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Editorial Note

Special Issue on Financial Economics 2018

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ABSTRACT

Four papers in Financial Economics are presented in this special issue. First, a fundamental modeling of the consumption savings problem through fuzzy sets is presented. Then follows a quick look into the importance of housing in asset pricing when risk aversion of agents changes with age. Third, a model of real estate agent efforts in non-selling activities is introduced and investigated. The final paper is yet another examination of some of the issues inherent with Epstein-Zin preferences in a stylized complete markets endowment economy of the type used in the long-run risk literature.

INTRODUCTION

While Financial Economics has been a highly successful area of research in recent decades, it is also one that faces significant and continuous challenges from all fronts that cannot be underestimated. It is also highly dynamic by nature as the field of financial assets is constantly expanding. Furthermore the global importance of financial markets has brought intense focus and relentless scrutiny to both theoretical and empirical models aided by the immense and ever expanding availability of data. For all these reasons it is ever more important to be looking outside the box and to be exploring alternative models.

In that regard I retain hope that this slim volume of four papers provides a modest contribution to financial economic modeling and that it also makes for some interesting reading.

Naturally contributions can be of a forward-looking positive nature (introducing new ways in modeling that appear to have some ability to explain existing questions and puzzles) or of a critical nature (pointing out how particular ways to model may bring about unpleasant features and failures). Both kinds are obviously valuable and both are represented in this special issue.

This issue starts off with an unusual fuzzy set model that might help explain a puzzle and is presented in the first paper titled "Ambiguity and the Excess Consumption Growth Puzzle." The authors construct a model where agents engage in precautionary saving. Ambiguity in information (about future labor income) along with a decision-making mechanism that is modeled by using fuzzy sets and membership functions - relative unknown but not entirely new ideas in economic modeling (Hauenschild and Stahlecker (2001)) – are main drivers here. The authors use this model to ask whether such a fuzzy decision-making mechanism and precautionary saving caused by ambiguity of future wealth can explain the excess consumption growth puzzle. Their investigation suggests that exactly when future wealth is ambiguous, their fuzzy decision-making mechanism may help successfully explain the excess consumption growth puzzle that is exhibited by post-World War II U.S. data.

Without a doubt, real estate is quite important for both people and financial (and not only) markets. The next two papers in this volume present models involving real estate. One paper looks at the effect of the housing markets in asset prices (a seminal paper in this strand is Piazzesi, Schneider and Tuzel (2007)), while the other takes a closer look at a group of important, but somehow neglected in theoretical models, players in real estate markets, the brokers.

The second paper of this volume is “Asset Pricing with Overlapping Generations and the Housing Market.” The author argues that her modeling of the real estate markets within an asset pricing overlapping generations framework (where the agents become more risk averse as they get older) might help towards explaining long standing asset pricing puzzles for the equity premium and the risk-free rate.

The third paper titled “Focus or Generalize: Real Estate Agent Effort Allocation and Compensation” is more specialized. It recognizes first the fact that real estate agents (brokers) have now both selling and non-selling (consulting, appraising and management) opportunities. While it is not the first paper to recognize this difference in broker activities (see for instance Benjamin, Jud, Roth and Winkler (2002)) it is the first paper to present a theoretical model of this distinction. The model of broker effort allocation among selling and non-selling activities is not only constructed and solved but also checked against the available data. A positive relationship between specialization and income is confirmed and the theoretical model proposed by the authors is largely supported in the empirical exercise that is included in this paper.

The issue ends with the rather critical in nature contribution of the fourth paper titled “Rational Ignorance in Long-run Risk Models.” This paper documents, in contrast with the forward-looking nature of the three previous papers, an unpleasant feature of the (well known) Epstein-Zin preferences (Epstein and Zin (1989)) in long-run risk models. The author studies a particular but also well-established long-run risk model. He shows that if economic agents prefer early resolution of uncertainty they seem to achieve higher utility if they commit to ignore information on the state of business cycle. While this might appear quite puzzling and surprising the paper presents, at the very least, a clear way to understand how this feature comes about as a result of the coarser information set shutting down the correlation between current and expected future consumption.

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