

# Improvement in Finite Sample Properties of the Hansen-Jagannathan Distance Test\*

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March 21, 2007

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\*The authors thank Christopher Gadarowski for providing the dataset for calibrating the Premium-Labor model and Masayuki Hirukawa and Victoria Zinde-Walsh for helpful comments. Shimotsu thanks the SSHRC for financial support.

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## Abstract

Jagannathan and Wang (1996) derive the asymptotic distribution of the Hansen-Jagannathan distance (HJ-distance) proposed by Hansen and Jagannathan (1997), and develop a specification test of asset pricing models based on the HJ-distance. While the HJ-distance has several desirable properties, Ahn and Gadarowski (2004) find that the specification test based on the HJ-distance overrejects correct models too severely in commonly used sample size to provide a valid test. This paper proposes to improve the finite sample properties of the HJ-distance test by applying the shrinkage method (Ledoit and Wolf, 2003) to compute its weighting matrix. The proposed method improves the finite sample performance of the HJ-distance test significantly.

JEL classification: C13; C52; G12

Keywords: Covariance matrix estimation; Factor models; Finite sample properties; Hansen-Jagannathan distance; Shrinkage method

# 1 Introduction

Asset pricing models are the cornerstone of finance. They reveal how portfolio returns are determined and which factors affect returns. Stochastic discount factors (SDF) describe portfolio returns from another point of view. SDFs display which prices are reasonable given the returns in the current period. Asset prices can be represented as inner products of payoffs and SDFs. If asset pricing models were the true data generating process (DGP) of returns, SDFs could price the returns perfectly.

In reality, asset pricing models are at best approximations. This implies no stochastic discount factors can price portfolios perfectly in general. Therefore, it is important to construct a measure of pricing errors produced by SDFs so that we are able to compare and evaluate SDFs. For this purpose, Hansen and Jagannathan (1997) develop the Hansen-Jagannathan distance (HJ-distance). This measure is in the quadratic form of the pricing errors weighted by the inverse of the second moment matrix of returns. Intuitively, the HJ-distance equals the maximum pricing error generated by a model for portfolios with unit second moment. It is also the least-squares distance between a stochastic discount factor and the family of SDFs that price portfolios correctly.

The HJ-distance has already been applied widely in financial studies. Typically, when a new model is proposed, the HJ-distance is employed to compare the new model with alternative ones. Hereby, the new model can be supported if it offers small pricing errors. This type of comparison has been adopted in many recent papers. For instance, by using the HJ-distance, Jagannathan and Wang (1998) discuss cross sectional regression models; Kan and Zhang (1999) study asset pricing models when one of the proposed factors is in fact useless; Campbell and Cochrane (2000) explain why the CAPM and its extensions are better at approximating asset pricing models than the standard consumption-based asset pricing theory; Hodrick and Zhang (2001) evaluate the specification errors of several empirical asset pricing models that have been developed as potential improvements on the CAPM; Lettau and Ludvigson (2001) explain the cross section of average stock returns; Jagannathan and Wang (2002) compare the SDF method with the Beta method in estimating risk premium; Vassalou (2003) studies models that include

a factor that captures news related to future Gross Domestic Product (GDP) growth; Jacobs and Wang (2004) investigate the importance of idiosyncratic consumption risk for the cross sectional variation in asset returns; Vassalou and Xing (2004) compute default measures for individual firms; Huang and Wu (2004) analyze the specifications of option pricing models based on time-changed Levy process; and Parker and Julliard (2005) evaluate the consumption capital asset pricing model in which an asset's expected return is determined by its equilibrium risk to consumption. Some other works test econometric specifications using the HJ-distance, including Bansal and Zhou (2002) and Shapiro (2002); Dittmar (2002) uses the HJ-distance to estimate the nonlinear pricing kernels in which the risk factor is endogenously determined and preferences restrict the definition of the pricing kernel.

The HJ-distance has several desirable properties in comparison to the  $J$ -statistic of Hansen (1982): first of all, it does not reward variability of SDFs. The weighting matrix used in the HJ-distance is the second moment of portfolio returns and independent of pricing errors, while the Hansen statistic uses the inverse of the second moment of the pricing errors as the weighting matrix and rewards models with high variability of pricing errors. Second, as Jagannathan and Wang (1996) point out, the weighting matrix of the HJ-distance remains the same across various pricing models, which makes it possible to compare the performances among competitive SDFs by the relative values of the HJ-distances. Unlike the Hansen statistic, the HJ-distance does not follow a chi-squared distribution asymptotically. Instead, Jagannathan and Wang (1996) show that, for linear factor models, the HJ-distance is asymptotically distributed as a weighted chi-squared distribution. In addition, they suggest a simulation method to develop the empirical  $p$ -value of the HJ-distance statistic.

However, Ahn and Gadarowski (2004) find that the specification test based on the HJ-distance severely overrejects correct models in commonly used sample size, compared with the Hansen test which mildly overrejects correct models. Ahn and Gadarowski (2004) attribute this overrejection to poor estimation of the pricing error variance matrix, which occurs because the number of assets is relatively large for the number of time-series observations. Ahn and Gadarowski (2004) report that the rejection probability reaches as large as 75% for a nominal

5% level test, demonstrating a serious need for an improvement of the finite sample properties of the HJ-distance test.

In this paper, we propose to improve the finite sample properties of the HJ-distance test via more accurate estimation of the *weighting matrix*, which is the inverse of the second moment matrix of portfolio returns. We justify our method by showing that poor estimation of the weighting matrix contributes significantly to the poor small sample performance of the HJ-distance test. When the exact second moment matrix is used, the rejection frequency becomes comparable to its nominal size.<sup>1</sup>

Of course, the true covariance matrix is unknown. We employ the idea of the shrinkage method following Ledoit and Wolf (2003) to obtain a more accurate estimate of the covariance matrix. The basic idea behind shrinkage estimation is to take an optimally weighted average of the sample covariance matrix and the covariance matrix implied by a possibly misspecified structural model. The structural model provides a covariance matrix estimate that is biased but has a small estimation error due to the small number of parameters to be estimated. The sample covariance matrix provides another estimate which has a small bias, but a large estimation error. The shrinkage estimation balances the trade-off between the estimation error and bias by taking a weighted average of these two estimates.

In this shrinkage method, one needs to choose a structural model serving as the shrinkage target. Here, because testing a SDF is the purpose of the HJ-distance test, a natural choice of the structural model is the asset pricing model whose SDF is tested by the HJ-distance test. The optimally weighted average is constructed by minimizing the distance between the weighted covariance matrix and the true covariance matrix, and the optimal weight can be estimated consistently from the data.

We allow both possibilities where the target model is correctly specified and misspecified. In the former case, the shrinkage target is asymptotically unbiased. In the latter case, the shrinkage target is biased, but the estimated weight on the shrinkage target converges to zero in probability as the sample size tends to infinity. Therefore, the proposed covariance matrix

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<sup>1</sup>Jobson and Korkie (1980) also report poor performance of the sample covariance matrix as an estimate of the population covariance when the sample size is not large enough compared with the dimension of the portfolio.

estimate is consistent in both cases.

Using this covariance matrix estimate greatly improves the finite sample performance of the HJ-distance test. We use similar data sets with Ahn and Gadarowski (2004). With 25 portfolios, the rejection frequencies are close to the nominal size even for the sample sizes of 160. With 100 portfolios, the rejection frequency is sometimes far from the nominal size, but it is much closer than the case in which the sample covariance matrix is used.

The rest of this paper is organized as follows: section 2 briefly reviews the HJ-distance and the specification test based on it; section 3 presents the problem of the small sample properties of the HJ-distance test; section 4 describes the proposed solution to this problem; and section 5 reports the simulation results; section 6 concludes.

## 2 Hansen-Jagannathan distance

Hansen and Jagannathan (1997) develop a measure of degree of misspecification of an asset pricing model. This measure, called the HJ-distance, is defined as the least squares distance between the stochastic discount factor associated with an asset pricing model and the family of stochastic discount factors that price all the assets correctly. Hansen and Jagannathan (1997) show that the HJ-distance is also equal to the maximum pricing errors generated by a model on the portfolios whose second moments of returns are equal to one.

Consider a portfolio of  $N$  primitive assets, and let  $R_t$  denote the  $t$ -th period gross returns of these assets.  $R_t$  is a  $1 \times N$  vector. A valid stochastic discount factor (SDF),  $m_t$ , satisfies  $E(m_t R_t') = 1_N$ , where  $1_N$  is a  $N$ -vector of ones. If an asset pricing model implies a stochastic discount factor  $m_t(\delta)$ , where  $\delta$  is a  $K \times 1$  unknown parameter, then the HJ-distance corresponding to this asset pricing model is given by

$$HJ(\delta) = \sqrt{E[w_t(\delta)]' G^{-1} E[w_t(\delta)]},$$

where  $w_t(\delta) = R_t' m_t(\delta) - 1_N$  denotes the pricing errors and  $G = E(R_t' R_t)$ .

