

# Asymptotic Variance Approximations for Invariant Estimators in Uncertain Asset-Pricing Models

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## Abstract

This paper derives explicit expressions for the asymptotic variances of the maximum likelihood and continuously-updated GMM estimators in models that may not satisfy the fundamental asset-pricing restrictions in population. The proposed misspecification-robust variance estimators allow the researcher to conduct valid inference on the model parameters even when the model is rejected by the data. While the results for the maximum likelihood estimator are only applicable to linear asset-pricing models, the asymptotic distribution of the continuously-updated GMM estimator is derived for general, possibly nonlinear, models. The large corrections in the asymptotic variances, that arise from explicitly incorporating model misspecification in the analysis, are illustrated using simulations and an empirical application.

**Keywords:** Asset pricing; Model misspecification; Continuously-updated GMM; Maximum likelihood; Asymptotic approximation; Misspecification-robust tests.

**JEL classification numbers:** C12; C13; G12.

# 1 Introduction

Given the complexity of the economic and financial systems, it seems natural to view all economic models only as approximations to the true data generating process (Watson, 1993; White, 1994; Canova, 1994; among others). As argued by Maasoumi (1990), “Misspecification of these models is therefore endemic and inevitable. Omission of relevant variables, inclusion of ‘irrelevant variables’, incorrect functional forms, incompleteness of systems of relations, and incorrect distributional assumptions are both common and present simultaneously.”

Models for which the likelihood function is available are now routinely estimated in a quasi-maximum likelihood framework and the statistical inference is performed using misspecification-robust standard errors (White, 1982, 1994). In contrast, misspecification-robust inference for moment condition models, estimated by the generalized method of moments (GMM), is much less widespread among applied researchers. It is still common practice to use the asymptotic standard errors of Hansen (1982), derived under the assumption of correct model specification, even when the model is rejected by the data. This is unfortunate since most economic models are defined by a set of conditional or unconditional moment restrictions and not allowing for possible (global) misspecification of these moment restrictions would render the GMM inference asymptotically invalid.

Maasoumi and Phillips (1982) and Gallant and White (1988) provide an early analysis of inference in globally misspecified models estimated by instrumental variables and GMM with a fixed weighting matrix, respectively. Hall and Inoue (2003) extended the asymptotic analysis in these studies to the two-step and iterated GMM estimators. They derived the limiting variance of these estimators in the presence of model misspecification and showed that the misspecification adjustment depends on the weighting matrix used in estimation. The consequences of model misspecification for GMM estimation and inference are summarized in Hall (2005). Despite these recent advances in the literature, the use of misspecification-robust standard errors in empirical work with GMM estimators is largely absent.

Misspecification-robust inference proves to be particularly important in evaluating linear asset-pricing models that are often found to be rejected by the data (see Kan and Robotti, 2009, Kan, Robotti, and Shanken, 2013, and Gospodinov, Kan, and Robotti, 2013, 2014, among others). While invariant estimators are believed to possess a number of appealing properties, misspecification-robust inference for these estimators is not yet available in the literature. In this paper, we derive

explicit expressions for the asymptotic variances of the ML and the continuously-updated GMM (CU-GMM) estimators (Hansen, 1982; Hansen, Heaton, and Yaron, 1996) in potentially misspecified asset-pricing models.

We focus on the ML and CU-GMM estimators for several reasons. First, the invariance of these estimators to normalizations and transformations of the data is particularly desirable in asset-pricing models (Peñaranda and Sentana, 2015) that could be written in both beta-pricing and stochastic discount factor (SDF) form. Second, the CU-GMM estimator is a member of the class of generalized empirical likelihood (GEL) estimators (Newey and Smith, 2004), which provides an alternative look into the first- and higher-order asymptotic properties of the CU-GMM estimator. In fact, we use the GEL framework to parameterize the degree of model misspecification as the distance of the pseudo-true value of the vector of Lagrange multipliers, associated with the moment conditions, from zero and cast the CU-GMM estimator as a solution to a quasi-likelihood problem. This allows us to work directly with the score function and to sidestep some explicit joint normality assumptions in the approach of Hall and Inoue (2003). Due to the quasi-likelihood interpretation of the estimated augmented parameter vector (the parameters of interest and the Lagrange multipliers), the asymptotic variance of the CU-GMM estimator takes the usual sandwich form as in White (1982, 1994). In this respect, we complement the results in Kitamura (1998) and Schennach (2007), and provide an explicit expression for the asymptotic variance of the CU-GMM estimator in potentially misspecified models. Our results for CU-GMM are derived for linear as well as nonlinear moment condition models.

On the other hand, the maximum likelihood (ML) estimator is developed only for linear beta-pricing models. The usefulness of this estimator is that it can be obtained in a closed form, which facilitates its practical implementation and theoretical analysis. One possibility in deriving the asymptotic distribution of the ML estimator under potentially misspecified models is to extend the two-stage Gaussian quasi-maximum likelihood setting of White (1994), which is robust to distributional assumptions and model misspecification. Instead, we maintain the normality assumption, which is often imposed in the ML estimation of the beta-pricing model, to obtain a more explicit expression for the asymptotic variance of the estimator. The proposed asymptotic standard errors help us quantify the importance of the model misspecification adjustment when conducting statistical inference. Furthermore, our setup allows us to express the ML estimator as an optimal minimum distance estimator and approximate its limiting behavior under misspecified models using

analytical tools for moment condition models as in Hall and Inoue (2003).

Overall, our theoretical and simulation results suggest that the impact of model misspecification on the asymptotic variance of the ML and CU-GMM estimators can be very large and of practical economic significance. It turns out that the size distortions arising from wrongly assuming correct model specification are much larger for these invariant estimators than for the non-invariant estimators studied by Kan and Robotti (2009), Kan, Robotti, and Shanken (2013), and Gospodinov, Kan, and Robotti (2013). For example, the rejection rate of the centered  $t$ -test that does not account for model misspecification could be as large as 49% for CU-GMM at the 10% significance level with 3600 observations and a degree of model misspecification calibrated to actual data. The proposed misspecification-robust standard errors correct these size distortions and, interestingly, provide substantial improvements even when the model is correctly specified.

The rest of the paper is structured as follows. Sections 2 and 3 derive the limiting distributions of the ML and CU-GMM estimators in misspecified linear asset-pricing models. The asymptotic results for the CU-GMM estimator are also extended to general nonlinear moment condition models. Section 4 provides simulation results on the empirical size and power of  $t$ -tests computed with standard errors under correct model specification and misspecification-robust standard errors. Section 5 illustrates the economic significance of the proposed misspecification adjustment using actual data for several popular asset-pricing models. Section 6 concludes.

## 2 ML Estimation and Misspecification-Robust Inference in the Beta-Pricing Representation

In this section, we discuss the maximum likelihood approach to estimation and statistical inference in unconditional beta-pricing models. Suppose that  $R_t$ , the gross returns on  $N$  test assets at time  $t$  ( $t = 1, \dots, T$ ), can be described by the following data generating process:

$$R_t = \alpha + \beta f_t + \epsilon_t, \tag{1}$$

where  $f_t$  denotes the realizations of  $K$  systematic factors at time  $t$  and  $\epsilon_t$  are the model innovations at time  $t$  with  $E[\epsilon_t] = 0_N$  and  $E[f_t \epsilon_t'] = 0_{K \times N}$ . Taking expectations on both sides yields

$$\mu_R = \alpha + \beta \mu_f, \tag{2}$$

where  $\mu_f = E[f_t]$  and  $\mu_R = E[R_t]$ . Under the  $K$ -factor asset-pricing model, we have

$$\mu_R = 1_N \gamma_0 + \beta \gamma_1, \quad (3)$$

where  $1_N$  is an  $N \times 1$  vector of ones,  $\gamma_0$  is the zero-beta rate, and  $\gamma_1$  is the vector of risk premia associated with the  $K$  risk factors  $f_t$ . Let  $\gamma = [\gamma_0, \gamma_1]'$  denote the parameter vector of interest. Comparing (2) with (3), we have the following restrictions on  $\alpha$ :

$$\alpha = 1_N \gamma_0 + \beta \phi, \quad (4)$$

where  $\phi = \gamma_1 - \mu_f$ . The multi-factor model can be written in matrix form as

$$Y = XB + \mathcal{E}, \quad (5)$$

where  $B = [\alpha, \beta]'$ , and the typical rows of  $X$ ,  $Y$ , and  $\mathcal{E}$  are  $x_t' = [1, f_t']$ ,  $R_t'$ , and  $\epsilon_t'$ , respectively.

ASSUMPTION MLE.A. *Assume that (a)  $(f_t, \epsilon_t)$  are i.i.d. normally distributed with  $V_f = \text{Var}[f_t]$  and  $\Sigma = \text{Var}[\epsilon_t]$ ; (b) the matrix  $H = [1_N, \beta]$  is of full column rank; and (c) the parameter space  $\Gamma$  is a compact subset of  $\mathbb{R}^{K+1}$ .*

The ML estimators of  $\mu_f$  and  $V_f$  are

$$\hat{\mu}_f = \frac{1}{T} \sum_{t=1}^T f_t, \quad (6)$$

$$\hat{V}_f = \frac{1}{T} \sum_{t=1}^T (f_t - \hat{\mu}_f)(f_t - \hat{\mu}_f)'. \quad (7)$$

We partition the parameter vector  $\delta = [\text{vec}(B)']', \text{vech}(\Sigma)']', \gamma_0, \phi']'$  into  $\delta = [\delta_1', \delta_2']'$ , where  $\delta_1 = [\text{vec}(B)']', \text{vech}(\Sigma)']'$  and  $\delta_2 = [\gamma_0, \phi']'$ . Under Assumption MLE.A(a), the log-likelihood function of the unrestricted model (5) is given by

$$\mathcal{L}_T(\delta_1) = -\frac{NT}{2} \log(2\pi) - \frac{T}{2} \log |\Sigma| - \frac{1}{2} \sum_{t=1}^T (R_t - B'x_t)' \Sigma^{-1} (R_t - B'x_t). \quad (8)$$

Then, the unrestricted ML estimators of  $B$  and  $\Sigma$  are

$$\hat{B} \equiv [\hat{\alpha}, \hat{\beta}]' = (X'X)^{-1}(X'Y), \quad (9)$$

$$\hat{\Sigma} = \frac{1}{T} (Y - X\hat{B})'(Y - X\hat{B}), \quad (10)$$

and

$$\mathcal{L}_T(\hat{\delta}_1) = -\frac{T}{2} \log |\hat{\Sigma}| - \frac{NT}{2} [\log(2\pi) + 1]. \quad (11)$$

The concentrated likelihood function is

$$\mathcal{L}_T(\tilde{\delta}_1|\delta_2) = -\frac{T}{2} \log |\tilde{\Sigma}| - \frac{NT}{2} [\log(2\pi) + 1], \quad (12)$$

where  $\tilde{\Sigma}$  denotes the estimated covariance of the residuals under the constraint (4) that the asset-pricing model holds. Note also that the constraint (4) can be expressed as  $\omega'(Q_1B + Q_2) = 0'_N$ , where  $\omega = [1, -\phi', -\gamma_0]'$ ,  $Q_1 = \begin{bmatrix} I_{K+1} \\ 0'_{K+1} \end{bmatrix}$ , and  $Q_2 = \begin{bmatrix} 0_{(K+1) \times N} \\ 1'_N \end{bmatrix}$ . Then, the likelihood ratio statistic of  $H_0 : \alpha = 1_N\gamma_0 + \beta\phi$  is given by

$$\mathcal{LR}_T(\delta_2|\hat{\delta}_1) = -T \log \left( 1 + \frac{\omega'(Q_1\hat{B} + Q_2)\hat{\Sigma}^{-1}(Q_1\hat{B} + Q_2)'\omega}{T\omega'Q_1(X'X)^{-1}Q_1'\omega} \right), \quad (13)$$

using that

$$\mathcal{LR}_T = 2 \left[ \mathcal{L}_T(\tilde{\delta}_1|\delta_2) - \mathcal{L}_T(\hat{\delta}_1) \right] = -T \log \left( \frac{|\tilde{\Sigma}|}{|\hat{\Sigma}|} \right) \quad (14)$$

and (Seber, 1984, p. 410)

$$\tilde{\Sigma} = \hat{\Sigma} + (\omega'(Q_1\hat{B} + Q_2))'[T\omega'Q_1(X'X)^{-1}Q_1'\omega]^{-1}\omega'(Q_1\hat{B} + Q_2). \quad (15)$$

