

A Telltale About Asset Prices

Citation for published version (APA):

Honarvar Gheysary, I. (2018). *A Telltale About Asset Prices: An Options Perspective*. [Doctoral Thesis, Maastricht University]. Datawyse / Universitaire Pers Maastricht. <https://doi.org/10.26481/dis.20180110ihg>

Document status and date:

Published: 01/01/2018

DOI:

[10.26481/dis.20180110ihg](https://doi.org/10.26481/dis.20180110ihg)

Document Version:

Publisher's PDF, also known as Version of record

Please check the document version of this publication:

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Valorization

The three essays of this dissertation extend our knowledge in the field of asset pricing, which in turn results into more efficient deployment of capital in financial markets and increases the aggregate utility of investors.

From an investor's perspective, at any point in time, it is crucial to know (1) what are the risk factors that can negatively affect her portfolio, and (2) what is the dynamics of the compensation that she should expect for taking each particular type of risk (risk premium). By knowing the important risk factors that might affect her portfolio, the investor can use hedging instruments and transfer the risk to another party or at least she can get prepared to act, once a known risk factor negatively affects her investment. Moreover, knowing the dynamics of the compensation for each type of risk enables the investor to improve the risk and return profile of her portfolio; the investor can "time" a risk factor by getting more exposure to it when she expects a huge compensation for taking risk, and similarly, reduce her loading on a risk factor when she sees no compensation for taking a particular type of risk. This dissertation broadens our knowledge on these two important aspects of investment by exploring the nature of some of the most important risk factors and the dynamics of the compensation for taking them.

Chapter 2 critically investigates the robustness of the compensation that previous studies find for exposure to the risk of higher market moments. The novel results of this chapter show that the counter-intuitive negative compensation that investors receive for taking the market skewness risk is only restricted to the periods when the investors have a very low level of risk aversion or when they have a very high level of sentiment. In other times, when investors are more rational, the size of this irrational premium becomes insignificant.

Chapter 3 investigates the characteristics of the uncertainty that exists in prices of stocks, oil and gold, and shows that stock market uncertainty is an important factor that affects the entire cross-section of expected stock returns. Investors in the stock market must always consider their exposure to stock market uncertainty, because this is a systematically priced risk factor that affects the risk premium and the expected

return of every stock. This chapter also identifies oil price uncertainty as a factor that affects the risk and return of the stocks in oil-relevant industries and therefore industry-specialized investors in oil-relevant sectors must consider their exposure to this factor. Finally, this chapter finds that gold price uncertainty is an idiosyncratic risk factor that can be diversified away and thus it does not carry a risk premium.

Chapter 4 of this dissertation provides deep insights in the risk and return dynamics of an important trading strategy, i.e. the liquidity provision. Interestingly, as the theory and the empirical analyses show, this strategy is more profitable when the investors are more risk averse or when the market is extremely volatile. This finding signals when an active investor should enter this strategy and when she should stop providing liquidity.

Moreover as previous studies show, many conventional investment strategies - such as passively holding the market portfolio or actively engaging in a momentum strategy - have a very low return when the market is volatile. In other words, the returns on these strategies are negatively correlated with the return on liquidity provision. Hence, the findings of chapter 4 show that following the liquidity provision strategy, besides the aforementioned conventional investment strategies, reduces the volatility and increases the Sharpe ratio of the overall portfolio.