We follow Ahn and Gadarowski (2004) and focus on linear factor pricing models. Linear

factor pricing models imply the SDF of the linear form  $m_t(\delta) = \tilde{X}_t\delta$ , where  $\tilde{X}_t = [1 \ X_t]$  is a  $1 \times K$  vector of factors including 1; see Hansen and Jagannathan (1997). Note that linear factor pricing models can accommodate nonlinear function of factors because  $\tilde{X}_t$  may contain polynomials of factors, and the linearity assumption here is not very restrictive. For example, Bansal, Hsieh, and Viswanathan (1993), Chapman (1997), and Dittmar (2002) consider nonlinear factor models of this type. In addition, many successful asset pricing models are in linear forms.<sup>2</sup>

The HJ-distance can be estimated by its sample analogue

$$HJ_T(\delta) = \sqrt{w_T(\delta)'G_T^{-1}w_T(\delta)},$$

where  $w_T(\delta) = T^{-1} \sum_{t=1}^T w_t(\delta) = D_T\delta - 1_N$ ,  $D_T = T^{-1} \sum_{t=1}^T R_t'\tilde{X}_t$  and  $G_T = T^{-1} \sum_{t=1}^T R_t'R_t$ . Following Jagannathan and Wang (1996), the parameter  $\delta$  is estimated by minimizing the sample HJ-distance  $HJ_T(\delta)$ , giving the estimate  $\delta_T$  as

$$\delta_T = (D_T'G_T^{-1}D_T)^{-1}D_T'G_T^{-1}1_N.$$

The estimator  $\delta_T$  is equivalent to a GMM estimator with the moment condition  $E[w_t(\delta)] = 0$  and the weighting matrix  $G_T^{-1}$ .

Jagannathan and Wang (1996) prove that, under the hypothesis that the SDF prices the returns correctly, the sample HJ-distance follows

$$T[HJ_T(\delta_T)]^2 \rightarrow_d \sum_{j=1}^{N-K} \lambda_j v_j,$$

where  $v_1, \dots, v_{N-K}$  are independent  $\chi^2(1)$  random variables, and  $\lambda_1, \dots, \lambda_{N-K}$  are nonzero eigenvalues of the following matrix:

$$\Lambda = \Omega^{1/2}G^{-1/2}[I_N - (G^{-1/2})'D(D'G^{-1}D)^{-1}D'G^{-1/2}](G^{-1/2})'(\Omega^{1/2})'.$$

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<sup>2</sup>For example, the Sharpe (1964)-Lintner (1965)-Black (1972) CAPM, the Breeden (1979) consumption CAPM, the Adler and Dumas (1983) international CAPM, the Chen, Roll, and Ross (1986) five macro factor model, and the Fama-French (1992, 1996) three factor model.

Here  $\Omega = E[w_t(\delta)w_t(\delta)']$  denotes the variance of pricing errors, and  $D = E(R_t'\tilde{X}_t)$ . It can be proved that  $A$  is positive semidefinite with rank  $N - K$ .  $G_T$  and  $D_T$  can be used to estimate  $G$  and  $D$  consistently. Under the hypothesis that the SDF prices the returns correctly,  $\Omega$  can be estimated consistently by  $\Omega_T = T^{-1} \sum_{t=1}^T w_t(\delta_T)w_t(\delta_T)'$ .

$\delta_T$  is not as efficient as the optimal GMM estimator that uses  $\Omega_T^{-1}$  (optimal weighting matrix) as the weighting matrix, defined as

$$\delta_{OPT,T} = (D_T'\Omega_T^{-1}D_T)^{-1}D_T'\Omega_T^{-1}\mathbf{1}_N.$$

Associated with  $\delta_{OPT,T}$  and  $\Omega_T^{-1}$  is the  $J$ -statistic of Hansen (1982)

$$J_T(\delta_{OPT,T}) = Tw_T(\delta_{OPT,T})'\Omega_T^{-1}w_T(\delta_{OPT,T}),$$

which is widely used for specification testing. Under the null hypothesis that the SDF prices the returns correctly, Hansen's  $J$ -statistic is asymptotically  $\chi^2$ -distributed with  $N - K$  degrees of freedom.

The HJ-distance has several desirable properties over the  $J$ -statistic. First, it does not reward the variability of SDFs. The weighting matrix used in the HJ-distance is the second moment of portfolio returns and independent of pricing errors. On the other hand, the  $J$ -statistic uses the inverse of the second moment of the pricing errors as the weighting matrix and hence rewards models with high variability of pricing errors. Second, as Jagannathan and Wang (1996) point out, the weighting matrix of the HJ-distance remains the same across various pricing models, which makes it possible to compare the performances among competitive SDFs by the relative values of the HJ-distances for a given dataset.

### 3 Finite sample properties of the HJ-distance test

In this section, we investigate the finite sample performances of the specification test based on the HJ-distance (henceforth the HJ-distance test) following the settings of Ahn and Gadarowski (2004).

### 3.1 Simulation design

We simulate three sets of data comparable to those in Ahn and Gadarowski (2004). The first set is a simple three-factor model with independent factor loadings, where the scale of expected returns and variability of the factors are roughly matched to those of the actual market-wide returns. The statistical properties of the factors and idiosyncratic errors are set to be identical to those in Ahn and Gadarowski (2004). We refer to this model as the Simple model henceforth. The second set of data is calibrated to resemble the statistical properties of the three-factor model in Fama-French (1992). The third set of data is calibrated based on the Premium-Labor model in Jagannathan and Wang (1996). The details of the data generation are provided in the Appendix.

We simulate each set of the data with 1000 replications. For each replication, we calculate the HJ-distance and test the null hypothesis that the stochastic discount factor implied by the DGP prices portfolio returns correctly. Since the stochastic discount factors are derived from the true DGPs, the actual rejection frequency is supposed to be close to the nominal level. The critical values of the HJ-distance test are calculated following the algorithm by Jagannathan and Wang (1996). First, draw  $M \times (N - K)$  independent random variables from  $\chi^2(1)$  distribution. Next, calculate  $u_j = \sum_{i=1}^{N-K} \lambda_i v_{ij}$  ( $j = 1, \dots, M$ ). Then the empirical  $p$ -value of the HJ-distance is

$$p = M^{-1} \sum_{j=1}^M I(u_j \geq T[HJ_T(\delta_T)]^2),$$

where  $I(\cdot)$  is an indicator function which equals one if the expression in the brackets is true and zero otherwise. In our simulation, we set  $M = 5,000$ .

### 3.2 Simulation results

Table 1 summarizes the results from this simulation with 25 and 100 portfolios and  $T = 160, 330, 700$ . Panel A of this table corresponds to Table 1 of Ahn and Gadarowski (2004), while Panels B and C correspond to Table 3 of Ahn and Gadarowski (2004). The first column in each panel is the significance level of the tests. The other columns report the actual rejection frequencies for different numbers of observations. The results are comparable to those in Ahn

and Gadarowski (2004).

[Table 1 around here]

The HJ-distance test overrejects the correct null under all combinations of the DGPs, the number of portfolios, and sample sizes. In the Simple model and Fama-French model, the size distortion is noticeable except for the combination of  $T = 700$  and 25 portfolios. The size distortion is particularly large with 100 portfolios but improves as  $T$  increases. In the Premium-Labor model, the HJ-distance test is severely oversized both with 25 and 100 portfolios and for all sample sizes. As suggested by Ahn and Gadarowski (2004), this excessive rejection frequencies for the HJ-distance may be due to a feature of the data based on the Premium-Labor model not present in the other data, possibly the temporal dependence of the factors.

Ahn and Gadarowski (2004) investigate the source of this overrejection and find that one of its sources is the poor estimation of the variance matrix of the pricing errors,  $\Omega$ . They find that repeating their simulations using the exact pricing error variance matrix  $\Omega$  removes most of the upward bias in the size of the HJ-distance test. However, the exact pricing error matrix is unknown, and hence it is impossible to use this method in practice and the problem of overrejection has remained unsolved.

We examine other possible sources of overrejection. It is well-known that the accuracy of the weighting matrix has a significant effect on the finite sample property of the GMM-based Wald tests (e.g., Burnside and Eichenbaum, 1996). We conjecture another possible source of the overrejection is the poorly estimated weighting matrix. Jagannathan and Wang (1996) use  $T^{-1} \sum_{t=1}^T R_t' R_t = \widehat{Var}(R_t) + \widehat{E}(R_t)' \widehat{E}(R_t)$  as an estimate of  $G = E(R_t' R_t) = Var(R_t) + E(R_t)' E(R_t)$ . While  $E(R_t)$  can be estimated accurately by the sample mean for the sample size of our interest, the sample covariance matrix can be a very inaccurate estimate of  $Var(R_t)$  when the number of observation is not large enough relative to the number of portfolios, as pointed out by Jobson and Korkie (1980). In our case, with 25 portfolios,  $G$  has  $(26 \times 25)/2 = 325$  elements. Consequently, the poor estimation of  $G$  may be another main reason for the poor small sample performance of the HJ-distance test.

We confirm this conjecture by repeating the simulations in Table 1 but replacing  $G_T$  with the exact second moment matrix  $G$ . Table 2 shows the resulting rejection frequencies of the HJ-distance test. We approximate  $G$  by the sample second moment matrix from 10,000 time-series observations. In all cases, the rejection rates of the HJ-distance test improve dramatically. The HJ-distance test now has good small sample properties in the Simple model and the Fama-French model. In particular, with 25 portfolios, the actual size is close to the nominal size for all  $T$ . Comparing it with Table 1 suggests that the improvement of the size of the original HJ-distance test with large  $T$  occurs mainly through a more accurate estimation of  $G$ . In the Premium-Labor model, there still remains size distortion, but its magnitude is much smaller than those in Panel C of Table 1.

[Table 2 around here]

## 4 Improved estimation of covariance matrix by shrinkage

The simulation evidence in the previous section reveals that the finite sample performance of the HJ-distance test improves significantly when one employs a better estimate of the second moment matrix of portfolio returns, or equivalently, a better estimate of the covariance matrix of portfolio returns. In this section, we explore the possibility of improved estimation of the portfolio covariance matrix by the shrinkage method following the approach of Ledoit and Wolf (2003).