Therefore, the ML estimator of  $\delta_2 = [\gamma_0, \phi']'$  can be defined as

$$\hat{\delta}_2 = \operatorname{argmin}_{\delta_2} -\mathcal{LR}_T(\delta_2|\hat{\delta}_1). \quad (16)$$

Since the second term in the parenthesis of (13) is a ratio of quadratic forms in  $\omega$ , the minimum is attained when  $\omega$  is proportional to the eigenvector associated with the largest eigenvalue of

$$[(Q_1\hat{B} + Q_2)\hat{\Sigma}^{-1}(Q_1\hat{B} + Q_2)']^{-1}[TQ_1(X'X)^{-1}Q_1']. \quad (17)$$

Let  $p = [p_1, \dots, p_{K+2}]'$  be the eigenvector associated with the largest eigenvalue of (17). Then, we have

$$\hat{\phi}_i = -p_{i+1}/p_1, \quad i = 1, \dots, K, \quad (18)$$

$$\hat{\gamma}_0 = -p_{K+2}/p_1, \quad (19)$$

and the ML estimator of  $\gamma_1$  is simply  $\hat{\gamma}_1 = \hat{\phi} + \hat{\mu}_f$ .<sup>1</sup>

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<sup>1</sup>Note that  $p_1$ , the first element of  $p$ , is nonzero with probability one. This is a direct consequence of the fact that when the factors and returns are continuously distributed, the eigenvector  $p$  is also continuously distributed and none of the elements of this eigenvector will have a probability mass at zero.

White (1994, Theorem 6.11) provides the asymptotic distribution of  $\hat{\delta}_2$  under potential model misspecification and non-normality of  $\epsilon_t$ . To obtain explicit expressions for the asymptotic covariance of  $\hat{\gamma} = [\hat{\gamma}_0, \hat{\gamma}'_1]'$  in globally misspecified models, in the following we deviate from White (1994) and maintain the joint normality assumption in MLE.A. This allows us to isolate and quantify the impact of model misspecification on the asymptotic covariance of  $\hat{\gamma}$ .

Note that the ML estimator of  $\gamma$  can also be expressed as

$$\hat{\gamma} = \operatorname{argmin}_{\gamma} \frac{(\hat{\mu}_R - \hat{H}\gamma)' \hat{\Sigma}^{-1} (\hat{\mu}_R - \hat{H}\gamma)}{1 + \gamma'_1 \hat{V}_f^{-1} \gamma_1}, \quad (20)$$

where  $\hat{\mu}_R = \frac{1}{T} \sum_{t=1}^T R_t$  and  $\hat{H} = [1_N, \hat{\beta}]$ . Define the pseudo-true values of  $\gamma$  as

$$\gamma^* \equiv \begin{bmatrix} \gamma_0^* \\ \gamma_1^* \end{bmatrix} = \operatorname{argmin}_{\gamma} \frac{(\mu_R - H\gamma)' \Sigma^{-1} (\mu_R - H\gamma)}{1 + \gamma'_1 V_f^{-1} \gamma_1}, \quad (21)$$

and let  $M = \left[ 1_N, \beta + \frac{(\mu_R - H\gamma^*) \gamma_1^{*'} V_f^{-1}}{1 + \gamma_1^{*'} V_f^{-1} \gamma_1^*} \right]$ ,  $s^* = (\mu_R - H\gamma^*)' \Sigma^{-1} (\mu_R - H\gamma^*)$ ,  $c^* = 1 + \gamma_1^{*'} V_f^{-1} \gamma_1^*$ ,  $C_1 = 2M' \Sigma^{-1} M - H' \Sigma^{-1} H$ ,  $C = H' \Sigma^{-1} H - \frac{s^*}{c^*} \tilde{V}_f^{-1}$ ,

$$\tilde{V}_f = \begin{bmatrix} 0 & 0'_K \\ 0_K & V_f \end{bmatrix} \quad (22)$$

and

$$\tilde{V}_f^{-1} = \begin{bmatrix} 0 & 0'_K \\ 0_K & V_f^{-1} \end{bmatrix}. \quad (23)$$

Theorem 1 below derives the asymptotic distribution of  $\hat{\gamma}$  for globally misspecified models.

**THEOREM 1.** *Suppose that Assumption MLE.A is satisfied and  $\mu_R \neq H\gamma$ , that is, the model is misspecified. Then, we have*

$$\sqrt{T}(\hat{\gamma} - \gamma^*) \xrightarrow{d} N(0_{K+1}, \Omega_m), \quad (24)$$

where  $\Omega_m = C^{-1} \left\{ c^* C_1 + C_1 \tilde{V}_f C_1 + s^* \left[ \left(1 - \frac{1}{c^{*2}}\right) C_1 + \left(1 + \frac{s^*(c^*-1)}{c^{*2}}\right) \tilde{V}_f^{-1} + \frac{1}{c^{*2}} H' \Sigma^{-1} H \right] \right\} C^{-1}$ .

**Proof.** See Appendix.

Note that when the model is correctly specified, we have  $s^* = 0$ ,  $M = H$ , and  $C_1 = C = H' \Sigma^{-1} H$ . In this case,

$$\sqrt{T}(\hat{\gamma} - \gamma^*) \xrightarrow{d} N(0_{K+1}, \Omega_c), \quad (25)$$

where  $\Omega_c = c^*(H' \Sigma^{-1} H)^{-1} + \tilde{V}_f$ .

### 3 CU-GMM Estimation and Misspecification-Robust Inference in the SDF Representation

Instead of writing the  $K$ -factor asset-pricing model in beta-pricing form as in (3), we can also express the  $K$ -factor asset-pricing model using a linear SDF  $x_t'\lambda$ , where  $\lambda = [\lambda_0, \lambda_1']' \in \Lambda$  is a  $(K + 1) \times 1$  parameter vector. For a given value of  $\lambda$ , the pricing errors of the  $N$  assets are defined as

$$e(\lambda) \equiv E[e_t(\lambda)] = E[R_t x_t' \lambda - 1_N] = G\lambda - 1_N, \quad (26)$$

where  $G = E[R_t x_t']$ . We say the asset-pricing model is globally misspecified if for all values of  $\lambda$  we have  $e(\lambda) \neq 0_N$ .

Let  $V(\lambda) = \lim_{T \rightarrow \infty} \text{Var} \left( T^{-1/2} \sum_{t=1}^T (e_t(\lambda) - e(\lambda)) \right)$  be a positive definite matrix and  $\lambda^*$  denote the pseudo-true value of  $\lambda$ , which is defined as

$$\lambda^* \equiv \begin{bmatrix} \lambda_0^* \\ \lambda_1^* \end{bmatrix} = \text{argmin}_{\lambda} e(\lambda)' V(\lambda)^{-1} e(\lambda). \quad (27)$$

In the case of correctly specified models,  $e(\lambda^*) = 0_N$  and  $\lambda^*$  is the true value of  $\lambda$ .

ASSUMPTION GMM.A. *Assume that (a)  $Y_t \equiv [f_t', R_t']'$  is a jointly stationary and ergodic process; (b)  $e_t(\lambda^*) - e(\lambda^*)$  forms a martingale difference sequence with variance matrix  $V(\lambda^*)$ ; (c)  $E[(e_t(\lambda) - e(\lambda))(e_t(\lambda) - e(\lambda))']$  is non-singular in some neighborhood of  $\lambda^*$ ; and (d) the parameter space  $\Lambda$  is a compact subset of  $R^{K+1}$ .*

Assumption GMM.A imposes some restrictions on the dynamic behavior of the data and the moment conditions. The martingale difference sequence assumption in GMM.A(b) can be relaxed by modifying the structure of the estimation problem along the lines suggested by Smith (2011). Let  $g_t = R_t x_t'$ ,  $G_T = \frac{1}{T} \sum_{t=1}^T g_t$ , and  $\bar{e}_T(\lambda) = \frac{1}{T} \sum_{t=1}^T e_t(\lambda) = G_T \lambda - 1_N$  is an  $N \times 1$  vector of sample pricing errors with a sample variance (given Assumption GMM.A(b))

$$V_T(\lambda) = \frac{1}{T} \sum_{t=1}^T [e_t(\lambda) - \bar{e}_T(\lambda)][e_t(\lambda) - \bar{e}_T(\lambda)]'. \quad (28)$$

Then, the CU-GMM estimator of  $\lambda$  is defined as<sup>2</sup>

$$\hat{\lambda} = [\hat{\lambda}_0, \hat{\lambda}_1']' = \text{argmin}_{\lambda} \bar{e}_T(\lambda)' V_T(\lambda)^{-1} \bar{e}_T(\lambda). \quad (29)$$

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<sup>2</sup>Newey and Smith (2004, footnote 2) establish the equality of this CU-GMM estimator and the CU-GMM estimator based on  $V_T(\lambda) = \frac{1}{T} \sum_{t=1}^T e_t(\lambda) e_t(\lambda)'$ .

In deriving the asymptotic variance for the CU-GMM estimator in (29) under model misspecification, we follow an approach that allows us to write the estimator of an augmented parameter vector as a solution to the score function of a just-identified problem. The point of departure is the observation that the CU-GMM estimator can be defined equivalently as a solution to a nonparametric likelihood problem that minimizes the Euclidean distance between a probability measure  $P_T$  that satisfies exactly the moment conditions, that is,  $E[e(\lambda)|P_T] = \int e(\lambda)dP_T = 0_N$ , and the empirical probability measure (see Antoine, Bonnal, and Renault, 2007, and Newey and Smith, 2004, among others). This primal problem can be recast conveniently as a dual (saddle-point) problem, where the duality parameter  $\rho(\lambda)$  is an  $N \times 1$  vector of Lagrange multipliers associated with the moment conditions  $e(\lambda) = 0_N$ . Let  $\rho^* \equiv \rho^*(\lambda)$  denote the pseudo-true value of  $\rho$  and  $\theta = [\rho', \lambda']' \in \Theta$  be an augmented  $N + K + 1$  parameter vector with a pseudo-true value  $\theta^* = [\rho^{*'}, \lambda^{*'}]'$ . For correctly specified models, we have  $\rho^* = 0_N$  while for misspecified models,  $\|\rho^*(\lambda)\| > 0$  for all  $\lambda \in \Lambda$ .

