</tr>
<tr>
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<td>2.6%</td>
<td>2.65%</td>
<td>2.56%</td>
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<td>1.66%</td>
<td>1.69%</td>
<td>1.63%</td>
</tr>
</tbody>
</table>

Table 7
Equity Premia at $\gamma = -2.0 \beta = 0.99 \sigma_c = 0.0632$
<table>
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<th>Firm 3</th>
</tr>
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<tbody>
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<td>10%</td>
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</tr>
<tr>
<td>50%</td>
<td>6.29%</td>
<td>6.42%</td>
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<td>5.97%</td>
</tr>
<tr>
<td>70%</td>
<td>4.69%</td>
<td>4.78%</td>
<td>4.96%</td>
<td>4.46%</td>
</tr>
<tr>
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<td>2.84%</td>
<td>3%</td>
<td>2.64%</td>
</tr>
</tbody>
</table>

Table 8
Equity Premia at $\gamma = -3.0$ $\beta = 0.95$ $\sigma_c = 0.0717$
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<th>Firm 3</th>
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<tr>
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</tr>
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<td>5.15%</td>
<td>5.21%</td>
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<td>70%</td>
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<td>3.71%</td>
<td>3.84%</td>
<td>3.54%</td>
</tr>
<tr>
<td>90%</td>
<td>2.27%</td>
<td>2.29%</td>
<td>2.39%</td>
<td>2.19%</td>
</tr>
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</table>

Table 9
Equity Premia at $\gamma = -3.0$ $\beta = 0.97$ $\sigma_e = 0.0626$
<table>
<thead>
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<th>Firm 2</th>
<th>Firm 3</th>
</tr>
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<tbody>
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<td>8.33%</td>
<td>8.44%</td>
<td>8.62%</td>
<td>8.06%</td>
</tr>
<tr>
<td>50%</td>
<td>6.08%</td>
<td>6.15%</td>
<td>6.29%</td>
<td>5.91%</td>
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<tr>
<td>70%</td>
<td>3.69%</td>
<td>3.73%</td>
<td>3.84%</td>
<td>3.57%</td>
</tr>
<tr>
<td>90%</td>
<td>1.87%</td>
<td>1.89%</td>
<td>1.97%</td>
<td>1.8%</td>
</tr>
</tbody>
</table>

Table 10
Equity Premia at $\gamma = -3.0$ $\beta = 0.97$ $\sigma_c = 0.0677$ $\delta_i + 0.01$
Table 11
Equity Premia at $\gamma = -3.0 \beta = 0.99 \sigma_c = 0.0557$

<table>
<thead>
<tr>
<th>$\mathbb{P}{Y &lt; y}$</th>
<th>Market</th>
<th>Firm 1</th>
<th>Firm 2</th>
<th>Firm 3</th>
</tr>
</thead>
<tbody>
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<td>7.5%</td>
<td>7.2%</td>
</tr>
<tr>
<td>30%</td>
<td>5.76%</td>
<td>5.78%</td>
<td>5.87%</td>
<td>5.68%</td>
</tr>
<tr>
<td>50%</td>
<td>4.55%</td>
<td>4.56%</td>
<td>4.63%</td>
<td>4.49%</td>
</tr>
<tr>
<td>70%</td>
<td>3.16%</td>
<td>3.17%</td>
<td>3.22%</td>
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</tr>
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<td>1.72%</td>
<td>1.66%</td>
</tr>
<tr>
<td>$\mathbb{P}{Y &lt; y}$</td>
<td>Market</td>
<td>Firm 1</td>
<td>Firm 2</td>
<td>Firm 3</td>
</tr>
<tr>
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<td>--------</td>
<td>--------</td>
<td>--------</td>
<td>--------</td>
</tr>
<tr>
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<td>13%</td>
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</tr>
<tr>
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<td>10.1%</td>
<td>10.4%</td>
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<tr>
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<td>5.51%</td>
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</tr>
<tr>
<td>90%</td>
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<td>2.73%</td>
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<td>2.57%</td>
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</table>