### 4.1 Shrinkage method and the HJ-distance

The shrinkage method dates back to the seminal paper by Stein (1956). The basic idea behind the shrinkage method is to balance the trade-off between bias and variance by taking a weighted average of two estimators. If one estimator is unbiased but has a large variance while the other estimator is biased but has a small variance, then taking a properly weighted average of the two estimators can outperform both estimators in terms of accuracy (mean squared error). The biased estimator is called the shrinkage target to which the unbiased estimator with a large variance is shrunk.

In our context, the sample covariance matrix is an unbiased estimator of the true covariance matrix but has a large variance. Note that the purpose of the HJ-distance test is to test if a SDF can price the returns correctly. Therefore, a natural choice of the shrinkage target is the covariance matrix implied by the factor model which implies the SDF of interest. Factor pricing models explain asset returns in terms of a few factors and uncorrelated residuals, thereby imposing a low-dimensional factor structure to the returns. Since the parameters of a factor model can be estimated with a small variance, the estimate of the asset covariance matrix implied by the factor model has a small variance, although it is a biased estimate when the factor model is misspecified.

One might argue for using the asset covariance matrix implied by the factor model alone, without combining it with the sample covariance. We advocate the shrinkage method in this paper because the HJ-distance test is often used to compare the fit of different SDFs. Comparing different SDFs by the HJ-distance requires one to use the same weighting matrix across all candidate SDFs, but one does not know which SDF is the correct SDF *a priori*. Using the shrinkage method allows one to use the same weighting matrix across different SDFs without assuming one particular SDF is the correct one.

## 4.2 Optimal shrinkage intensity

Shrinkage method assigns  $\alpha$  weight to a covariance matrix implied by a factor model and the other  $1 - \alpha$  weight to the sample covariance matrix. Using the shrinkage method requires the determination of  $\alpha$ , which is called the shrinkage intensity. Ledoit and Wolf (2003) derive the analytical formula for the optimal  $\alpha$  and discuss its estimation when the shrinkage target is a single-factor model and is a misspecified model of asset returns. We extend their method to multiple-factor shrinkage targets as well as to the case where the shrinkage target is the correct model of asset returns.

As in Section 2, let  $R_t$  denote a  $1 \times N$  vector of the  $t$ -th period gross returns of  $N$  assets, and let  $X_t$  denote a  $1 \times K^*$  vector of factors not including a constant, where  $K^* = K - 1$ . Let  $R_{ti}$  denote the  $t$ -th period gross return of the  $i$ -th asset, so that  $R_t = (R_{t1}, \dots, R_{tN})$ .

Suppose the following  $K$ -factor linear asset pricing model is used to construct the shrinkage target. It is not necessary that the model generates the actual stock returns.

$$R_{ti} = \mu_i + X_t \beta_i + \varepsilon_{ti}, \quad t = 1, \dots, T, \quad (1)$$

where  $\beta_i$  is a  $K^* \times 1$  vector of slopes for the  $i$ th asset, and  $\varepsilon_{ti}$  is the mean-zero idiosyncratic error for asset  $i$  in period  $t$ .  $\varepsilon_{ti}$  has a constant variance  $\delta_{ii}$  across time, and is uncorrelated to  $\varepsilon_{tj}$  with  $j \neq i$  and to the factors. The model (1) may be the asset pricing model corresponding to the SDF we test, but any other linear factor model can be used. Let  $\beta = (\beta_1, \dots, \beta_N)$  denote the  $K^* \times N$  matrix of the slopes,  $\mu = (\mu_1, \dots, \mu_N)$  be the  $1 \times N$  vector of the intercepts, and  $\varepsilon_t = (\varepsilon_{t1}, \dots, \varepsilon_{tN})$ . Then the factor model (1) is written as

$$R_t = \mu + X_t \beta + \varepsilon_t, \quad \text{Var}(\varepsilon_t) = \Delta = \text{diag}(\delta_{ii}), \quad t = 1, \dots, T. \quad (2)$$

We impose the following assumptions on the stock returns and factors.

**Assumption 1** *Stock returns  $R_t$  and factors  $X_t$  are independently and identically distributed over time.*

**Assumption 2**  *$R_t$  and  $X_t$  have finite fourth moment, and  $\text{Var}(R_t) = \Sigma$ .*

The iid assumption is used in Ledoit and Wolf (2003). We may allow  $R_t$  and  $X_t$  to be heteroskedastic and/or serially correlated by assuming they satisfy conditions such as mixing or near-epoch dependence without affecting the logic underlying our argument. We use the iid assumption because it is an acceptable first-cut approximation and relaxing it adds substantial notational complexity.

The asset pricing model (2) implies the following covariance matrix of  $R_t$ :

$$\Phi = \beta' \text{Var}(X_t) \beta + \Delta.$$

We can estimate  $\Phi$  by estimating its components. Regressing the  $i$ -th portfolio returns on an intercept and the factors, we obtain the least squares estimate of  $\beta_i$  and the residual variance

estimate. Let  $b_i$  and  $d_{ii}$  denote these estimates of  $\beta_i$  and  $\delta_{ii}$ , respectively. Let  $b = (b_1, \dots, b_N)$  and  $D = \text{diag}(d_{ii})$ , then the estimate of  $\Phi$  is

$$F = b' \widehat{\text{Var}}(X_t) b + D, \quad (3)$$

where  $\widehat{\text{Var}}(X_t)$  is the sample covariance matrix of the factors.

We estimate  $\Sigma$  by a weighted average of  $F$  and the sample covariance of  $R_t$ ,  $S$ , with the weight (shrinkage intensity)  $\alpha$  assigned to the shrinkage target  $F$ . We choose the shrinkage intensity  $\alpha$  so that it minimizes a risk function. Let  $\|Z\|$  be the Frobenius norm of an  $N \times N$  matrix  $Z$ , so

$$\|Z\|^2 = \text{Trace}(Z'Z) = \sum_{i=1}^N \sum_{j=1}^N z_{ij}^2.$$

Following Ledoit and Wolf (2003), we use the following risk function

$$Q(\alpha) = E[L(\alpha)],$$

where  $L(\alpha)$  is a quadratic measure of the distance between the true and estimated covariance matrices

$$L(\alpha) = \|\alpha F + (1 - \alpha)S - \Sigma\|^2.$$

Let  $s_{ij}$ ,  $f_{ij}$ ,  $\sigma_{ij}$ , and  $\phi_{ij}$  denote the  $(i, j)$ -th element of  $S$ ,  $F$ ,  $\Sigma$ , and  $\Phi$ , respectively. It follows that

$$\begin{aligned} Q(\alpha) &= \sum_{i=1}^N \sum_{j=1}^N E(\alpha f_{ij} + (1 - \alpha)s_{ij} - \sigma_{ij})^2 \\ &= \sum_{i=1}^N \sum_{j=1}^N \{ \text{Var}(\alpha f_{ij} + (1 - \alpha)s_{ij}) + [E(\alpha f_{ij} + (1 - \alpha)s_{ij} - \sigma_{ij})]^2 \} \\ &= \sum_{i=1}^N \sum_{j=1}^N \{ \alpha^2 \text{Var}(f_{ij}) + (1 - \alpha)^2 \text{Var}(s_{ij}) + 2\alpha(1 - \alpha) \text{Cov}(f_{ij}, s_{ij}) + \alpha^2 (\phi_{ij} - \sigma_{ij})^2 \}. \end{aligned}$$

The optimal  $\alpha$  can be derived by differentiating  $Q(\alpha)$  with respect to  $\alpha$ . The second order condition is satisfied since  $Q(\alpha)$  is concave. Solving the first order condition for  $\alpha$  gives the optimal  $\alpha$  as

$$\alpha^* = \frac{\sum_{i=1}^N \sum_{j=1}^N \text{Var}(s_{ij}) - \sum_{i=1}^N \sum_{j=1}^N \text{Cov}(f_{ij}, s_{ij})}{\sum_{i=1}^N \sum_{j=1}^N \text{Var}(f_{ij} - s_{ij}) + \sum_{i=1}^N \sum_{j=1}^N (\phi_{ij} - \sigma_{ij})^2},$$

which is the same as (3) in Ledoit and Wolf (2003). Multiplying both the numerator and the denominator by  $T$ , we obtain

$$\alpha^* = \frac{\sum_{i=1}^N \sum_{j=1}^N \text{Var}(\sqrt{T}s_{ij}) - \sum_{i=1}^N \sum_{j=1}^N \text{Cov}(\sqrt{T}f_{ij}, \sqrt{T}s_{ij})}{\sum_{i=1}^N \sum_{j=1}^N \text{Var}(\sqrt{T}f_{ij} - \sqrt{T}s_{ij}) + T \sum_{i=1}^N \sum_{j=1}^N (\phi_{ij} - \sigma_{ij})^2}. \quad (4)$$

As in Ledoit and Wolf (2003), define  $\pi = \sum_{i=1}^N \sum_{j=1}^N \text{AsyVar}[\sqrt{T}s_{ij}]$ ,  $\rho = \sum_{i=1}^N \sum_{j=1}^N \text{AsyCov}[\sqrt{T}f_{ij}, \sqrt{T}s_{ij}]$ , and let  $\gamma = \sum_{i=1}^N \sum_{j=1}^N (\phi_{ij} - \sigma_{ij})^2$  denote the measure of the misspecification of the factor model (2). Define  $\eta = \sum_{i=1}^N \sum_{j=1}^N \text{AsyVar}[\sqrt{T}(f_{ij} - s_{ij})]$ . We consider the limit of  $\alpha^*$  as  $T \rightarrow \infty$  in two cases separately, depending on whether  $\Phi = \Sigma$ . First, consider the case where  $\Phi \neq \Sigma$ . Since  $S$  is consistent while  $F$  is not, the optimal shrinkage intensity  $\alpha^*$  converges to 0 as  $T \rightarrow \infty$ . Ledoit and Wolf (2003) prove in their Theorem 1 that

$$T\alpha^* \rightarrow \frac{\pi - \rho}{\gamma}, \quad \text{as } T \rightarrow \infty. \quad (5)$$

When  $\Phi = \Sigma$ , both  $S$  and  $F$  are consistent for  $\Sigma$ , but they have different variance. In this case, the optimal shrinkage intensity  $\alpha^*$  converges to a non-degenerate limit

$$\alpha^* \rightarrow \frac{\pi - \rho}{\eta}, \quad \text{as } T \rightarrow \infty. \quad (6)$$

This case is not considered in Ledoit and Wolf (2003), but the proof of (6) follows from the proof of Theorem 1 of Ledoit and Wolf (2003, pp. 610-611). From (5) and (6), the shrinkage estimate  $\alpha F + (1 - \alpha)S$  is consistent for  $\Sigma$  under both  $\Phi \neq \Sigma$  and  $\Phi = \Sigma$ . Note that  $(\pi - \rho)/\eta$  does not necessarily equal 1.  $(\pi - \rho)/\eta = 1$  if  $F$  is an asymptotically efficient estimator of  $\Sigma$ .