Let  $\hat{\theta} = [\hat{\rho}', \hat{\lambda}']'$ . The first-order conditions of this nonparametric likelihood problem are given by (Antoine, Bonnal, and Renault, 2007)

$$\bar{s}_T(\hat{\theta}) \equiv \frac{1}{T} \sum_{t=1}^T s_t(\theta) \Big|_{\theta=\hat{\theta}} = 0_{N+K+1}, \quad (30)$$

where

$$s_t(\theta) = - \begin{bmatrix} [1 + \rho' (e_t(\lambda) - e(\lambda))] e_t(\lambda) \\ [1 + \rho' (e_t(\lambda) - e(\lambda))] g_t' \rho \end{bmatrix}. \quad (31)$$

The  $N + K + 1$  vector  $s_t(\theta)$  can be interpreted as the score function of a quasi-likelihood problem. As argued above, we augment the first-order conditions for the parameter vector of interest  $\lambda$  with the parameter vector of Lagrange multipliers  $\rho$  in order to make the model misspecification, which is reflected in  $\rho$ , explicit in deriving the limiting distribution. Note also that from the first  $N$  equations in (30), we have  $\hat{\rho} = -V_T(\hat{\lambda})^{-1} \bar{e}_T(\hat{\lambda})$ .

Let  $w_t(\theta^*) = [1 + \rho^{*'} (e_t(\lambda^*) - e(\lambda^*))]$ ,  $B = E[w_t(\theta^*)g_t] + E[(e_t(\lambda^*) - e(\lambda^*)) \rho^{*'}(g_t - G)]$ ,  $C = E[(g_t - G)' \rho^* \rho^{*'}(g_t - G)]$ , and  $V = V(\lambda^*)$ . Next, we state the limiting distribution of the CU-GMM estimator in misspecified models.

**THEOREM 2.** *Suppose that Assumption GMM.A holds,  $G$  is of full column rank, and  $Y_t$  has finite eighth moments. Then, it follows that*

$$\sqrt{T}(\hat{\theta} - \theta^*) \xrightarrow{d} N(0_{N+K+1}, \Xi), \quad (32)$$

where  $\Xi \equiv E[l_t l_t']$ ,  $l_t \equiv [l'_{1t}, l'_{2t}]'$ , and

$$l_{1t} = V^{-1} [w_t(\theta^*) e_t(\lambda^*) - B l_{2t}], \quad (33)$$

$$l_{2t} = (C - B' V^{-1} B)^{-1} w_t(\theta^*) [g_t' \rho^* - B' V^{-1} e_t(\lambda^*)]. \quad (34)$$

PROOF. See Appendix.

The variance matrix  $\Xi$  in Theorem 2 can be consistently estimated using the sample analogs of (33) and (34). Importantly, the result in Theorem 2 can be easily extended to nonlinear moment condition models. Let  $g_t^{(2)}(\lambda) = (\partial/\partial\lambda') \text{vec}(g_t(\lambda))$ , where  $g_t(\lambda) = \partial e_t(\lambda)/\partial\lambda'$  is now a function of  $\lambda$ , and  $\tilde{C} = (I_{K+1} \otimes \rho^{*'}) E[g_t^{(2)}(\lambda^*)] + E[(g_t(\lambda^*) - G(\lambda^*))' \rho^* \rho^{*'} (g_t(\lambda^*) - G(\lambda^*))]$ . The following theorem states the result for possibly misspecified nonlinear models.

**THEOREM 3.** *In addition to Assumption GMM.A, assume that (a) the pseudo-true values  $\lambda^*$  and  $\rho^*$  are unique and  $\lambda^*$  is in the interior of  $\Lambda$ ; (b)  $e_t(\lambda)$  is twice continuously differentiable in  $\lambda$  and  $E[\sup_{\lambda \in \Lambda} |e_t(\lambda)|] < \infty$ ; (c)  $E[\sup_{\theta \in \mathcal{N}(\theta^*)} \|\frac{\partial}{\partial\theta'} s_t(\theta)\|] < \infty$  for some neighborhood  $\mathcal{N}$  of  $\theta^*$ ; (d)  $E\|s_t(\theta^*) s_t(\theta^*)'\|$  exists and is finite; (e)  $E[\frac{\partial}{\partial\theta'} s_t(\theta^*)]$  is of full rank. Then, it follows that*

$$\sqrt{T}(\hat{\theta} - \theta^*) \xrightarrow{d} N(0_{N+K+1}, \tilde{\Xi}), \quad (35)$$

where  $\tilde{\Xi} \equiv E[\tilde{l}_t \tilde{l}_t']$ ,  $\tilde{l}_t \equiv [\tilde{l}'_{1t}, \tilde{l}'_{2t}]'$  and

$$\tilde{l}_{1t} = V^{-1} [w_t(\theta^*) e_t(\lambda^*) - B \tilde{l}_{2t}], \quad (36)$$

$$\tilde{l}_{2t} = (\tilde{C} - B' V^{-1} B)^{-1} w_t(\theta^*) [g_t(\lambda^*)' \rho^* - B' V^{-1} e_t(\lambda^*)]. \quad (37)$$

PROOF. See Appendix.

Note that for linear models,  $g_t^{(2)}(\lambda^*)$  is a zero matrix and  $\tilde{C} = C = E[(g_t - G)' \rho^* \rho^{*'} (g_t - G)]$ . Thus, the result in Theorem 3 reduces to the asymptotic distribution in Theorem 2. Furthermore, for correctly specified models, the limiting distribution in Theorem 3 specializes to the result in Theorem 3.2 of Newey and Smith (2004). More specifically, for correctly specified models, we have  $\rho^* = 0_N$ ,  $w_t(\theta^*) = 1$ ,  $B = G$ ,  $C = 0_{(K+1) \times (K+1)}$ ,  $(C - B' V^{-1} B)^{-1} = -(G' V^{-1} G)^{-1}$ , and

$$l_{1t} = V^{-1} [e_t(\lambda^*) - G l_{2t}], \quad (38)$$

$$l_{2t} = (G' V^{-1} G)^{-1} G' V^{-1} e_t(\lambda^*). \quad (39)$$

Peñaranda and Sentana (2015) show the equivalence between the CU-GMM estimation of the linear SDF and beta-pricing frameworks. Let<sup>3</sup>

$$w_t(\hat{\lambda}) = \frac{1 - (e_t(\hat{\lambda}) - \bar{e}_T(\hat{\lambda}))' V_T(\hat{\lambda})^{-1} \bar{e}_T(\hat{\lambda})}{T}. \quad (40)$$

Then, the CU-GMM estimates of  $\mu_f$ ,  $V_f$ , and  $\beta$  can be obtained (in a computationally very efficient way) as  $\tilde{\mu}_f = \sum_{t=1}^T w_t(\hat{\lambda}) f_t$ ,  $\tilde{V}_f = \sum_{t=1}^T w_t(\hat{\lambda}) f_t (f_t - \tilde{\mu}_f)'$ , and  $\tilde{\beta} = \sum_{t=1}^T w_t(\hat{\lambda}) R_t (f_t - \tilde{\mu}_f)' \tilde{V}_f^{-1}$ .<sup>4</sup> These estimates are subsequently used to construct estimates of the zero-beta rate and risk premium parameters,  $\hat{\gamma}_0 = \frac{1}{\hat{\lambda}_0 + \tilde{\mu}_f' \hat{\lambda}_1}$  and  $\hat{\gamma}_1 = -\frac{\tilde{V}_f \hat{\lambda}_1}{\hat{\lambda}_0 + \tilde{\mu}_f' \hat{\lambda}_1}$ , respectively. The asymptotic variances of  $\hat{\gamma}_0$  and  $\hat{\gamma}_1$  can then be obtained by the delta method.

## 4 Monte Carlo Simulations

In this section, we evaluate the performance of the proposed variance estimators by reporting the empirical size and power of  $t$ -tests that are constructed using standard errors under correct model specification and misspecification-robust standard errors. To facilitate the power comparisons, we report size-adjusted power in all tables. In our simulations, we consider the popular linear model of Fama and French (FF3, 1993) with a constant term and three risk factors ( $x_t = [1, mkt_t, smb_t, hml_t]'$ ), where  $mkt$  denotes the excess return (in excess of the one-month T-bill rate) on the value-weighted stock market index (NYSE-AMEX-NASDAQ),  $smb$  is the return difference between portfolios of stocks with small and large market capitalizations, and  $hml$  is the return difference between portfolios of stocks with high and low book-to-market ratios (“value” and “growth” stocks, respectively). The asset-pricing model can either be correctly specified or misspecified.

In our baseline simulations, the returns on the test assets and the risk factors are drawn from a multivariate normal distribution. In addition, we analyze the impact of non-normality and finite moment requirements on our variance approximations by drawing the returns and the factors from a multivariate  $t$ -distribution with eight degrees of freedom.<sup>5</sup> The variance matrix of the simulated risk factors and test asset returns is set equal to the estimated variance matrix of the three Fama-French factors and the test asset returns on the 25 Fama-French size and book-to-market ranked portfolios

<sup>3</sup>Newey and Smith (2004) and Antoine, Bonnal, and Renault (2007) show that  $w_t(\hat{\lambda})$ ,  $t = 1, \dots, T$ , in (40) represent the implied probability weights associated with the CU-GMM estimator.

<sup>4</sup>We refer the readers to an online appendix for the CU-GMM estimation of the beta-pricing model.

<sup>5</sup>In our empirical application, the degree-of-freedom parameter of the multivariate  $t$ -distribution is estimated to be 8.1.

augmented with 10 industry portfolios over the 1963:7–2015:7 sample period.<sup>6</sup> For misspecified models, the means of the simulated returns are set equal to the means of the actual returns. Then, for example, one can use the Hansen and Jagannathan distance (HJD, 1997) to quantify the degree of model misspecification. The resulting HJD for FF3 is 0.3996, which is in line with the HJD values commonly reported in empirical applications with monthly data. For correctly specified models, the means of the simulated returns are set such that the asset-pricing model restrictions are satisfied (that is, the pricing errors are zero). The time-series sample sizes are  $T = 300, 600, 1200,$  and  $3600$ . The number of Monte Carlo replications is set equal to 100,000.

For the beta-pricing model, the vector of risk premium parameters  $\gamma$  is estimated by the ML estimator  $\hat{\gamma}$ . The estimator  $\hat{\gamma}$  is used to construct a consistent estimate of the variance matrix

$$\hat{\Omega}_c = \hat{c}(\hat{H}'\hat{\Sigma}^{-1}\hat{H})^{-1} + \hat{V}_f, \quad (41)$$

under the assumption of a correctly specified model, and the variance matrix

$$\hat{\Omega}_m = \hat{C}^{-1} \left\{ \hat{c}\hat{C}_1 + \hat{C}_1\hat{V}_f\hat{C}_1 + \hat{s} \left[ \left(1 - \frac{1}{\hat{c}^2}\right)\hat{C}_1 + \left(1 + \frac{\hat{s}(\hat{c}-1)}{\hat{c}^2}\right)\hat{V}_f^{-1} + \frac{1}{\hat{c}^2}\hat{H}'\hat{\Sigma}^{-1}\hat{H} \right] \right\} \hat{C}^{-1}, \quad (42)$$

under the assumption of a misspecified model, where  $\hat{c} = 1 + \hat{\gamma}'_1\hat{V}_f^{-1}\hat{\gamma}_1$ ,  $\hat{s} = (\hat{\mu}_R - \hat{H}\hat{\gamma})'\hat{\Sigma}^{-1}(\hat{\mu}_R - \hat{H}\hat{\gamma})$ ,  $\hat{M} = \left[ 1_N, \hat{\beta} + \frac{(\hat{\mu}_R - \hat{H}\hat{\gamma})\hat{\gamma}'_1\hat{V}_f^{-1}}{1 + \hat{\gamma}'_1\hat{V}_f^{-1}\hat{\gamma}_1} \right]$ ,  $\hat{C}_1 = 2\hat{M}'\hat{\Sigma}^{-1}\hat{M} - \hat{H}'\hat{\Sigma}^{-1}\hat{H}$ ,  $\hat{C} = \hat{H}'\hat{\Sigma}^{-1}\hat{H} - \frac{\hat{s}}{\hat{c}}\hat{V}_f^{-1}$ ,

$$\hat{V}_f = \begin{bmatrix} 0 & 0'_K \\ 0_K & \hat{V}_f \end{bmatrix}, \quad (43)$$

and

$$\hat{V}_f^{-1} = \begin{bmatrix} 0 & 0'_K \\ 0_K & \hat{V}_f^{-1} \end{bmatrix}. \quad (44)$$

The square roots of the diagonal elements of  $\hat{\Omega}_c$  and  $\hat{\Omega}_m$  are then used to obtain the  $t$ -tests under correct model specification, denoted by  $t_c(\hat{\gamma})$ , and the misspecification-robust  $t$ -tests, denoted by  $t_m(\hat{\gamma})$ .

