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Pricing long-lived securities in dynamic endowment economies*

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Abstract

We solve for asset prices in a general affine representative-agent economy with isoelastic recursive utility and rare events. Our novel solution method is exact in two special cases: no preference for early resolution of uncertainty and elasticity of intertemporal substitution equal to one. Our results clarify model properties governed by the elasticity of intertemporal substitution, by risk aversion, and by the preference for early resolution of uncertainty. Finally, we show in a general setting that the linear relation between normal-times covariances and expected returns need not hold in a model with rare events.

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