### 4.3 Estimation of the optimal shrinkage intensity

Since  $\pi$ ,  $\rho$ ,  $\mu$  and  $\gamma$  in the formula for  $\alpha^*$  are unobservable, we must find estimators for them. Define  $\pi_{ij} = \text{AsyVar}[\sqrt{T}s_{ij}]$ ,  $\rho_{ij} = \text{AsyCov}[\sqrt{T}f_{ij}, \sqrt{T}s_{ij}]$ ,  $\gamma_{ij} = (\phi_{ij} - \sigma_{ij})^2$ , and  $\eta_{ij} = \text{AsyVar}[\sqrt{T}(f_{ij} - s_{ij})]$ , so that  $\pi = \sum_{i=1}^N \sum_{j=1}^N \pi_{ij}$ ,  $\rho = \sum_{i=1}^N \sum_{j=1}^N \rho_{ij}$ ,  $\gamma = \sum_{i=1}^N \sum_{j=1}^N \gamma_{ij}$ , and  $\eta = \sum_{i=1}^N \sum_{j=1}^N \eta_{ij}$ . In the following, we present consistent estimates of these

quantities and show the asymptotic behavior of our estimate of  $\alpha^*$ .

### 4.3.1 $\pi_{ij}$ and $\gamma_{ij}$

From Lemma 1 of Ledoit and Wolf (2003), a consistent estimator for  $\pi_{ij}$  is given by

$$p_{ij} = \frac{1}{T} \sum_{t=1}^T [(R_{ti} - m_i)(R_{tj} - m_j) - s_{ij}]^2,$$

where  $m_i = T^{-1} \sum_{t=1}^T R_{ti}$  is the sample average of the return of the  $i$ -th asset. Define  $c_{ij} = (f_{ij} - s_{ij})^2$ , then  $c_{ij} \rightarrow_p \gamma_{ij}$  follows from Lemma 3 of Ledoit and Wolf (2003).

### 4.3.2 $\rho_{ij}$

When  $i = j$ , note that  $f_{ii} = s_{ii}$ . Thus we can use  $p_{ii}$  to estimate  $\rho_{ii}$ . When  $i \neq j$ , first define  $M = I - T^{-1}\mathbf{1}\mathbf{1}'$ , where  $I$  is a  $T \times T$  identity matrix and  $\mathbf{1}$  is a  $T \times 1$  vector of ones. Collect the factors into a  $T \times K^*$  matrix  $X$ :  $X = (X'_1, \dots, X'_T)'$ . We use  $R_{.i}$  to denote a  $T \times 1$  vector of the  $i$ -th asset return. Recall that (see (3))

$$F = b' \widehat{Var}(X_t) b + D,$$

where  $b = (b_1, \dots, b_N)$ , and  $b_i$  is given by  $b_i = (X'MX)^{-1}X'MR_{.i}$ .  $D$  is a diagonal matrix of residual variance estimates.

Define  $S_{xi} = T^{-1}R'_{.i}MX$ , which is the  $1 \times K^*$  sample covariance vector between  $X_t$  and  $R_{tj}$ , and define  $S_{xx} = T^{-1}X'MX$ , which is the  $K^* \times K^*$  sample covariance matrix of  $X_t$ . Then we can express  $f_{ij}$  for  $i \neq j$  as

$$f_{ij}R'_{.i}MX(X'MX)^{-1}T^{-1}(X'MX)(X'MX)^{-1}X'MR_{.j} = S_{xi}(S_{xx})^{-1}(S_{xj})'. \quad (7)$$

Let  $\bar{X} = T^{-1} \sum_{t=1}^T X_t = 1 \times K^*$  vector of the sample average of the factors;  $\sigma_{xj} = 1 \times K^*$  covariance vector between  $X_t$  and  $R_{tj}$ ;  $\sigma_{xx} = K^* \times K^*$  covariance matrix of  $X_t$ .

The following lemma provides a consistent estimator of  $\rho_{ij}$ . Recall that  $s_{ij}$  denotes the

$(i, j)$ -th element of  $S$  and is equal to the sample covariance between  $R_{ti}$  and  $R_{tj}$ .

**Lemma 1** *A consistent estimator of  $\rho_{ij}$  is given by  $r_{ij}$ , defined as follows: for  $i = j$ , set  $r_{ii} = p_{ii}$ , and for  $i \neq j$ , set  $r_{ij}$  as*

$$r_{ij} = Z_i S_{xx}^{-1} (S_{xj})' + S_{xi} S_{xx}^{-1} (Z_j)' - S_{xi} S_{xx}^{-1} Z_x S_{xx}^{-1} (S_{xj})',$$

where  $Z_i$  and  $Z_x$  are consistent estimates of  $AsyCov[\sqrt{T}S_{xi}, \sqrt{T}s_{ij}]$  and  $AsyCov[\sqrt{T}S_{xx}, \sqrt{T}s_{ij}]$ , respectively, and they take the form

$$\begin{aligned} Z_i &= T^{-1} \sum_{t=1}^T [(R_{ti} - m_i)(X_t - \bar{X}) - S_{xi}] [(R_{ti} - m_i)(R_{tj} - m_j) - s_{ij}], \\ Z_x &= T^{-1} \sum_{t=1}^T [(X_t - \bar{X})'(X_t - \bar{X}) - S_{xx}] [(R_{ti} - m_i)(R_{tj} - m_j) - s_{ij}]. \end{aligned}$$

**Proof** For  $i = j$ , the stated result follows from  $f_{ii} = s_{ii}$ . For  $i \neq j$ , from (7),  $f_{ij}$  converges to  $\sigma_{xi} \sigma_{xx}^{-1} (\sigma_{xj})'$  in probability. Expanding  $\sqrt{T}f_{ij}$  around  $\sqrt{T}\sigma_{xi} \sigma_{xx}^{-1} (\sigma_{xj})'$  gives

$$\begin{aligned} \sqrt{T}f_{ij} &= \sqrt{T}\sigma_{xi} \sigma_{xx}^{-1} (\sigma_{xj})' + \sqrt{T}(S_{xi} - \sigma_{xi}) \sigma_{xx}^{-1} (\sigma_{xj})' + \sqrt{T}\sigma_{xi} \sigma_{xx}^{-1} (S_{xj} - \sigma_{xj})' \\ &\quad - \sigma_{xi} \sigma_{xx}^{-1} \sqrt{T}(S_{xx} - \sigma_{xx}) \sigma_{xx}^{-1} (\sigma_{xj})' + o_p(1), \end{aligned}$$

where the third term follows from  $\partial(X(\theta)^{-1})/\partial\theta = -X(\theta)^{-1}(\partial X(\theta)/\partial\theta)X(\theta)^{-1}$ . It follows that

$$\begin{aligned} AsyCov[\sqrt{T}f_{ij}, \sqrt{T}s_{ij}] &= AsyCov[\sqrt{T}S_{xi}, \sqrt{T}s_{ij}] \sigma_{xx}^{-1} (\sigma_{xj})' + \sigma_{xi} \sigma_{xx}^{-1} AsyCov[\sqrt{T}(S_{xj})', \sqrt{T}s_{ij}] \\ &\quad - \sigma_{xi} \sigma_{xx}^{-1} AsyCov[\sqrt{T}S_{xx}, \sqrt{T}s_{ij}] \sigma_{xx}^{-1} (\sigma_{xj})'. \end{aligned}$$

Since  $(X_t, R_t)$  is iid, the three asymptotic covariances on the right-hand side are estimated consistently by  $Z_i$ ,  $(Z_j)'$ , and  $Z_x$ , respectively. The required result follows because  $S_{xj}$  and  $S_{xx}$  are consistent estimates of  $\sigma_{xj}$  and  $\sigma_{xx}$ .  $\square$

### 4.3.3 $\eta_{ij}$

A similar analysis gives the following lemma. Its proof follows from the proof of lemma 1 and hence omitted. Let  $\{A\}_{kl}$  denote the  $(k, l)$ -th element of matrix  $A$ , and let  $\{a\}_k$  denote the  $k$ -th element of vector  $a$ .