Tables I and II report the actual probabilities of rejection for the MLE  $t$ -tests ( $t_c(\hat{\gamma})$  and  $t_m(\hat{\gamma})$ ) of  $H_0 : \gamma_{1,i} = \gamma_{1,i}^*$  and  $H_0 : \gamma_{1,i} = 0$  ( $i = 1, \dots, K$ ) using standard normal critical values. For correctly specified models, the true values  $\gamma^*$  are set equal to their ordinary least squares cross-sectional regression (CSR) estimates  $(\hat{H}'\hat{H})^{-1}\hat{H}'\hat{\mu}_R$  from the actual data, while for misspecified models the pseudo-true values  $\gamma^*$  are set equal to their ML estimates from the actual data.

<sup>6</sup>The test asset return and the factor data are obtained from Kenneth French's website.

Tables I and II about here

Table I presents the results for the FF3 specification when the model is correctly specified. Table II is for the misspecified model. Although the model is correctly specified, the centered  $t$ -test under correct specification,  $t_c$ , tends to slightly overreject in small samples. Interestingly, the centered misspecification-robust  $t$ -test,  $t_m$ , corrects these size distortions and provides improvements despite the fact that the true misspecification adjustment is zero in this case. When the model is misspecified, the  $t$ -tests  $t_c$  are no longer valid, and this is reflected in the fairly significant overrejections. In contrast, the centered misspecification-robust  $t$ -tests  $t_m$  are almost perfectly sized even in small samples. For example, for  $T = 600$  and a 10% significance level, the centered  $t_c$  statistic for  $mkt$  rejects the null hypothesis 21.9% of the time under model misspecification ( $t_c(\hat{\gamma}_{1,1})$  in Panel A of Table II). In contrast, the centered misspecification-robust  $t_m$  statistic rejects the null hypothesis 9.8% of the time under model misspecification ( $t_m(\hat{\gamma}_{1,1})$  in Panel B of Table II). As for power, both tests behave very similarly. It should be noted that power can be low at times. This depends on, among other things, how far from zero the pseudo-true parameters are.

We explore departures from the normality assumption in Tables III and IV. In these tables, the returns and the factors are multivariate  $t$ -distributed with eight degrees of freedom. Note that this distribution (i) generates fat tails and conditional heteroskedasticity in returns, and (ii) makes the MLE inference invalid since the normality assumption is violated.

Tables III and IV about here

When the model is correctly specified (Table III), the impact of non-normality on  $t_c$  and  $t_m$  is negligible, and the size and power properties of the two tests are very similar to the ones under normality in Table I. When the model is misspecified, the centered misspecification-robust  $t$ -test tends to slightly overreject the null in very large samples but is almost perfectly sized in small samples. For example, for  $T = 3600$  and a 10% significance level, the centered  $t_m$  statistic for  $mkt$  rejects the null hypothesis 11.2% of the time ( $t_m(\hat{\gamma}_{1,1})$  in Panel B of Table IV). The centered  $t_c$  statistic continues to be theoretically invalid since the model is misspecified, and it exhibits slightly bigger overrejections compared to the normal case. As for power, both tests behave similarly, with power being about the same as under normality. Overall,  $t_m$  enjoys very nice size and power properties and seems to be little affected by the presence of heavy tails in financial data.

For the SDF representation of the asset-pricing model, the parameter vector  $\theta = [\rho', \lambda']'$  is estimated using the CU-GMM estimator  $\hat{\theta} = [\hat{\rho}', \hat{\lambda}']'$ . Let  $w_t(\hat{\theta}) = 1 + \hat{\rho}'[e_t(\hat{\lambda}) - \bar{e}_T(\hat{\lambda})]$ ,  $\hat{B} = \frac{1}{T} \sum_{t=1}^T w_t(\hat{\theta})g_t + \frac{1}{T} \sum_{t=1}^T [e_t(\hat{\lambda}) - \bar{e}_T(\hat{\lambda})]\hat{\rho}'(g_t - G_T)$ , and  $\hat{C} = \frac{1}{T} \sum_{t=1}^T (g_t - G_T)' \hat{\rho}'(g_t - G_T)$ . Then,

$$\hat{l}_{1t} = V_T(\hat{\lambda})^{-1} \left[ w_t(\hat{\theta})e_t(\hat{\lambda}) - \hat{B}\hat{l}_{2t} \right] \quad (45)$$

and

$$\hat{l}_{2t} = (\hat{C} - \hat{B}'V_T(\hat{\lambda})^{-1}\hat{B})^{-1}w_t(\hat{\theta}) \left[ g_t'\hat{\rho} - \hat{B}'V_T(\hat{\lambda})^{-1}e_t(\hat{\lambda}) \right] \quad (46)$$

are used to construct a consistent estimator  $\hat{\Xi}$  of the asymptotic variance matrix of  $\hat{\theta}$  in Theorem 2. The square roots of the last  $K+1$  diagonal elements of  $\hat{\Xi}$  are used to construct the misspecification-robust  $t$ -tests, denoted by  $t_m(\hat{\lambda})$ . The variance estimator of  $\hat{\theta}$  under correct model specification is obtained from

$$\hat{l}_{1t} = V_T(\hat{\lambda})^{-1} \left[ e_t(\hat{\lambda}) - G_T\hat{l}_{2t} \right], \quad (47)$$

$$\hat{l}_{2t} = (G_T'V_T(\hat{\lambda})^{-1}G_T)^{-1}G_T'V_T(\hat{\lambda})^{-1}e_t(\hat{\lambda}), \quad (48)$$

and the square roots of the last  $K+1$  diagonal elements are used to construct the  $t$ -tests under correct model specification, denoted by  $t_c(\hat{\lambda})$ .

Tables V and VI report the actual probabilities of rejection for the CU-GMM  $t$ -tests ( $t_c(\hat{\lambda})$  and  $t_m(\hat{\lambda})$ ) of  $H_0 : \lambda_{1,i} = \lambda_{1,i}^*$  and  $H_0 : \lambda_{1,i} = 0$  ( $i = 1, \dots, K$ ) using standard normal critical values. For correctly specified models, the true values  $\lambda^*$  are set equal to  $\hat{\lambda} = [(1 + \hat{\mu}'_f \hat{V}_f^{-1} \hat{\gamma}_1) / \hat{\gamma}_0, -\hat{\gamma}'_1 \hat{V}_f^{-1} / \hat{\gamma}_0]'$  (with  $\hat{\gamma} = (\hat{H}'\hat{H})^{-1}\hat{H}'\hat{\mu}_R$ ) from the actual data. In order to compute the pseudo-true values  $\lambda^*$  when the model is misspecified, we partition

$$\text{Var} \begin{bmatrix} f_t \\ R_t \end{bmatrix} = \begin{bmatrix} V_f & V_{fR} \\ V_{Rf} & V_R \end{bmatrix}. \quad (49)$$

It is easy to show that under the *i.i.d.* multivariate elliptical distributional assumption on the factors and the returns, the optimal weighting matrix (the variance matrix of the moment conditions) is given by

$$\begin{aligned} V(\lambda) &= [(\lambda_0 + \mu'_f \lambda_1)^2 + (1 + \kappa)\lambda'_1 V_f \lambda_1]V_R + (\lambda_0 + \mu'_f \lambda_1)(\mu_R \lambda'_1 V_{fR} + V_{Rf} \lambda_1 \mu'_R) \\ &\quad + (\lambda'_1 V_f \lambda_1)\mu_R \mu'_R + (1 + 2\kappa)V_{Rf} \lambda_1 \lambda'_1 V_{fR}, \end{aligned} \quad (50)$$

where  $\kappa$  is the multivariate excess kurtosis of the factors and the returns. The weighting matrix is obtained by setting  $\kappa = 0$  for the multivariate normality case, and by setting  $\kappa = 2/(\nu - 4)$  for

the multivariate  $t$ -distribution case with  $\nu$  degrees of freedom. Then, for misspecified models, the pseudo-true values  $\lambda^*$  are set equal to their CU-GMM estimates from the actual data using this form of the weighting matrix.

Tables V and VI about here

While the pattern of results is somewhat similar to that of the MLE, the CU-GMM estimator appears to be much more sensitive to model misspecification. This is partly due to the numerical instability of the CU-GMM estimator, especially when  $N$  is large, which leads to poorer asymptotic approximations and more pronounced size distortions. For example, in the correctly specified FF3 model with  $T = 600$ , the centered  $t_c$  test rejects the null for the market factor 17.1% of the time at the 10% significance level while the centered  $t_m$  test rejects the null 9.0% of the time (Panels A and B of Table V). For the misspecified FF3 model with  $T = 600$ , the corresponding rejection rates for the centered  $t_c$  and  $t_m$  tests are 60.1% and 12.7% (Panels A and B of Table VI), respectively. In fact, the rejection rates for the centered  $t_c$  test can be as large as 27.6% (Panel A of Table V) for correctly specified models and 68.3% (Panel A of Table VI) for misspecified models at the 10% significance level.

This should serve as a warning signal to applied researchers who routinely use standard errors constructed under the assumption of a correctly specified model in evaluating the statistical significance of the SDF parameters. It suggests that the researcher will conclude erroneously (with very high probability) that the risk factor is important for the pricing of the test assets. While the centered misspecification-robust  $t$ -tests also exhibit some slight size distortions for small sample sizes,<sup>7</sup> their empirical size approaches quickly the nominal level when  $T$  increases. Importantly, the misspecification-robust  $t$ -tests provide large size corrections not only for the case of misspecified models but also for correctly specified models where the  $t_c$  tests are theoretically valid. Moreover, as Tables V and VI illustrate, the effective size correction that the misspecification-robust  $t$ -tests perform does not reflect negatively on the power of the tests neither in correctly specified nor in misspecified models.

Finally, in Tables VII and VIII, we conducted simulations with data drawn from a multivariate  $t$ -distribution with eight degrees of freedom. In this case, the variance approximation used in  $t_m$  is,

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<sup>7</sup>These size distortions are somewhat expected for a small  $T$  and a relatively large  $N$  given the small number of time series observations per moment condition.

strictly speaking, invalid since the condition of finite eighth moments of the data is not satisfied.

Tables VII and VIII about here

Overall, the simulations suggest that our proposed method continues to work well under this more extreme scenario. While there are some overrejections for the centered  $t_m$  test for small sample sizes in misspecified models, they appear to be due primarily to the large number of test assets (moment restrictions) used in our analysis. In simulations that are not reported to conserve space ( $N = 10$  and  $N = 25$ ), these size distortions largely disappear. As in the previous tables, the size-adjusted power is similar for  $t_c$  and  $t_m$ .