Table 12
Equity Premia at $\gamma = -4.0 \beta = 0.95 \sigma_c = 0.0664$
<table>
<thead>
<tr>
<th>$P {Y &lt; y}$</th>
<th>Market</th>
<th>Firm 1</th>
<th>Firm 2</th>
<th>Firm 3</th>
</tr>
</thead>
<tbody>
<tr>
<td>10%</td>
<td>11.5%</td>
<td>11.5%</td>
<td>11.9%</td>
<td>11.4%</td>
</tr>
<tr>
<td>30%</td>
<td>7.25%</td>
<td>7.23%</td>
<td>7.46%</td>
<td>7.14%</td>
</tr>
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<td>4.03%</td>
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<td>3.16%</td>
<td>3.28%</td>
<td>3.39%</td>
</tr>
</tbody>
</table>

Table 13
Equity Premia at $\gamma = -4.0$ $\beta = 0.97$ $\sigma_c = 0.0517$
<table>
<thead>
<tr>
<th>$\mathbb{P}{Y &lt; y}$</th>
<th>Market</th>
<th>Firm 1</th>
<th>Firm 2</th>
<th>Firm 3</th>
</tr>
</thead>
<tbody>
<tr>
<td>10%</td>
<td>9.14%</td>
<td>9.19%</td>
<td>9.35%</td>
<td>8.97%</td>
</tr>
<tr>
<td>30%</td>
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</tr>
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<td>1.7%</td>
<td>1.74%</td>
<td>1.67%</td>
</tr>
</tbody>
</table>

Table 14
Equity Premia at $\gamma = -4.0$ $\beta = 0.99$ $\sigma_c = 0.0514$
$P \{ Y < y \}$ | $t = 1$ | $t = 2$ | $t = 3$
---|---|---|---
10% | 5.28% | 10.9% | 16.9% 
30% | 1.85% | 4.05% | 6.56% 
50% | -0.297% | -0.11% | 0.474% 
70% | -1.85% | -3.2% | -4.12% 
90% | -2.83% | -5.41% | -7.69%

Table 15
Term Structure at $\gamma = -2.0 \beta = 0.97$
<table>
<thead>
<tr>
<th>$P { Y &lt; y }$</th>
<th>$t = 1$</th>
<th>$t = 2$</th>
<th>$t = 3$</th>
</tr>
</thead>
<tbody>
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<td>4.93%</td>
<td>10.2%</td>
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<td>1.15%</td>
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<td>-1.32%</td>
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<td>-2.33%</td>
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<td>70%</td>
<td>-2.89%</td>
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<td>-7.04%</td>
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<td>-3.22%</td>
<td>-6.34%</td>
<td>-9.24%</td>
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</table>

Table 16
Term Structure at $\gamma = -3.0 \beta = 0.97$
Fig. 3. Consumption at $\gamma = -1.0 \: \beta = 0.95$
Fig. 4. Consumption at $\gamma = -1.0$, $\beta = 0.97$
Fig. 5. Consumption at $\gamma = -1.0 \beta = 0.99$
Fig. 6. Consumption at $\gamma = -2.0$ $\beta = 0.95$
Fig. 7. Consumption at $\gamma = -2.0$ $\beta = 0.97$
Fig. 8. Consumption at $\gamma = -2.0 \beta = 0.99$
Fig. 9. Consumption at $\gamma = -3.0 \ \beta = 0.95$
Fig. 10. Consumption at $\gamma = -3.0 \beta = 0.97$
Fig. 11. Consumption at $\gamma = -3.0 \; \beta = 0.99$
Fig. 12. Consumption at $\gamma = -4.0 \beta = 0.95$
Fig. 13. Consumption at $\gamma = -4.0 \beta = 0.97$
Fig. 14. Consumption at $\gamma = -4.0$ $\beta = 0.99$
Fig. 15. Market Price at $\gamma = -3.0 \beta = 0.97$
Fig. 16. Market Profits at $\gamma = -3.0 \beta = 0.97$
Fig. 17. Changes in Market Price at $\gamma = -3.0$ $\beta = 0.97$
Fig. 18. Changes in Market Profits at $\gamma = -3.0$ $\beta = 0.97$