**Lemma 2** *A consistent estimator of  $\eta_{ij}$  is given by  $h_{ij} = w_{ij} + p_{ij} - 2r_{ij}$ , where  $w_{ij}$  is a consistent estimator of  $\text{AsyVar}[\sqrt{T}f_{ij}]$ . For  $i = j$ , we set  $w_{ii} = p_{ii}$ . For  $i \neq j$ ,  $w_{ij}$  is given by*

$$\begin{aligned} w_{ij} &= S_{xj}S_{xx}^{-1}Z_{ii}^aS_{xx}^{-1}(S_{xj})' + S_{xi}S_{xx}^{-1}Z_{jj}^aS_{xx}^{-1}(S_{xi})' + 2S_{xi}S_{xx}^{-1}Z_{ji}^aS_{xx}^{-1}(S_{xj})' \\ &+ \sum_{k=1}^K \sum_{l=1}^K \left[ \{S_{xi}S_{xx}^{-1}\}_k \{S_{xj}S_{xx}^{-1}\}_l S_{xi}S_{xx}^{-1}Z_{kl}^bS_{xx}^{-1}(S_{xj})' \right] \\ &- 2 \sum_{k=1}^K \sum_{l=1}^K \left[ \{S_{xi}S_{xx}^{-1}\}_k \{S_{xj}S_{xx}^{-1}\}_l (Z_{i,kl}^cS_{xx}^{-1}(S_{xj})' + Z_{j,kl}^cS_{xx}^{-1}(S_{xi})') \right] \end{aligned}$$

where  $Z_{ij}^a$ ,  $Z_{kl}^b$ ,  $Z_{i,kl}^c$  are consistent estimates of  $\text{AsyCov}[\sqrt{T}S_{xi}, \sqrt{T}S_{xj}]$ ,  $\text{AsyCov}[\sqrt{T}S_{xx}, \sqrt{T}\{S_{xx}\}_{kl}]$ , and  $\text{AsyCov}[\sqrt{T}S_{xi}, \sqrt{T}\{S_{xx}\}_{kl}]$ , respectively, and they take the form

$$\begin{aligned} Z_{ij}^a &= T^{-1} \sum_{t=1}^T [(R_{ti} - m_i)(X_t - \bar{X})' - (S_{xi})'] [(R_{tj} - m_j)(X_t - \bar{X}) - S_{xj}], \\ Z_{kl}^b &= T^{-1} \sum_{t=1}^T [(X_t - \bar{X})'(X_t - \bar{X}) - S_{xx}] [\{(X_t - \bar{X})'(X_t - \bar{X}) - S_{xx}\}_{kl}], \\ Z_{i,kl}^c &= T^{-1} \sum_{t=1}^T [(R_{ti} - m_i)(X_t - \bar{X}) - S_{xi}] [\{(X_t - \bar{X})'(X_t - \bar{X}) - S_{xx}\}_{kl}]. \end{aligned}$$

### 4.3.4 Estimate of $\alpha^*$ and its asymptotic behavior

We construct an estimate of the optimal shrinkage intensity by replacing the unknowns in  $\alpha^*$  in

(4) with their estimates:

$$\hat{\alpha} = \frac{\sum_{i=1}^N \sum_{j=1}^N p_{ij} - \sum_{i=1}^N \sum_{j=1}^N r_{ij}}{\sum_{i=1}^N \sum_{j=1}^N h_{ij} + T \sum_{i=1}^N \sum_{j=1}^N c_{ij}}. \quad (8)$$

We analyze the asymptotic behavior of  $\hat{\alpha}$  for the following two cases:

Case 1.  $\Phi \neq \Sigma$ .

Case 2. The stock returns are generated by the factor model (2), and  $\varepsilon_t$  is independently and identically distributed over time with finite fourth moment.

These two cases cover most situations of practical interest. They leave out only a small case in which  $\Phi = \Sigma$  but the stock returns are not generated by the factor model (2).

The following lemma shows that, in Case 1,  $T\hat{\alpha}$  converges in probability to the limit of  $T\alpha^*$ , while in Case 2,  $\hat{\alpha}$  converges to a random variable which is smaller than  $\alpha^*$ . Since  $0 < \alpha^0 < \alpha^*$  and  $Q(\alpha)$  is concave, the shrinkage estimator has a smaller risk than the sample covariance matrix. The simulations in the following section show that using the shrinkage estimator leads to a substantial improvement of the finite sample performance of the HJ-distance test.

**Lemma 3** *As  $T \rightarrow \infty$ , we have*

$$\begin{aligned} T\hat{\alpha} &\rightarrow_p \frac{\pi - \rho}{\gamma} = \lim_{T \rightarrow \infty} T\alpha^*, & \text{in Case 1,} \\ \hat{\alpha} &\rightarrow_d \alpha^0 = \frac{\pi - \rho}{\eta + \xi} < \alpha^*, & \text{in Case 2,} \end{aligned}$$

where  $\xi = \sum_{i=1, i \neq j}^N \sum_{j=1}^N (\xi_{ij})^2$  and  $\{\xi_{ij}\}_{i,j=1, \dots, N, i \neq j}$  are jointly normally distributed with mean zero.

Indeed, an estimate of  $\alpha^*$  that is consistent in both Case 1 and Case 2 is given by

$$\tilde{\alpha} = \frac{\sum_{i=1}^N \sum_{j=1}^N p_{ij} - \sum_{i=1}^N \sum_{j=1}^N r_{ij}}{\sum_{i=1}^N \sum_{j=1}^N h_{ij} + T^a \sum_{i=1}^N \sum_{j=1}^N c_{ij}}, \quad a \in (0, 1). \quad (9)$$

By downweighting  $\sum_{i=1}^N \sum_{j=1}^N c_{ij}$ , this estimate favors the possibility that  $\Phi = \Sigma$ . From the proof of Lemma 3, it follows straightforwardly that  $\tilde{\alpha} \rightarrow_p 0$  in Case 1 and  $\tilde{\alpha} \rightarrow_p (\pi - \rho)/\eta$  in Case 2. However,  $\tilde{\alpha}$  converges to 0 at a slower rate than  $\alpha^*$  in Case 1. This reflects a trade-off between the consistency in both cases and the higher-order consistency in Case 1. Our preference

of  $\hat{\alpha}$  over  $\tilde{\alpha}$  and our choice of a conservative position regarding this trade-off seems appropriate, because we expect that simple factor models are used as a shrinkage target in practice and those models are neither likely to nor meant to provide a complete description of the observed data.

**Proof** In Case 1, rewrite  $T\hat{\alpha}$  as

$$T\hat{\alpha} = \frac{\sum_{i=1}^N \sum_{j=1}^N p_{ij} - \sum_{i=1}^N \sum_{j=1}^N r_{ij}}{(1/T) \sum_{i=1}^N \sum_{j=1}^N h_{ij} + \sum_{i=1}^N \sum_{j=1}^N c_{ij}}.$$

Then the stated result follows from  $p_{ij} \rightarrow_p \pi_{ij}$  and  $c_{ij} \rightarrow_p \gamma_{ij}$  (Ledoit and Wolf (2003), Lemmas 1 and 3), and Lemmas 1 and 2.

In Case 2, it follows from  $p_{ij} \rightarrow_p \pi_{ij}$  and Lemmas 1 and 2 that

$$\hat{\alpha} = \frac{\sum_{i=1}^N \sum_{j=1}^N p_{ij} - \sum_{i=1}^N \sum_{j=1}^N r_{ij}}{\sum_{i=1}^N \sum_{j=1}^N h_{ij} + T \sum_{i=1}^N \sum_{j=1}^N c_{ij}} = \frac{\pi - \rho + o_p(1)}{\eta + o_p(1) + \sum_{i=1}^N \sum_{j=1}^N T c_{ij}}.$$

We proceed to derive the asymptotic distribution of  $Tc_{ij} = T(f_{ij} - s_{ij})^2$ . Recall  $c_{ij} = 0$  for  $i = j$ . For  $i \neq j$ , we have, from the definition of  $s_{ij}$  and (7),

$$s_{ij} = T^{-1} R'_i M R_{.j}, \quad f_{ij} = T^{-1} R'_i M X (X' M X)^{-1} X' M R_{.j}. \quad (10)$$

Define  $\varepsilon_{.i} = (\varepsilon_{1i}, \dots, \varepsilon_{Ti})'$ , and rewrite the model (2) as  $R_{.i} = \mu_i \mathbf{1} + X \beta_i + \varepsilon_{.i}$  for  $i = 1, \dots, N$ . Substituting this into (10), we can express the difference between  $f_{ij}$  and  $s_{ij}$  as

$$\begin{aligned} f_{ij} - s_{ij} &= T^{-1} (X \beta_i + \varepsilon_{.i})' M X (X' M X)^{-1} X' M (X \beta_j + \varepsilon_{.j}) - T^{-1} (X \beta_i + \varepsilon_{.i})' M (X \beta_j + \varepsilon_{.j}) \\ &= T^{-1} \varepsilon'_{.i} M X (X' M X)^{-1} X' M \varepsilon_{.j} - T^{-1} \varepsilon'_{.i} M \varepsilon_{.j} \\ &= T^{-1} (T^{-1/2} \varepsilon'_{.i} M X) (T^{-1} X' M X)^{-1} (T^{-1/2} X' M \varepsilon_{.j}) - T^{-1} \varepsilon'_{.i} M \varepsilon_{.j}. \end{aligned}$$

