

Abstract

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This thesis consists of three chapters, the first two in the field of financial econometrics, and the third one in the area of asset pricing. In the first chapter, we compare the finite sample power of short and long-horizon tests in nonlinear predictive regression models of regime switching between bull and bear markets, allowing for time varying transition probabilities. As a point of reference, we also provide a similar comparison in a linear predictive regression model without regime switching. Overall, our results do not support the contention of higher power in longer horizon tests in either the linear or nonlinear regime switching models. Nonetheless, it is possible that other plausible nonlinear models provide stronger justification for long-horizon tests.

Using finite sample simulation methods, we assess the power of long-horizon predictive tests and compare them to their short-run counterparts, when the true underlying model contains financial asset bubbles. Our results indicate that long-run predictive test using valuation predictors -- specifically the dividend price ratio-- do pick up the return predictability inherent in the asset bubbles. However, after size-adjustment, the long-run predictive framework has a small advantage over its short-run counterpart when the predictor is highly persistent and provides a larger, yet still modest power improvement when the predictor is moderately persistent.

The third chapter proposes a simple Bayesian learning framework to assess leverage ratios in the presence of parameter uncertainty about mean log cash flow. In particular it can explain why firm's leverage ratios have been observed to increase with firm age. Market values are increasing in uncertainty about mean cash flow and leverage ratios are decreasing with market values. Over the life period of firm, the managers and investors rationally learn from realized

cash flows. Due to the convex relationship between cash flow and firm value, ceteris paribus, this results in a decrease in market value and an increase in the leverage ratio. Firm level panel data provides empirical evidence consistent with the model predictions after correcting for the endogeneity of the book to market and profitability control variates. The empirical results suggest that the firm leverage ratio increases over firm age due to learning.