The Effects of Volatility Feedback on Strategic Asset Allocation

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Abstract

We first derive a bivariate diffusion system for stock returns and the corresponding volatility based on Campbell and Hentschel's (1992) volatility feedback model and then solve the dynamic asst allocation problem. The resulting optimal portfolio weight consists of an important factor hedging against future volatility changes. Much higher certainty equivalent wealth can be achieved by taking this hedging factor into account.