Since  $T^{-1/2} \varepsilon'_{.i} M X = T^{-1/2} \sum_{t=1}^T \varepsilon_{ti} X_t - (T^{-1/2} \sum_{t=1}^T \varepsilon_{ti}) (T^{-1} \sum_{t=1}^T X_t) = O_p(1)$ ,  $T^{-1} X' M X \rightarrow_p \sigma_{xx}$ , and  $T^{-1/2} \varepsilon'_{.i} M \varepsilon_{.j} = T^{-1/2} \sum_{t=1}^T \varepsilon_{ti} \varepsilon_{tj} - (T^{-1/2} \sum_{t=1}^T \varepsilon_{ti}) (T^{-1} \sum_{t=1}^T \varepsilon_{tj}) = T^{-1/2} \sum_{t=1}^T \varepsilon_{ti} \varepsilon_{tj} +$

$o_p(1)$ , it follows that

$$\sqrt{T}(f_{ij} - s_{ij}) = T^{-1/2} \sum_{t=1}^T \varepsilon_{ti} \varepsilon_{tj} + o_p(1).$$

Since  $\varepsilon_{ti} \varepsilon_{tj}$  is iid with mean 0 and finite variance, an  $(N^2 - N) \times 1$  vector  $\{T^{-1/2} \sum_{t=1}^T \varepsilon_{ti} \varepsilon_{tj}\}_{i,j=1,\dots,N, i \neq j}$  converges to a normally distributed random vector in distribution.  $\square$

The following theorem is a simple consequence of Lemma 3:

**Theorem 1** *Define the shrinkage covariance matrix estimate  $\hat{\Sigma}$  as*

$$\hat{\Sigma} = \hat{\alpha}F + (1 - \hat{\alpha})S.$$

*Then  $\hat{\Sigma} \rightarrow_p \Sigma$  as  $T \rightarrow \infty$ , because if  $\Phi \neq \Sigma$  then  $\hat{\alpha} \rightarrow 0$  and if  $\Phi = \Sigma$  then both  $F$  and  $S$  are consistent for  $\Sigma$ .*

## 5 Simulation results with the shrinkage method

With the shrinkage covariance matrix estimate  $\hat{\Sigma}$  constructed in the previous section, we define the shrinkage estimate of the second moment of the asset returns as

$$\hat{G} = \hat{\Sigma} + \left(\frac{1}{T}R'\mathbf{1}\right)\left(\frac{1}{T}R'\mathbf{1}\right)'$$

In this section, we examine the finite sample performance of the HJ-distance test when the inverse of  $\hat{G}$  is used as the weighting matrix. The other settings of the Monte Carlo experiments are the same as in Section 2. In order to avoid overshrinkage or negative shrinkage, we set 0 and 1 as the lower and upper bound for  $\hat{\alpha}$ .

Table 3 reports the rejection frequencies of the HJ-distance test with  $\hat{G}$ . Compared with Table 1, we find that the rejection frequencies improve in all cases. For example, for the Simple model and Fama-French model with 25 portfolios, the rejection frequency of the HJ-distance test in Table 1 is more than twice the nominal level for  $T = 160$  and 330, whereas the rejection frequencies in Table 3 are close to the nominal level for all  $T$ . With 100 portfolios, the HJ-distance test with  $\hat{G}$  still tends to overreject the correct null, but the degree of overrejection is

much smaller than in Table 1.

[Table 3 around here]

Kan and Zhou (2004) derive the exact distribution of the HJ-distance under the normality assumption. Their Tables I and III report the rejection frequency of the asymptotic HJ-distance test and that of the feasible version of their exact test, respectively. We compare their Table III with the results for the Fama-French model in our Table 3.<sup>3</sup> With 25 portfolios, the HJ-distance test with shrinkage performs as well as the exact test, and the actual sizes of both tests are close to the nominal size. With 100 portfolios, the exact test performs substantially better than the shrinkage version. This is probably due to a poor chi-squared approximation. However, very few applications use as many as 100 portfolios; of the applications of the HJ-distance tests surveyed in the Introduction, all of them but Jagannathan and Wang (1996) use fewer than 25 portfolios. Therefore, we may conclude that the HJ-distance test with shrinkage performs as well as the exact test for most portfolio sizes of practical interest.

Table 4 reports the summary statistics of the estimated optimal shrinkage intensity  $\hat{\alpha}$ . Figure 1 shows the kernel density estimate of  $\hat{\alpha}$  for the Simple model. This corresponds to the case where  $\Phi = \Sigma$  in Lemma 3. The results with the other factor models are similar and thus not reported here. From Table 4 and Figure 1, we can see that  $\hat{\alpha}$  is centered around  $0.8 \sim 1$  and the estimated covariance matrices are much closer to  $F$  than the sample covariance matrix when  $\Phi = \Sigma$ . Figure 2 shows the kernel density estimate of  $\hat{\alpha}$  when the data are simulated from the Simple model with 100 portfolios, but only two of the three factors are used in constructing  $F$ . This corresponds to the case where  $\Phi \neq \Sigma$  in Lemma 3. Figure 2 shows that  $\hat{\alpha}$  is converging to zero, corroborating Lemma 3.

[Table 4 around here]

One important feature of the shrinkage method is that it provides a better estimate of the HJ-distance itself. Table 5 reports the MSE of the HJ-distance with two estimates of  $G$

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<sup>3</sup>Although Kan and Zhou (2004) describe their factors as the Premium-Labor factors when  $K = 3$ , the rejection frequencies of the asymptotic test in their Table I for  $K = 3$  are too small compared with the results with the Premium-Labor model in our Table 1 and Table 3 of Ahn and Gadarowski (2004). In fact, their results for  $K = 3$  in Table I are more compatible with our results with the Fama-French model.

relative to the HJ-distance computed with the true value of  $G$ . The MSE of the HJ-distance with shrinkage is less than half of and substantially smaller than the MSE of the HJ-distance with sample covariance. Therefore, the shrinkage method provides a more accurate comparison of the HJ-distance across different models. Note that this feature is not present with the exact distribution approach.

[Table 5 around here]

We are also interested in the sensitivity of the shrinkage method to the overspecification and/or underspecification of the factor model used in constructing  $F$ . Tables 6 and 7 report the results of the following simulation experiment. For each model, we conduct the HJ-distance test as in Table 3 but we use an overspecified or underspecified factor model to estimate the factor model (1) and construct the shrinkage target  $F$ . For the overspecified case, we generate two additional factors with the same statistical properties as the original factors, and use the five-factor model to estimate  $F$ . In the underspecified case, we pick two arbitrary factors from the original three factors, and use the two-factor model to estimate  $F$ . In the overspecified case,  $F$  is still consistent for  $\Sigma$  but suffers from extra sampling error, while  $F$  is inconsistent for  $\Sigma$  and the shrinkage estimate should converge to the sample covariance in the underspecified case.

[Table 6 and Table 7 around here]

Table 6 reports the results with the overspecified target factor model. The rejection frequencies reported in Table 6 are close to those in Table 3, and using an overspecified shrinkage target causes little deterioration in the performance of the HJ-distance test. On the other hand, the results with the underspecified target factor model reported in Table 7 are substantially worse than those in Table 3, except for the Premium-Labor model. However, they are still better than those in Table 1, in particular with the Fama-French and Premium-Labor models. Therefore, when conducting the HJ-distance test, a researcher can benefit significantly from using the shrinkage method to estimate  $G$ , in particular when the shrinkage target is correctly specified or overspecified.

## 6 Conclusion

The HJ-distance test rejects correct SDFs too often in the finite sample, which limits its practical use. We find that one reason for this phenomenon is a poorly estimated covariance matrix of the asset returns. We propose to use the shrinkage method to construct an improved estimate of this matrix.

The sample covariance matrix is often used to estimate the covariance matrix of asset returns. When the number of portfolios is large, however, this estimate suffers from a large estimation error. The shrinkage method uses another estimate that imposes some structure onto this high dimensional estimation problem, and combines it optimally with the sample covariance matrix. Our simulation results show that the shrinkage method significantly mitigates the overrejection problem of the HJ-distance test.

A few questions remain to be addressed in future research. First, the shrinkage method mitigates but does not completely solve the overrejection problem of the HJ-distance test, in particular when the portfolio size is as large as 100. A further improvement would be desirable. Second, it would be interesting to investigate how to choose the shrinkage target optimally and how to obtain a better estimate of the optimal shrinkage intensity. Third, the estimation of the covariance matrix plays an important role in many tests in empirical finance. It would be worthwhile to examine whether the method proposed in this paper can improve the finite properties of those tests.

## A Appendix

### A.1 Simple model

The first Simple model is generated by following the procedure of Ahn and Gadarowski (2004). Specifically, the data are generated by the following data generating process:

$$R_{ti} = \mu + X_{t1}\beta_{1i} + X_{t2}\beta_{2i} + X_{t3}\beta_{3i} + e_{ti},$$

where  $i$  is the index of individual portfolio returns, and  $t$  is the index of time.  $R_{ti}$  is the gross return of portfolio  $i$  at time  $t$ .  $X_{tj}$  ( $j=1,2$ , and  $3$ ) is the common factor for time  $t$ , drawn from a normal distribution with mean equal to  $0.0022$  and variance equal to  $6.944 \times 10^{-5}$ .  $\beta_{ki}$  ( $k=1,2$ , and  $3$ ) is the corresponding beta of factor  $X_k$  for portfolio  $i$ , and they are drawn from uniform distribution  $U[0, 2]$ .  $e_{it}$  is the idiosyncratic error that is normally distributed with mean zero and variance  $6.944 \times 10^{-5}$ .  $\mu$ ,  $\beta$  and  $X$  are chosen at values which make the mean and variance of gross returns roughly consistent with historical data in the US stock market.

### A.2 Fama-French and Premium-Labor models

We follow the procedure of Ahn and Gadarowski (2004) to generate data sets calibrated to resemble the statistical properties of the Fama-French and Premium-Labor models. First, we collect 330 time-series observations of monthly returns of the Fama-French portfolios and the Fama-French factors between July 1963 and December 1990<sup>4</sup>. For the Premium-Labor model, we follow the steps in Jagannathan and Wang (1996) to obtain the portfolio returns and the factors.