## 5 Empirical Application

We use our methodology to estimate the parameters  $\gamma$  and  $\lambda$  of three asset-pricing models. The first model is the simple static CAPM with  $x_t = [1, mkt_t]'$ , where  $mkt$  is the excess return on the value-weighted stock market index that was defined in the previous section. The CAPM performed well in early tests, but has fared poorly since. The second model is the three-factor specification of Fama and French (FF3, 1993) with  $x_t = [1, mkt_t, smb_t, hml_t]'$  that is described in the simulation part of the paper. Finally, we consider the five-factor model of Fama and French (FF5, 2015), an empirical specification that is becoming increasingly popular in the asset-pricing literature. For this model,  $x_t = [1, mkt_t, smb_t, hml_t, rmw_t, cma_t]'$ , where  $rmw$  (profitability factor) is the average return on two robust operating profitability portfolios minus the average return on two weak operating profitability portfolios, and  $cma$  (investment factor) is the average return on two conservative investment portfolios minus the average return on two aggressive investment portfolios. The test asset returns  $R_t$  are (as in the simulation section of the paper) the monthly returns on the value-weighted 25 Fama-French size and book-to-market ranked portfolios and the 10 industry portfolios ( $N = 35$ ) for the period July 1963 – July 2015. As argued in Lewellen, Nagel, and Shanken (2010), the 25 Fama-French portfolios appear to be characterized by a strong factor structure, and the inclusion of the industry portfolios presents a greater challenge to the various asset-pricing models.

Kan and Zhou (2006) argue that the monthly portfolio returns on the 25 Fama-French benchmark portfolios and the three factor portfolios of Fama and French (1993) are well described by

a multivariate  $t$  distribution with eight degrees of freedom. When we apply the ML methods described in Section 2.1 of Kan and Zhou (2006) to our dataset of 40 financial time series (that is, 35 benchmark portfolios and five factors), we obtain 8.1 as an estimate of the degrees of freedom parameter of the multivariate  $t$ -distribution. Additional tests based on Mardia’s (1970) measures of multivariate skewness and kurtosis (see Section 1.2 of Kan and Zhou, 2006) also indicate that the number of degrees of freedom of the multivariate  $t$  distribution is at least eight in our dataset. Given the outcome of these tests, our regularity assumption of finite eighth moments for CU-GMM does not appear to be at odds with the financial data used in our empirical analysis.

In addition to the invariant ML and CU-GMM estimators, we also present results for the non-invariant generalized least squares (GLS) CSR and HJD estimators in the beta-pricing and SDF representations, respectively.<sup>8</sup> While inefficient compared to the invariant estimators, CSR and HJD provide useful benchmarks given their numerical stability and popularity in empirical work.

To quantify the degree of misspecification of these models, we performed a model specification test using each of the four estimators. For all models and estimators, the null of correct model specification is strongly rejected with  $p$ -values equal to 0.000. To determine whether the models are well identified, we also applied the Cragg and Donald (1997) rank test to the beta-pricing and SDF representations of the models. The results from the rank test suggest that the models are well identified as the test rejects the null of a reduced rank with  $p$ -values of 0.000. In summary, these pre-tests provide convincing evidence that the models are misspecified but properly identified.

Hence, to ensure valid statistical inference, the standard errors for the estimated parameters need to be adjusted to account for the additional uncertainty arising from model misspecification. However, it is common practice in empirical work to employ the traditional standard errors derived under the assumption of correct model specification, even when the null of correct model specification is rejected by the data. For this reason, in Table IX, we report  $t$ -statistics constructed under the assumption of a correctly specified model ( $t_c$ ) in addition to the misspecification-robust  $t$ -statistics ( $t_m$ ).

Table IX about here

For the beta-pricing model, the ML and CSR estimators (Panel A of Table IX) deliver similar

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<sup>8</sup>For the GLS CSR estimator and related misspecification-robust  $t$ -tests, we refer the reader to Kan, Robotti, and Shanken (2013). For the HJD estimator and related misspecification-robust  $t$ -tests, we refer the reader to Kan and Robotti (2009) and Gospodinov, Kan, and Robotti (2013).

results. In addition, the differences between the  $t_c$  and  $t_m$  tests are generally small and rarely lead to different conclusions regarding the statistical significance of the individual parameters (the only noticeable exception is the investment factor in FF5 estimated by ML). This is likely due to the fact that all factors are traded and the model misspecification adjustment is typically not large in this scenario (see Kan, Robotti, and Shanken, 2013). It also appears that the misspecification adjustment for the ML standard errors is larger than the corresponding adjustment for the CSR estimator.

The model misspecification adjustment is much more pronounced for the CU-GMM estimator in the SDF representation of the model (Panel B of Table IX). For example, consider FF5. When using standard errors constructed under correct model specification, one would conclude that, except for  $mkt$ , all factors are priced at the 5% significance level. In contrast, incorporating model misspecification in the analysis produces standard errors that are much larger than those constructed under correct model specification. In particular, the new profitability and investment factors of Fama and French (2015) do not appear to be priced at the 5% significance level. The inference based on misspecification-robust standard errors suggests that only  $smb$  is priced (albeit with much smaller  $t$ -statistics) at the 5% significance level. The SDF parameter estimates on all the other risk factors are statistically insignificant. The evidence of pricing in CAPM and FF3 is also much weaker once the uncertainty associated with potential model misspecification is incorporated in the inference procedure. As for the beta-pricing representation, the non-invariant estimator (HJD) in the SDF setup exhibits less sensitivity to model misspecification (see Gospodinov, Kan, and Robotti, 2013), although the evidence of pricing for  $mkt$ ,  $hml$ ,  $rmw$ , and  $cma$  in FF5 is even weaker than for CU-GMM.

To summarize, accounting for model misspecification often makes a qualitative difference in determining whether estimates of the risk premia or the SDF parameters are statistically significant. Applied researchers should be cautious in interpreting high  $t$ -ratios constructed under correct model specification as evidence that the underlying factors are important in explaining the cross-sectional differences in asset expected returns.

## 6 Conclusions

This paper derives the asymptotic variance of the ML and CU-GMM estimators in potentially misspecified models, represented either in beta-pricing or SDF form. This fills an important gap in the literature given the increasing popularity of invariant estimators and the widespread belief that economic models are inherently misspecified. The new expressions for the asymptotic variances of the ML and CU-GMM estimators are explicit and easy-to-use in practice.

We illustrate the importance of using misspecification-robust standard errors of the parameter estimates in the context of various linear asset-pricing models. While, as expected, the misspecification-robust tests deliver impressive improvements when the true model is misspecified, these tests also tend to provide substantial small-sample corrections when the model is correctly specified, especially for CU-GMM. All these size corrections are achieved at no apparent cost associated with loss of power. As a result, the main recommendation that emerges from our analysis is that the proposed misspecification-robust standard errors should always be used in applied work regardless of whether the model is believed (based, for example, on the outcome of a pre-test of overidentifying restrictions) to be correctly specified or misspecified.

# Appendix

## Preliminary Lemma 1

LEMMA 1. *The matrix  $C = H'\Sigma^{-1}H - \frac{s^*}{c^*}\tilde{V}_f^{-1}$  is a positive definite matrix.*

### Proof

Let  $\eta$  be a  $K + 2$  vector,  $\tilde{A} = [\mu_R, H]'\Sigma^{-1}[\mu_R, H]$  and  $\tilde{B} = \begin{bmatrix} 1 & 0 & 0'_K \\ 0 & 0 & 0'_K \\ 0_K & 0_K & V_f^{-1} \end{bmatrix}$ . Then, we can write the minimization problem in (21) as

$$\min_{\eta} \frac{\eta'\tilde{A}\eta}{\eta'\tilde{B}\eta}. \quad (\text{A.1})$$

By restricting  $\eta = [0, \gamma]'$ , it is easy to see that

$$\min_{\eta} \frac{\eta'\tilde{A}\eta}{\eta'\tilde{B}\eta} < \min_{\eta: \eta=[0, \gamma]'} \frac{\eta'\tilde{A}\eta}{\eta'\tilde{B}\eta} = \min_{\gamma} \frac{\gamma'H'\Sigma^{-1}H\gamma}{\gamma'\tilde{V}_f^{-1}\gamma}. \quad (\text{A.2})$$

Note that it is a strict inequality because when the model is identified, the optimal  $\eta$  on the left hand side is chosen such that the first element is normalized to one (that is, nonzero). Since the left hand side is equal to  $s^*/c^*$ , the largest eigenvalue of  $(H'\Sigma^{-1}H)^{-1}\tilde{V}_f^{-1}$  is less than  $c^*/s^*$ , which in turn implies that  $H'\Sigma^{-1}H - (s^*/c^*)\tilde{V}_f^{-1}$  is a positive definite matrix. This completes the proof. ■

## Proof of Theorem 1

Let

$$\hat{M} = \left[ 1_N, \hat{\beta} + \frac{\hat{m}(\hat{\gamma})\hat{\gamma}'_1\hat{V}_f^{-1}}{1 + \hat{\gamma}'_1\hat{V}_f^{-1}\hat{\gamma}_1} \right], \quad (\text{A.3})$$

where  $\hat{m}(\hat{\gamma}) = \hat{\mu}_R - \hat{H}\hat{\gamma}$ . The first order conditions of (20) and (21) are given by

$$\hat{M}'\hat{\Sigma}^{-1}\hat{m}(\hat{\gamma}) = 0_{K+1}, \quad (\text{A.4})$$

$$M'\Sigma^{-1}m^* = 0_{K+1}, \quad (\text{A.5})$$

where  $m^* \equiv m(\gamma^*) = \mu_R - H\gamma^*$ . Using a Taylor series expansion, we can write

$$\sqrt{T}[\hat{m}(\hat{\gamma}) - \hat{m}(\gamma^*)] = -\sqrt{T}H(\hat{\gamma} - \gamma^*) + O_p(T^{-\frac{1}{2}}), \quad (\text{A.6})$$

and in addition, using the fact that  $\hat{\Sigma} \xrightarrow{p} \Sigma$ ,  $\hat{M} \xrightarrow{p} M$ , and  $\hat{m}(\gamma^*) \xrightarrow{p} m^*$ , we have

$$\begin{aligned}
& \sqrt{T}M'\Sigma^{-1}[\hat{m}(\gamma^*) - m^*] \\
&= \sqrt{T}M'\Sigma^{-1}\hat{m}(\gamma^*) \\
&= -\sqrt{T}(\hat{M} - M)'\Sigma^{-1}\hat{m}(\gamma^*) - \sqrt{T}\hat{M}'(\hat{\Sigma}^{-1} - \Sigma^{-1})\hat{m}(\gamma^*) - \sqrt{T}\hat{M}'\hat{\Sigma}^{-1}[\hat{m}(\hat{\gamma}) - \hat{m}(\gamma^*)] \\
&= -\sqrt{T}(\hat{M} - M)'\Sigma^{-1}m^* - \sqrt{T}M'(\hat{\Sigma}^{-1} - \Sigma^{-1})m^* - \sqrt{T}M'\Sigma^{-1}[\hat{m}(\hat{\gamma}) - \hat{m}(\gamma^*)] + O_p(T^{-\frac{1}{2}}).
\end{aligned} \tag{A.7}$$

Under the normality assumption,

$$\sqrt{T}\text{vec}(\hat{\Sigma}^{-1} - \Sigma^{-1}) \xrightarrow{d} N(0_{N^2}, (\Sigma^{-1} \otimes \Sigma^{-1})(I_{N^2} + K_N)), \tag{A.8}$$

where  $K_N$  is an  $N^2 \times N^2$  commutation matrix. Then, defining  $s^* = m^{*\prime}\Sigma^{-1}m^*$  and using the fact that  $M'\Sigma^{-1}m^* = 0_{K+1}$ , we can obtain the limiting distribution of the second term in (A.7) as

$$\sqrt{T}M'(\hat{\Sigma}^{-1} - \Sigma^{-1})m^* \xrightarrow{d} N(0_{K+1}, s^*M'\Sigma^{-1}M), \tag{A.9}$$

and it is asymptotically independent of  $\hat{m}(\gamma^*)$ .

