Shiller AER (1981)

If one uses the principle from elementary statistics that the variance of the sum of two uncorrelated variables is the sum of their variances, one then has $\text{var}(p^*) = \text{var}(u) + \text{var}(p)$. Since variances cannot be negative, this means $\text{var}(p) \leq \text{var}(p^*)$ or, converting to more easily interpreted standard deviations,

\begin{equation}
\sigma(p) \leq \sigma(p^*)
\end{equation}

Summers JoF (1981)

\[ P_t = P_t^* = E \left[ \sum_{s=t}^{\infty} \frac{D_s}{(1 + r)^{s-t}} \varphi_t \right] \]

\[ P_t = E \left( \frac{P_{t+1}}{1 + r} \right) + E(D_t) \]
\[
E(R_t) = E\left( \frac{P_{t+1}}{1+r} - 1 + \frac{(1+r)_t}{P_t} \right)
\]

\[R_t = r + e_t\]

In contrast assume a “fad”

\[P_t = P_t^* + u_t\]
\[u_t = \alpha u_{t-1} + v_t\]

**Table 1**

<table>
<thead>
<tr>
<th>(\sigma_e^2)</th>
<th>(\alpha)</th>
<th>.75</th>
<th>.90</th>
<th>.95</th>
<th>.99</th>
<th>.995</th>
</tr>
</thead>
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<tr>
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<td>-0.008</td>
<td>-0.003</td>
<td>0.000</td>
<td>0.000</td>
<td></td>
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<td>0.25</td>
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<td>-0.022</td>
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<td>-0.001</td>
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<td>-0.040</td>
<td>-0.017</td>
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<tr>
<td>0.01</td>
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<td>-0.048</td>
<td>-0.023</td>
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</table>

Note: Calculations are based on Equation (8).

Equations (3), (4) and (5) imply that excess returns \(Z_t = (R_t - r)\) follow an ARMA (1, 1) process. That is:

\[Z_t = \alpha Z_{t-1} + e_t - \alpha e_{t-1} + \nu_t - \nu_{t-1}.\]  

(6)

Granger and Newbold [7] show that since \(Z_t\) can be expressed as the sum of an ARMA (1, 1) process and white noise, ARMA (0, 0), it can be represented as an ARMA (1, 1) process. Equation (6) can be used to calculate the variance and the autocorrelations of \(Z_t\). These calculations yield:

\[
\sigma_e^2 = 2(1 - \alpha)\sigma_u^2 + \sigma^2
\]

(7)

\[
\rho_k = \frac{-\alpha^{k-1}(1 - \alpha)^2\sigma_u^2}{1(1 - \alpha)\sigma_u^2 + \sigma^2}
\]

(8)

where \(\rho_k\) denotes the \(k\)th-order autocorrelation. Note that the model predicts that the \(Z_t\) should display negative serial correlation. When excess returns are positive, some part is on average spurious, due to a shock, \(\nu_t\). As prices revert to fundamental values, negative excess returns result.

Weak form efficiency: Can be tested by \(H_0: \rho_k = 0\).

Note that standard error of an autocorrelation coefficient is \(1/\sqrt{n-3}\), assuming constant variance of excess returns, and Normality of \(e\). For \(n=600\) (monthly obs), s.e.\(\approx 0.042\). Using more reasonable assumptions, it would take 5000 years to have a 50% chance of rejecting null.