Asset Pricing with Stochastic Habit Formation

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May 2, 2007

Abstract

This paper analyzes consumption and investment problems for a agent facing uncertainty over the process of their habit formation. This agent must take into account not only economic risk but also habit risk. As a result, optimal portfolio and consumption policies are well affected by this preference shift risk. In cotrast to single-beta model, equilibrium risk premium is determined by two factors: covariance of marginal utility from consumption (consumption beta) and that of marginal disutility from the habitual living standard (habit beta). A risk-free interest rate is also examined.

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