For the third term in (A.7), we have

$$-\sqrt{T}M'\Sigma^{-1}[\hat{m}(\hat{\gamma}) - \hat{m}(\gamma^*)] = \sqrt{T}M'\Sigma^{-1}H(\hat{\gamma} - \gamma^*) + O_p(T^{-\frac{1}{2}}) = \sqrt{T}M'\Sigma^{-1}M(\hat{\gamma} - \gamma^*) + O_p(T^{-\frac{1}{2}}), \tag{A.10}$$

where the last equality follows from the fact that  $M'\Sigma^{-1}M = M'\Sigma^{-1}H$  because of (A.5).

It remains to expand the first term in (A.7). Writing

$$\begin{aligned}
& \sqrt{T}(\hat{M} - M)'\Sigma^{-1}m^* \\
&= \left[ \sqrt{T}(\hat{\beta} - \beta)'\Sigma^{-1}m^* + \left[ \frac{0}{\frac{\sqrt{T}\hat{V}_f^{-1}\hat{\gamma}_1\hat{m}(\hat{\gamma})'}{1+\hat{\gamma}'_1\hat{V}_f^{-1}\hat{\gamma}_1} - \frac{\sqrt{T}V_f^{-1}\gamma_1^*m^{*\prime}}{1+\gamma_1^{*\prime}V_f^{-1}\gamma_1^*}} \right] \Sigma^{-1}m^* \right] \\
&= \sqrt{T}(\hat{H} - H)'\Sigma^{-1}m^* + \left[ \left[ \frac{0}{\frac{\sqrt{T}\hat{V}_f^{-1}\hat{\gamma}_1\hat{m}(\hat{\gamma})'}{1+\hat{\gamma}'_1\hat{V}_f^{-1}\hat{\gamma}_1} - \frac{\sqrt{T}V_f^{-1}\gamma_1^*m^{*\prime}}{1+\gamma_1^{*\prime}V_f^{-1}\gamma_1^*}} \right] \Sigma^{-1}m^* \right].
\end{aligned} \tag{A.11}$$

The second term in (A.11) has three sources of randomness. Using the delta method and letting

$c^* = 1 + \gamma_1^{*\prime} V_f^{-1} \gamma_1^*$ , we can approximate the second term in (A.11) as

$$\begin{aligned}
& \left[ \frac{\sqrt{T} \hat{V}_f^{-1} \hat{\gamma}_1 \hat{m}(\hat{\gamma})'}{1 + \hat{\gamma}_1' \hat{V}_f^{-1} \hat{\gamma}_1} - \frac{\sqrt{T} V_f^{-1} \gamma_1^* m^{*\prime}}{1 + \gamma_1^{*\prime} V_f^{-1} \gamma_1^*} \right] \Sigma^{-1} m^* \\
&= \frac{\sqrt{T} V_f^{-1} \gamma_1^* [\hat{m}(\hat{\gamma}) - \hat{m}(\gamma^*) + \hat{m}(\gamma^*) - m^*]' \Sigma^{-1} m^*}{c^*} \\
&+ \frac{\sqrt{T} (\hat{V}_f^{-1} - V_f^{-1}) \gamma_1^* s^*}{c^*} - \frac{V_f^{-1} \gamma_1^* s^*}{c^{*2}} \sqrt{T} \gamma_1^{*\prime} (\hat{V}_f^{-1} - V_f^{-1}) \gamma_1^* \\
&+ \frac{\sqrt{T} V_f^{-1} (\hat{\gamma}_1 - \gamma_1^*) s^*}{c^*} - \frac{V_f^{-1} \gamma_1^* s^*}{c^{*2}} 2 \gamma_1^{*\prime} V_f^{-1} \sqrt{T} (\hat{\gamma}_1 - \gamma_1^*) + O_p(T^{-\frac{1}{2}}). \tag{A.12}
\end{aligned}$$

Combining the second and the third terms in (A.12), we have

$$\frac{\sqrt{T} (\hat{V}_f^{-1} - V_f^{-1}) \gamma_1^* s^*}{c^*} - \frac{V_f^{-1} \gamma_1^* s^*}{c^{*2}} \sqrt{T} \gamma_1^{*\prime} (\hat{V}_f^{-1} - V_f^{-1}) \gamma_1^* = \frac{s^*}{c^*} A \sqrt{T} (\hat{V}_f^{-1} - V_f^{-1}) \gamma_1^*, \tag{A.13}$$

where

$$A = I_K - \frac{V_f^{-1} \gamma_1^* \gamma_1^{*\prime}}{c^*}. \tag{A.14}$$

It can be readily shown that

$$\frac{s^*}{c^*} A \sqrt{T} (\hat{V}_f^{-1} - V_f^{-1}) \gamma_1^* \xrightarrow{d} N \left( 0_K, \frac{s^{*2}}{c^{*2}} \left[ (c^* - 1) V_f^{-1} + \left( \frac{2}{c^{*2}} - 1 \right) V_f^{-1} \gamma_1^* \gamma_1^{*\prime} V_f^{-1} \right] \right), \tag{A.15}$$

and this random variable is independent of  $\hat{\Sigma}$ ,  $\hat{\mu}_R$ , and  $\hat{\beta}$ . Combining the last two terms in (A.12),

we have

$$\left[ \begin{array}{c} 0 \\ \frac{\sqrt{T} V_f^{-1} (\hat{\gamma}_1 - \gamma_1^*) s^*}{c^*} - \frac{V_f^{-1} \gamma_1^* s^*}{c^{*2}} 2 \gamma_1^{*\prime} V_f^{-1} \sqrt{T} (\hat{\gamma}_1 - \gamma_1^*) \end{array} \right] = \frac{s^*}{c^*} B \sqrt{T} (\hat{\gamma} - \gamma^*), \tag{A.16}$$

where

$$B = \left[ \begin{array}{cc} 0 & 0'_K \\ 0_K & V_f^{-1} - \frac{2 V_f^{-1} \gamma_1^* \gamma_1^{*\prime} V_f^{-1}}{c^*} \end{array} \right]. \tag{A.17}$$

Collecting all these terms, we obtain

$$\begin{aligned}
& \sqrt{T} M' \Sigma^{-1} [\hat{m}(\gamma^*) - m^*] + \sqrt{T} (\hat{H} - H)' \Sigma^{-1} m^* + \sqrt{T} (M - H)' \Sigma^{-1} [\hat{m}(\gamma^*) - m^*] \\
&+ \left[ \begin{array}{c} 0 \\ \frac{\sqrt{T} A (\hat{V}_f^{-1} - V_f^{-1}) \gamma_1^* s^*}{c^*} \end{array} \right] + \sqrt{T} M' (\hat{\Sigma}^{-1} - \Sigma^{-1}) m^* \\
&= -\sqrt{T} (M - H)' \Sigma^{-1} [\hat{m}(\hat{\gamma}) - \hat{m}(\gamma^*)] - \frac{\sqrt{T} B (\hat{\gamma} - \gamma^*) s^*}{c^*} - \sqrt{T} M' \Sigma^{-1} [\hat{m}(\hat{\gamma}) - \hat{m}(\gamma^*)] \\
&\Rightarrow \sqrt{T} (2M - H)' \Sigma^{-1} [\hat{m}(\gamma^*) - m^*] + \sqrt{T} (\hat{H} - H)' \Sigma^{-1} m^* \\
&+ \left[ \begin{array}{c} 0 \\ \frac{\sqrt{T} A (\hat{V}_f^{-1} - V_f^{-1}) \gamma_1^* s^*}{c^*} \end{array} \right] + \sqrt{T} M' (\hat{\Sigma}^{-1} - \Sigma^{-1}) m^* \\
&= \left[ (2M - H)' \Sigma^{-1} H - \frac{s^*}{c^*} B \right] \sqrt{T} (\hat{\gamma} - \gamma^*). \tag{A.18}
\end{aligned}$$

Using the fact that

$$C = (2M - H)' \Sigma^{-1} H - \frac{s^*}{c^*} B = 2M' \Sigma^{-1} M - H' \Sigma^{-1} H - \frac{s^*}{c^*} B, \quad (\text{A.19})$$

we can then write

$$\begin{aligned} \sqrt{T}(\hat{\gamma} - \gamma^*) &\xrightarrow{d} C^{-1}(2M - H)' \Sigma^{-1} \sqrt{T}[\hat{m}(\gamma^*) - m^*] + \sqrt{T} C^{-1}(\hat{H} - H)' \Sigma^{-1} m^* \\ &\quad + C^{-1} \begin{bmatrix} 0 \\ \frac{\sqrt{T} A(\hat{V}_f^{-1} - V_f^{-1}) \gamma_{1*} s^*}{c^*} \end{bmatrix} + C^{-1} M' \sqrt{T}(\hat{\Sigma}^{-1} - \Sigma^{-1}) m^*. \end{aligned} \quad (\text{A.20})$$

The last two terms in (A.20) are independent of each other and also independent of the first two terms, and their variances are given by

$$\frac{s^{*2}}{c^{*2}} C^{-1} \begin{bmatrix} 0 \\ 0_K \quad (\gamma_1^{*'} V_f^{-1} \gamma_1^*) V_f^{-1} + \left(\frac{0'_K}{c^{*2}} - 1\right) V_f^{-1} \gamma_1^* \gamma_1^{*'} V_f^{-1} \end{bmatrix} C^{-1} + s^* C^{-1} M' \Sigma^{-1} M C^{-1}. \quad (\text{A.21})$$

Since

$$H' \Sigma^{-1} H - M' \Sigma^{-1} M = \frac{s^*}{c^{*2}} \begin{bmatrix} 0 & 0'_K \\ 0_K & V_f^{-1} \gamma_1^* \gamma_1^{*'} V_f^{-1} \end{bmatrix}, \quad (\text{A.22})$$

we can write

$$C = H' \Sigma^{-1} H - \frac{s^*}{c^*} \tilde{V}_f^{-1}. \quad (\text{A.23})$$

Given that

$$\hat{m}(\gamma^*) - m^* = \hat{\alpha} - \alpha - (\hat{\beta} - \beta) \phi^* + \hat{\beta}(\hat{\mu}_f - \mu_f), \quad (\text{A.24})$$

where  $\phi^* = \gamma_1^* - \mu_f$ , we obtain

$$\sqrt{T}[\hat{m}(\gamma^*) - m^*] \xrightarrow{d} N\left(0_N, (1 + \gamma_1^{*'} V_f^{-1} \gamma_1^*) \Sigma + H \tilde{V}_f H'\right). \quad (\text{A.25})$$