Second, we apply the two-pass estimation following Shanken (1992). Specifically, we regress the portfolio returns on the corresponding factors by OLS, obtain the estimates of  $\beta_{ki}$ , and collect the residuals. We then compute the diagonal sample covariance matrix of the residuals.

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<sup>4</sup>URL is [http://mba.tuck.dartmouth.edu/pages/faulty/ken.french/data\\_library.html](http://mba.tuck.dartmouth.edu/pages/faulty/ken.french/data_library.html)

Subsequently, we run the following cross sectional regression:

$$E[R_{ti}] = \mu + (E(X_{t1}) + \eta_1)\beta_{1i} + (E(X_{t2}) + \eta_2)\beta_{2i} + (E(X_{t3}) + \eta_3)\beta_{3i}.$$

This gives the estimates of the risk-free rate,  $\mu$ , and the factor-mean adjusted risk prices,  $\eta_k$ .

Finally, we simulate the factors from normal distribution with the mean and the covariance equal to the sample mean and the sample covariance matrix derived from the actual data of the corresponding factors. The error terms,  $e_{ti}$ , are drawn from normal distribution with the mean equal to zero and the variance equal to the sample covariance of the residuals. The calibrated portfolio returns are generated by the following equation:

$$R_{ti} = \mu + (X_{t1} + \eta_1)\beta_{1i} + (X_{t2} + \eta_2)\beta_{2i} + (X_{t3} + \eta_3)\beta_{3i} + e_{ti}$$

The risk-adjusted prices are incorporated in order to simulate the portfolio return close to the true data.

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Table 1: Rejection frequencies of the specification test using the HJ-distance

| Number of Observations | $T=160$ | $T=330$ | $T=700$ |
|------------------------|---------|---------|---------|
| (A)Simple Model        |         |         |         |
| 25 Portfolios          |         |         |         |
| 1%                     | 4.5     | 2.4     | 1.9     |
| 5%                     | 15.1    | 8.7     | 7.7     |
| 10%                    | 23.8    | 16.4    | 13.4    |
| 100 Portfolios         |         |         |         |
| 1%                     | 99.6    | 51.3    | 11.7    |
| 5%                     | 99.9    | 71.8    | 27.4    |
| 10%                    | 99.9    | 81.3    | 39.3    |
| (B)Fama-French Model   |         |         |         |
| 25 Portfolios          |         |         |         |
| 1%                     | 5.8     | 3.3     | 1.1     |
| 5%                     | 15.1    | 10.6    | 7.1     |
| 10%                    | 23.9    | 18.9    | 12.8    |
| 100 Portfolios         |         |         |         |
| 1%                     | 99.8    | 53.7    | 13.8    |
| 5%                     | 100.0   | 76.0    | 30.8    |
| 10%                    | 100.0   | 84.3    | 44.6    |
| (C)Premium-Labor Model |         |         |         |
| 25 Portfolios          |         |         |         |
| 1%                     | 14.9    | 11.3    | 9.2     |
| 5%                     | 31.9    | 26.0    | 19.5    |
| 10%                    | 42.7    | 34.4    | 29.0    |
| 100 Portfolios         |         |         |         |
| 1%                     | 99.7    | 79.1    | 36.8    |
| 5%                     | 99.9    | 90.1    | 59.1    |
| 10%                    | 99.9    | 94.3    | 69.6    |

This table shows the rejection rates over 1000 trials using the p-values for the HJ-distance. For Panel (A), factors and returns are simulated to make the mean and variance of gross returns roughly consistent with historical data in the US stock market. For Panel (B) and (C), factors and returns are simulated using either the Fama-French (1993) model or the Premium-Labor model per Jagannathan and Wang (1996).

Table 2: Rejection frequencies of the specification test using the HJ-distance with the exact weighting matrix  $G$

| Number of Observations | $T=160$ | $T=330$ | $T=700$ |
|------------------------|---------|---------|---------|
| (A)Simple Model        |         |         |         |
| 25 Portfolios          |         |         |         |
| 1%                     | 0.9     | 1.2     | 1.3     |
| 5%                     | 5.4     | 5.8     | 6.8     |
| 10%                    | 12.4    | 11.8    | 12.1    |
| 100 Portfolios         |         |         |         |
| 1%                     | 0.8     | 1.2     | 1.2     |
| 5%                     | 4.4     | 5.7     | 5.7     |
| 10%                    | 11.6    | 10.9    | 10.9    |
| (B)Fama-French Model   |         |         |         |
| 25 Portfolios          |         |         |         |
| 1%                     | 1.0     | 1.2     | 0.7     |
| 5%                     | 4.9     | 5.7     | 5.0     |
| 10%                    | 9.9     | 11.8    | 11.9    |
| 100 Portfolios         |         |         |         |
| 1%                     | 1.1     | 1.6     | 1.3     |
| 5%                     | 7.4     | 7.4     | 5.8     |
| 10%                    | 16.8    | 14.7    | 13.6    |
| (C)Premium-Labor Model |         |         |         |
| 25 Portfolios          |         |         |         |
| 1%                     | 4.5     | 6.7     | 6.9     |
| 5%                     | 15.2    | 20.3    | 16.3    |
| 10%                    | 24.3    | 29.7    | 25.9    |
| 100 Portfolios         |         |         |         |
| 1%                     | 3.1     | 7.3     | 8.2     |
| 5%                     | 14.2    | 22.3    | 23.0    |
| 10%                    | 26.5    | 35.1    | 36.3    |

This table shows the rejection rates over 1000 trials using the  $p$ -value of the HJ-distance, but approximating the weighting matrix,  $G$ , by the sample second moment matrix from 10,000 time-series observations.

Table 3: Rejection frequencies of the specification test using the HJ-distance with shrinkage estimation of  $G$

| Number of Observations | $T=160$ | $T=330$ | $T=700$ |
|------------------------|---------|---------|---------|
| (A)Simple Model        |         |         |         |
| 25 Portfolios          |         |         |         |
| 1%                     | 1.6     | 1.3     | 0.8     |
| 5%                     | 6.6     | 6.8     | 5.4     |
| 10%                    | 13.4    | 12.8    | 10.4    |
| 100 Portfolios         |         |         |         |
| 1%                     | 3.9     | 1.3     | 0.9     |
| 5%                     | 15.1    | 7.2     | 5.3     |
| 10%                    | 28.4    | 13.7    | 11.1    |
| (B)Fama-French Model   |         |         |         |
| 25 Portfolios          |         |         |         |
| 1%                     | 1.3     | 1.2     | 0.7     |
| 5%                     | 5.8     | 5.1     | 4.0     |
| 10%                    | 9.9     | 9.8     | 9.6     |
| 100 Portfolios         |         |         |         |
| 1%                     | 23.3    | 7.7     | 2.8     |
| 5%                     | 49.9    | 22.9    | 11.2    |
| 10%                    | 64.3    | 33.6    | 20.5    |
| (C)Premium-Labor Model |         |         |         |
| 25 Portfolios          |         |         |         |
| 1%                     | 6.6     | 9.7     | 5.4     |
| 5%                     | 18.8    | 20.8    | 13.5    |
| 10%                    | 28.7    | 32.4    | 23.4    |
| 100 Portfolios         |         |         |         |
| 1%                     | 31.5    | 19.5    | 11.2    |
| 5%                     | 59.0    | 42.4    | 28.8    |
| 10%                    | 73.0    | 58.4    | 40.0    |

This table shows the rejection rates over 1000 trials using the  $p$ -value of the HJ-distance, but approximating the weighting matrix,  $G$ , by shrinkage method, which average the sample covariance and the structure covariance with an optimal weight.

Table 4: Summary statistics of  $\hat{\alpha}$

| Number of Observations | $T=160$ | $T=330$ | $T=700$ |
|------------------------|---------|---------|---------|
| (A)Simple Model        |         |         |         |
| 25 Portfolios          |         |         |         |
| mean                   | 0.8290  | 0.8757  | 0.8981  |
| standard deviation     | 0.1287  | 0.1040  | 0.0895  |
| 100 Portfolios         |         |         |         |
| mean                   | 0.8180  | 0.8722  | 0.8951  |
| standard deviation     | 0.0953  | 0.0679  | 0.0532  |
| (B)Fama-French Model   |         |         |         |
| 25 Portfolios          |         |         |         |
| mean                   | 0.9280  | 0.9462  | 0.9605  |
| standard deviation     | 0.0780  | 0.0631  | 0.0533  |
| 100 Portfolios         |         |         |         |
| mean                   | 0.6324  | 0.6443  | 0.6514  |
| standard deviation     | 0.0909  | 0.0875  | 0.0844  |
| (C)Premium-Labor Model |         |         |         |
| 25 Portfolios          |         |         |         |
| mean                   | 0.8120  | 0.8152  | 0.8199  |
| standard deviation     | 0.0832  | 0.0780  | 0.0753  |
| 100 Portfolios         |         |         |         |
| mean                   | 0.7304  | 0.7326  | 0.7340  |
| standard deviation     | 0.0297  | 0.0238  | 0.0206  |

This table shows the mean and the standard deviation of the estimated optimal shrinkage intensity  $\hat{\alpha}$  for each model.