Hence, the asymptotic variance of the first term in (A.20) is

$$\begin{aligned} &c^* C^{-1} (2M - H)' \Sigma^{-1} (2M - H) C^{-1} + C^{-1} (2M - H)' \Sigma^{-1} H \tilde{V}_f H' \Sigma^{-1} (2M - H) C^{-1} \\ &= c^* C^{-1} H' \Sigma^{-1} H C^{-1} + C^{-1} (2M - H)' \Sigma^{-1} H \tilde{V}_f H' \Sigma^{-1} (2M - H) C^{-1}, \end{aligned} \quad (\text{A.26})$$

where the invertibility of  $C$  follows from Lemma 1. Using that under Assumption MLE.A,

$$\sqrt{T} \text{vec}(\hat{\beta} - \beta) \xrightarrow{d} N\left(0_{NK}, V_f^{-1} \otimes \Sigma\right), \quad (\text{A.27})$$

we obtain the asymptotic variance of the second term in (A.20) as

$$s^* C^{-1} \tilde{V}_f^{-1} C^{-1}. \quad (\text{A.28})$$

Let  $\tilde{B} = \sqrt{T}[\hat{\alpha} - \alpha, \hat{\beta} - \beta]$  and  $\tilde{b} = \text{vec}(\tilde{B})$ . We have

$$\tilde{b} \xrightarrow{d} N \left( 0_{N(K+1)}, \begin{bmatrix} 1 + \mu'_f V_f^{-1} \mu_f & -\mu'_f V_f^{-1} \\ -V_f^{-1} \mu_f & V_f^{-1} \end{bmatrix} \otimes \Sigma \right). \quad (\text{A.29})$$

Then, using

$$\begin{aligned} E[\sqrt{T}[\hat{m}(\gamma^*) - m^*]m^{*\prime}\Sigma^{-1}\sqrt{T}(\hat{\beta} - \beta)] &= E[\sqrt{T}[\hat{\alpha} - \alpha - (\hat{\beta} - \beta)\phi^*]m^{*\prime}\Sigma^{-1}\sqrt{T}(\hat{\beta} - \beta)] \\ &= E \left[ \tilde{B} \begin{bmatrix} 1 \\ -\phi^* \end{bmatrix} m^{*\prime}\Sigma^{-1}\tilde{B} \begin{bmatrix} 0'_K \\ I_K \end{bmatrix} \right] \\ &= E \left[ ([1, -\phi^{*\prime}] \otimes I_N) \tilde{b}\tilde{b}' \left( \begin{bmatrix} 0'_K \\ I_K \end{bmatrix} \otimes \Sigma^{-1}m^* \right) \right] \\ &= -\gamma_1^{*\prime}V_f^{-1} \otimes m^* \\ &= -m^*\gamma_1^{*\prime}V_f^{-1}, \end{aligned} \quad (\text{A.30})$$

we obtain the asymptotic variance between the first and second terms in (A.20) as

$$\begin{aligned} C^{-1}(2M - H)'\Sigma^{-1}m^*[0, -\gamma_1^{*\prime}V_f^{-1}]C^{-1} &= C^{-1}H'\Sigma^{-1}m^*[0, \gamma_1^{*\prime}V_f^{-1}]C^{-1} \\ &= c^*C^{-1}H'\Sigma^{-1}(M - H)C^{-1}. \end{aligned} \quad (\text{A.31})$$

Combining all the results, we obtain

$$\sqrt{T}(\hat{\gamma} - \gamma^*) \xrightarrow{d} N(0_{K+1}, \Omega_m), \quad (\text{A.32})$$

where

$$\begin{aligned} \Omega_m &= c^*C^{-1}H'\Sigma^{-1}HC^{-1} \\ &\quad + C^{-1}(2M - H)'\Sigma^{-1}H\tilde{V}_fH'\Sigma^{-1}(2M - H)C^{-1} \\ &\quad + s^*C^{-1}\tilde{V}_f^{-1}C^{-1} + c^*C^{-1}H'\Sigma^{-1}(M - H)C^{-1} \\ &\quad + c^*C^{-1}(M - H)'\Sigma^{-1}HC^{-1} \\ &\quad + \frac{s^{*2}}{c^{*2}}C^{-1} \begin{bmatrix} 0 & 0'_K \\ 0_K & (\gamma_1^{*\prime}V_f^{-1}\gamma_1^*)V_f^{-1} + (\frac{2}{c^{*2}} - 1)V_f^{-1}\gamma_1^*\gamma_1^{*\prime}V_f^{-1} \end{bmatrix} C^{-1} \\ &\quad + s^*C^{-1}M'\Sigma^{-1}MC^{-1}. \end{aligned} \quad (\text{A.33})$$

Let  $C_1 = 2M'\Sigma^{-1}M - H'\Sigma^{-1}H$ . Then, we can write

$$\begin{aligned} \Omega_m &= c^*C^{-1}C_1C^{-1} + C^{-1}C_1\tilde{V}_fC_1C^{-1} + s^*C^{-1}\tilde{V}_f^{-1}C^{-1} + s^*C^{-1}M'\Sigma^{-1}MC^{-1} \\ &\quad + \frac{s^{*2}}{c^{*2}}C^{-1} \begin{bmatrix} 0 & 0'_K \\ 0_K & (\gamma_1^{*\prime}V_f^{-1}\gamma_1^*)V_f^{-1} + (\frac{2}{c^{*2}} - 1)V_f^{-1}\gamma_1^*\gamma_1^{*\prime}V_f^{-1} \end{bmatrix} C^{-1}. \end{aligned} \quad (\text{A.34})$$

Using the identities

$$M'\Sigma^{-1}M = C_1 + \frac{s^*}{c^{*2}} \begin{bmatrix} 0 & 0'_K \\ 0_K & V_f^{-1}\gamma_1^*\gamma_1'^*V_f^{-1} \end{bmatrix}, \quad (\text{A.35})$$

$$H'\Sigma^{-1}H - C_1 = \frac{2s^*}{c^{*2}} \begin{bmatrix} 0 & 0'_K \\ 0_K & V_f^{-1}\gamma_1^*\gamma_1'^*V_f^{-1} \end{bmatrix}, \quad (\text{A.36})$$

we can write  $\Omega_m$  as

$$\Omega_m = C^{-1} \left\{ c^*C_1 + C_1\tilde{V}_fC_1 + s^* \left[ \left(1 - \frac{1}{c^{*2}}\right) C_1 + \left(1 + \frac{s^*(c^* - 1)}{c^{*2}}\right) \tilde{V}_f^{-1} + \frac{1}{c^{*2}}H'\Sigma^{-1}H \right] \right\} C^{-1}. \quad (\text{A.37})$$

This completes the proof. ■

## Proof of Theorem 2

A mean value expansion of  $\bar{s}_T(\hat{\theta})$  about  $\theta^*$  yields

$$0_{N+K+1} = \bar{s}_T(\theta^*) + H_T(\tilde{\theta})(\hat{\theta} - \theta^*) \quad (\text{A.38})$$

or

$$\sqrt{T}(\hat{\theta} - \theta^*) = -[H_T(\tilde{\theta})]^{-1}\sqrt{T}\bar{s}_T(\theta^*), \quad (\text{A.39})$$

where  $H_T(\theta) = \frac{1}{T} \sum_{t=1}^T h_t(\theta)$  with  $h_t(\theta) = (\partial/\partial\theta')s_t(\theta)$ , and  $\tilde{\theta}$  is an intermediate point on the line segment joining  $\hat{\theta}$  and  $\theta^*$ . More specifically,

$$h_t(\theta) = - \begin{bmatrix} (e_t(\lambda) - e(\lambda))(e_t(\lambda) - e(\lambda))' & w_t(\theta)g_t + (e_t(\lambda) - e(\lambda))\rho'(g_t - G) \\ w_t(\theta)g_t' + (g_t - G)'\rho(e_t(\lambda) - e(\lambda))' & (g_t - G)'\rho\rho'(g_t - G) \end{bmatrix}, \quad (\text{A.40})$$

where  $w_t(\theta) = [1 + \rho'(e_t(\lambda) - e(\lambda))]$ . Our regularity conditions ensure that

$$\sqrt{T}\bar{s}_T(\theta^*) \xrightarrow{d} N(0_{N+K+1}, S), \quad (\text{A.41})$$

and

$$\sqrt{T}(\hat{\theta} - \theta^*) \xrightarrow{d} N(0_{N+K+1}, H^{-1}S(H')^{-1}), \quad (\text{A.42})$$

where  $S = E[s_t(\theta^*)s_t(\theta^*)']$ ,

$$H \equiv E[H_T(\theta^*)] = \begin{bmatrix} V & B \\ B' & C \end{bmatrix}, \quad (\text{A.43})$$

and  $V$ ,  $B$ , and  $C$  are defined in the text.

To derive the explicit expression for the asymptotic variance matrix of  $\hat{\theta}$  in Theorem 2, we write

$$H^{-1}S(H')^{-1} = E[l_t l_t'], \quad (\text{A.44})$$

where

$$l_t \equiv \begin{bmatrix} l_{1t} \\ l_{2t} \end{bmatrix} = H^{-1} s_t(\theta^*). \quad (\text{A.45})$$

From the definition of  $H$  in (A.43), we can use the formula for the inverse of a partitioned matrix to obtain

$$H^{-1} = \begin{bmatrix} V^{-1}(I_N + B\tilde{H}B'V^{-1}) & -V^{-1}B\tilde{H} \\ -\tilde{H}'B'V^{-1} & \tilde{H} \end{bmatrix}, \quad (\text{A.46})$$

where  $\tilde{H} = (C - B'V^{-1}B)^{-1}$ . Observe that  $C - B'V^{-1}B$  is the Schur complement of  $V$  in  $H$  and its invertibility follows from our assumptions and the properties of Schur complements. Using (A.46) and (31), we can express  $l_{1t}$  and  $l_{2t}$  as

$$l_{1t} = V^{-1} [w_t(\theta^*)e_t(\lambda^*) - Bl_{2t}], \quad (\text{A.47})$$

$$l_{2t} = \tilde{H}w_t(\theta^*) [g_t'\rho^* - B'V^{-1}e_t(\lambda^*)]. \quad (\text{A.48})$$

This delivers the desired result. ■

### Proof of Theorem 3

Note that in the case of nonlinear moment conditions, the upper-left, upper-right, lower-left, and lower-right blocks of the  $h_t(\theta)$  matrix are given by

$$-(e_t(\lambda) - e(\lambda))(e_t(\lambda) - e(\lambda))', \quad (\text{A.49})$$

$$- [w_t(\theta)g_t(\lambda) + (e_t(\lambda) - e(\lambda))\rho'(g_t(\lambda) - G(\lambda))], \quad (\text{A.50})$$

$$- [w_t(\theta)g_t(\lambda)' + (g_t(\lambda) - G(\lambda))\rho(e_t(\lambda) - e(\lambda))'], \quad (\text{A.51})$$

$$- \left[ w_t(\theta)(I_{K+1} \otimes \rho')g_t^{(2)}(\lambda) + (g_t(\lambda) - G(\lambda))'\rho\rho'(g_t(\lambda) - G(\lambda)) \right], \quad (\text{A.52})$$

respectively. The rest of the proof follows similar arguments as those in the proof of Theorem 2. ■

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**Table I**  
**Size and power properties of MLE  $t$ -tests under normality:**  
**Correctly specified model**

The table presents the actual probabilities of rejection for the  $t$ -tests of  $H_0 : \gamma_{1,i} = \gamma_{1,i}^*$  and  $H_0 : \gamma_{1,i} = 0$  ( $i = 1, \dots, K$ ) for different levels of significance. The model includes a constant term and three risk factors (FF3 specification). The true values of the risk premium parameters are  $\gamma_{1,1}^* = -0.0028$ ,  $\gamma_{1,2}^* = 0.0022$ , and  $\gamma_{1,3}^* = 0.0028$ . Panel A presents the empirical size and power for  $t$ -tests that are constructed assuming that the model is correctly specified ( $t_c$ ). Panel B reports the empirical size and power for misspecification-robust  $t$ -tests ( $t_m$ ). The factors and the returns are multivariate normally distributed.