Table 5: The mean squared error of the HJ-distance from two estimation methods of G

| Number of Observations | $T=160$ | $T=330$                 | $T=700$                 |
|------------------------|---------|-------------------------|-------------------------|
| (A)Simple Model        |         |                         |                         |
| 25 Portfolios          |         |                         |                         |
| sample covariance      | 0.0084  | 0.0017                  | 0.00046                 |
| shrinkage estimation   | 0.0033  | 0.0009                  | 0.00032                 |
| 100 Portfolios         |         |                         |                         |
| sample covariance      | 0.5630  | 0.0394                  | 0.0040                  |
| shrinkage estimation   | 0.0424  | 0.0067                  | 0.0009                  |
| (B)Fama-French Model   |         |                         |                         |
| 25 Portfolios          |         |                         |                         |
| sample covariance      | 0.00440 | $4.9618 \times 10^{-4}$ | $6.4341 \times 10^{-5}$ |
| shrinkage estimation   | 0.00098 | $1.1522 \times 10^{-4}$ | $1.4838 \times 10^{-5}$ |
| 100 Portfolios         |         |                         |                         |
| sample covariance      | 0.5606  | 0.0385                  | 0.0036                  |
| shrinkage estimation   | 0.0511  | 0.0077                  | 0.0009                  |
| (C)Premium-Labor Model |         |                         |                         |
| 25 Portfolios          |         |                         |                         |
| sample covariance      | 0.0049  | $7.4934 \times 10^{-4}$ | $1.1823 \times 10^{-4}$ |
| shrinkage estimation   | 0.0009  | $1.6685 \times 10^{-4}$ | $2.9242 \times 10^{-5}$ |
| 100 Portfolios         |         |                         |                         |
| sample covariance      | 0.5139  | 0.0366                  | 0.0038                  |
| shrinkage estimation   | 0.0331  | 0.0054                  | 0.0007                  |

This table compares the HJ-distances when the sample covariance or the shrinkage covariance is used as the weighting matrix. Here, we report the mean squared error.

Table 6: Rejection frequencies of the HJ-distance test using five factors to estimate  $G$

| Number of Observations | $T=160$ | $T=330$ | $T=700$ |
|------------------------|---------|---------|---------|
| (A)Simple Model        |         |         |         |
| 25 Portfolios          |         |         |         |
| 1%                     | 1.3     | 1.3     | 0.8     |
| 5%                     | 6.6     | 6.4     | 5.3     |
| 10%                    | 12.8    | 12.3    | 10.4    |
| 100 Portfolios         |         |         |         |
| 1%                     | 3.5     | 1.3     | 0.9     |
| 5%                     | 14.9    | 7.1     | 5.2     |
| 10%                    | 28.0    | 13.2    | 11.0    |
| (B)Fama-French Model   |         |         |         |
| 25 Portfolios          |         |         |         |
| 1%                     | 1.2     | 1.2     | 0.7     |
| 5%                     | 5.4     | 4.9     | 3.9     |
| 10%                    | 9.6     | 9.6     | 9.4     |
| 100 Portfolios         |         |         |         |
| 1%                     | 23.4    | 7.8     | 2.5     |
| 5%                     | 49.7    | 22.3    | 10.8    |
| 10%                    | 63.0    | 33.7    | 20.4    |
| (C)Premium-Labor Model |         |         |         |
| 25 Portfolios          |         |         |         |
| 1%                     | 6.3     | 9.6     | 5.4     |
| 5%                     | 17.9    | 20.5    | 13.4    |
| 10%                    | 28.8    | 31.4    | 23.2    |
| 100 Portfolios         |         |         |         |
| 1%                     | 28.5    | 21.0    | 11.6    |
| 5%                     | 55.5    | 44.9    | 30.0    |
| 10%                    | 70.4    | 57.0    | 42.0    |

This table shows the rejection rates over 1000 trials using the  $p$ -value of the HJ-distance. We simulate the factors and returns in the same way as we have done in Table 1, but we use two more factors in the structure model. They are simulated with the same statistic properties of the first two factors in the original three factors.

Table 7: Rejection frequencies of the HJ-distance test using two factors to estimate  $G$

| Number of Observations | $T=160$ | $T=330$ | $T=700$ |
|------------------------|---------|---------|---------|
| (A)Simple Model        |         |         |         |
| 25 Portfolios          |         |         |         |
| 1%                     | 4.2     | 1.8     | 1.2     |
| 5%                     | 13.1    | 9.8     | 7.1     |
| 10%                    | 23.0    | 17.2    | 11.8    |
| 100 Portfolios         |         |         |         |
| 1%                     | 97.2    | 45.0    | 11.0    |
| 5%                     | 99.6    | 69.8    | 28.4    |
| 10%                    | 99.9    | 81.3    | 41.4    |
| (B)Fama-French Model   |         |         |         |
| 25 Portfolios          |         |         |         |
| 1%                     | 4.0     | 1.9     | 1.1     |
| 5%                     | 11.7    | 7.5     | 5.6     |
| 10%                    | 18.6    | 14.8    | 10.3    |
| 100 Portfolios         |         |         |         |
| 1%                     | 17.3    | 5.4     | 2.3     |
| 5%                     | 39.3    | 17.7    | 10.0    |
| 10%                    | 54.4    | 29.4    | 17.8    |
| (C)Premium-Labor Model |         |         |         |
| 25 Portfolios          |         |         |         |
| 1%                     | 6.6     | 9.6     | 5.5     |
| 5%                     | 18.3    | 20.7    | 13.4    |
| 10%                    | 28.7    | 32.1    | 23.2    |
| 100 Portfolios         |         |         |         |
| 1%                     | 32.5    | 20.1    | 10.9    |
| 5%                     | 60.3    | 42.7    | 28.2    |
| 10%                    | 73.8    | 58.3    | 39.6    |

This table shows the rejection rates over 1000 trials using the  $p$ -value of the HJ-distance. We simulate the factors and returns in the same way as we have done in Table 1, but we use only the first two factors in the structure model.

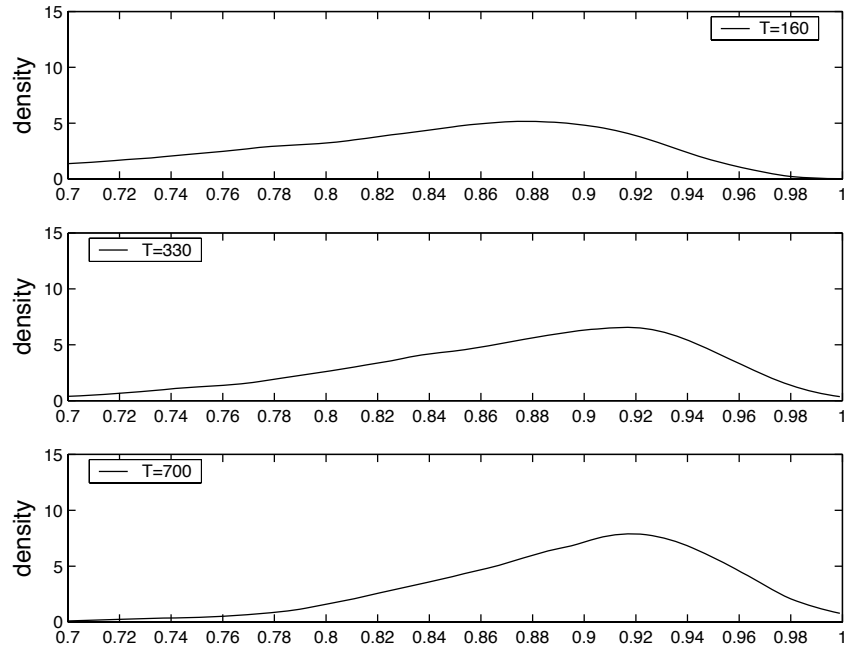


Figure 1: The density functions for  $\hat{\alpha}$  in the Simple Model of 100 Portfolios

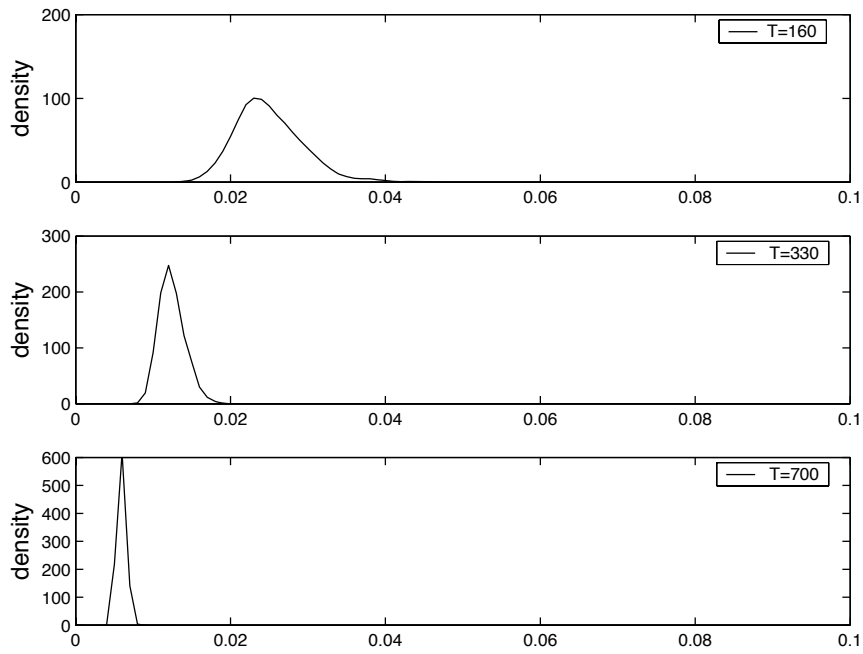


Figure 2: The density functions for  $\hat{\alpha}$  in a misspecified Simple Model of 100 Portfolios