		Size			Power		
		Level of Significance			Level of Significance		
$T$		10%	5%	1%	10%	5%	1%
Panel A: $t_c$							
$t_c(\hat{\gamma}_{1,1})$	300	0.140	0.079	0.021	0.198	0.117	0.034
	600	0.119	0.063	0.014	0.301	0.198	0.074
	1200	0.109	0.057	0.012	0.479	0.354	0.164
	3600	0.103	0.052	0.010	0.875	0.797	0.598
$t_c(\hat{\gamma}_{1,2})$	300	0.102	0.051	0.011	0.344	0.233	0.086
	600	0.102	0.052	0.011	0.537	0.410	0.199
	1200	0.099	0.049	0.010	0.794	0.697	0.455
	3600	0.100	0.050	0.010	0.995	0.990	0.955
$t_c(\hat{\gamma}_{1,3})$	300	0.102	0.051	0.010	0.509	0.388	0.182
	600	0.101	0.051	0.010	0.764	0.654	0.407
	1200	0.101	0.051	0.010	0.956	0.918	0.784
	3600	0.100	0.050	0.010	1.000	1.000	0.999
Panel B: $t_m$							
$t_m(\hat{\gamma}_{1,1})$	300	0.092	0.044	0.008	0.199	0.118	0.035
	600	0.094	0.046	0.009	0.300	0.198	0.074
	1200	0.097	0.049	0.009	0.480	0.354	0.164
	3600	0.099	0.049	0.009	0.875	0.797	0.599
$t_m(\hat{\gamma}_{1,2})$	300	0.101	0.051	0.011	0.344	0.233	0.086
	600	0.101	0.052	0.011	0.537	0.410	0.199
	1200	0.099	0.049	0.010	0.794	0.696	0.455
	3600	0.100	0.050	0.010	0.995	0.990	0.955
$t_m(\hat{\gamma}_{1,3})$	300	0.101	0.050	0.010	0.509	0.388	0.182
	600	0.100	0.050	0.010	0.764	0.654	0.408
	1200	0.100	0.050	0.010	0.956	0.918	0.784
	3600	0.100	0.050	0.010	1.000	1.000	0.999

**Table II**  
**Size and power properties of MLE  $t$ -tests under normality:**  
**Misspecified model**

The table presents the actual probabilities of rejection for the  $t$ -tests of  $H_0 : \gamma_{1,i} = \gamma_{1,i}^*$  and  $H_0 : \gamma_{1,i} = 0$  ( $i = 1, \dots, K$ ) for different levels of significance. The model includes a constant term and three risk factors (FF3 specification). The pseudo-true values of the risk premium parameters are  $\gamma_{1,1}^* = -0.0075$ ,  $\gamma_{1,2}^* = 0.0025$ , and  $\gamma_{1,3}^* = 0.0033$ . Panel A presents the empirical size and power for  $t$ -tests that are constructed assuming that the model is correctly specified ( $t_c$ ). Panel B reports the empirical size and power for misspecification-robust  $t$ -tests ( $t_m$ ). The factors and the returns are multivariate normally distributed.

		Size			Power		
		Level of Significance			Level of Significance		
$T$		10%	5%	1%	10%	5%	1%
Panel A: $t_c$							
$t_c(\hat{\gamma}_{1,1})$	300	0.244	0.166	0.069	0.478	0.353	0.154
	600	0.219	0.142	0.053	0.749	0.643	0.399
	1200	0.204	0.130	0.047	0.953	0.913	0.772
	3600	0.194	0.121	0.041	1.000	1.000	0.999
$t_c(\hat{\gamma}_{1,2})$	300	0.103	0.052	0.011	0.411	0.292	0.118
	600	0.103	0.053	0.011	0.635	0.509	0.279
	1200	0.100	0.050	0.010	0.882	0.808	0.594
	3600	0.101	0.051	0.010	0.999	0.998	0.990
$t_c(\hat{\gamma}_{1,3})$	300	0.104	0.052	0.011	0.624	0.501	0.267
	600	0.103	0.053	0.011	0.871	0.790	0.570
	1200	0.102	0.052	0.010	0.989	0.975	0.914
	3600	0.103	0.052	0.010	1.000	1.000	1.000
Panel B: $t_m$							
$t_m(\hat{\gamma}_{1,1})$	300	0.096	0.048	0.010	0.475	0.353	0.160
	600	0.098	0.049	0.010	0.746	0.634	0.397
	1200	0.099	0.050	0.010	0.952	0.910	0.763
	3600	0.099	0.049	0.010	1.000	1.000	0.999
$t_m(\hat{\gamma}_{1,2})$	300	0.101	0.051	0.011	0.411	0.292	0.118
	600	0.101	0.052	0.011	0.635	0.509	0.279
	1200	0.099	0.049	0.010	0.882	0.808	0.594
	3600	0.100	0.050	0.010	0.999	0.998	0.990
$t_m(\hat{\gamma}_{1,3})$	300	0.100	0.050	0.010	0.624	0.501	0.266
	600	0.100	0.051	0.010	0.871	0.790	0.569
	1200	0.100	0.050	0.010	0.989	0.975	0.914
	3600	0.101	0.050	0.010	1.000	1.000	1.000

**Table III**  
**Size and power properties of MLE  $t$ -tests under non-normality:**  
**Correctly specified model**

The table presents the actual probabilities of rejection for the  $t$ -tests of  $H_0 : \gamma_{1,i} = \gamma_{1,i}^*$  and  $H_0 : \gamma_{1,i} = 0$  ( $i = 1, \dots, K$ ) for different levels of significance. The model includes a constant term and three risk factors (FF3 specification). The true values of the risk premium parameters are  $\gamma_{1,1}^* = -0.0028$ ,  $\gamma_{1,2}^* = 0.0022$ , and  $\gamma_{1,3}^* = 0.0028$ . Panel A presents the empirical size and power for  $t$ -tests that are constructed assuming that the model is correctly specified ( $t_c$ ). Panel B reports the empirical size and power for misspecification-robust  $t$ -tests ( $t_m$ ). The factors and the returns are multivariate  $t$ -distributed. The number of degrees of freedom of the  $t$ -distribution is set equal to eight.

		Size			Power		
		Level of Significance			Level of Significance		
$T$		10%	5%	1%	10%	5%	1%
Panel A: $t_c$							
$t_c(\hat{\gamma}_{1,1})$	300	0.137	0.076	0.019	0.201	0.122	0.037
	600	0.117	0.063	0.014	0.307	0.205	0.071
	1200	0.108	0.055	0.012	0.485	0.363	0.166
	3600	0.105	0.053	0.010	0.871	0.797	0.592
$t_c(\hat{\gamma}_{1,2})$	300	0.102	0.052	0.010	0.342	0.233	0.091
	600	0.100	0.049	0.010	0.537	0.415	0.202
	1200	0.100	0.050	0.010	0.794	0.693	0.446
	3600	0.100	0.050	0.009	0.996	0.990	0.955
$t_c(\hat{\gamma}_{1,3})$	300	0.102	0.052	0.011	0.515	0.388	0.185
	600	0.101	0.051	0.010	0.764	0.657	0.417
	1200	0.100	0.050	0.010	0.957	0.917	0.779
	3600	0.100	0.048	0.010	1.000	1.000	0.999
Panel B: $t_m$							
$t_m(\hat{\gamma}_{1,1})$	300	0.092	0.044	0.008	0.200	0.122	0.037
	600	0.094	0.046	0.009	0.307	0.203	0.072
	1200	0.096	0.047	0.009	0.484	0.363	0.166
	3600	0.101	0.050	0.009	0.871	0.797	0.592
$t_m(\hat{\gamma}_{1,2})$	300	0.101	0.051	0.010	0.342	0.233	0.091
	600	0.100	0.049	0.010	0.537	0.415	0.202
	1200	0.100	0.050	0.010	0.794	0.693	0.446
	3600	0.100	0.050	0.009	0.996	0.990	0.955
$t_m(\hat{\gamma}_{1,3})$	300	0.101	0.051	0.011	0.515	0.388	0.184
	600	0.101	0.050	0.010	0.764	0.656	0.417
	1200	0.099	0.050	0.010	0.957	0.917	0.779
	3600	0.099	0.048	0.010	1.000	1.000	0.999

**Table IV**  
**Size and power properties of MLE  $t$ -tests under non-normality:**  
**Misspecified model**

The table presents the actual probabilities of rejection for the  $t$ -tests of  $H_0 : \gamma_{1,i} = \gamma_{1,i}^*$  and  $H_0 : \gamma_{1,i} = 0$  ( $i = 1, \dots, K$ ) for different levels of significance. The model includes a constant term and three risk factors (FF3 specification). The pseudo-true values of the risk premium parameters are  $\gamma_{1,1}^* = -0.0075$ ,  $\gamma_{1,2}^* = 0.0025$ , and  $\gamma_{1,3}^* = 0.0033$ . Panel A presents the empirical size and power for  $t$ -tests that are constructed assuming that the model is correctly specified ( $t_c$ ). Panel B reports the empirical size and power for misspecification-robust  $t$ -tests ( $t_m$ ). The factors and the returns are multivariate  $t$ -distributed. The number of degrees of freedom of the  $t$ -distribution is set equal to eight.

		Size			Power		
		Level of Significance			Level of Significance		
$T$		10%	5%	1%	10%	5%	1%
Panel A: $t_c$							
$t_c(\hat{\gamma}_{1,1})$	300	0.247	0.168	0.071	0.480	0.354	0.161
	600	0.226	0.150	0.058	0.746	0.637	0.399
	1200	0.214	0.139	0.052	0.948	0.907	0.763
	3600	0.212	0.135	0.050	1.000	1.000	0.999
$t_c(\hat{\gamma}_{1,2})$	300	0.104	0.053	0.010	0.408	0.291	0.125
	600	0.101	0.050	0.011	0.637	0.516	0.279
	1200	0.102	0.051	0.010	0.880	0.804	0.594
	3600	0.101	0.051	0.010	0.999	0.999	0.990
$t_c(\hat{\gamma}_{1,3})$	300	0.105	0.054	0.011	0.628	0.502	0.274
	600	0.103	0.052	0.011	0.869	0.790	0.577
	1200	0.102	0.052	0.011	0.989	0.975	0.908
	3600	0.102	0.050	0.010	1.000	1.000	1.000
Panel B: $t_m$							
$t_m(\hat{\gamma}_{1,1})$	300	0.104	0.053	0.011	0.479	0.356	0.166
	600	0.107	0.054	0.011	0.743	0.631	0.396
	1200	0.108	0.055	0.012	0.947	0.904	0.753
	3600	0.112	0.058	0.013	1.000	1.000	0.999
$t_m(\hat{\gamma}_{1,2})$	300	0.102	0.052	0.010	0.408	0.291	0.125
	600	0.100	0.049	0.010	0.637	0.516	0.279
	1200	0.100	0.050	0.010	0.880	0.804	0.594
	3600	0.100	0.050	0.009	0.999	0.999	0.990
$t_m(\hat{\gamma}_{1,3})$	300	0.101	0.052	0.011	0.628	0.502	0.274
	600	0.101	0.051	0.010	0.869	0.790	0.578
	1200	0.100	0.050	0.010	0.989	0.975	0.909
	3600	0.099	0.048	0.010	1.000	1.000	1.000

**Table V**  
**Size and power properties of CU-GMM  $t$ -tests under normality:**  
**Correctly specified model**

The table presents the actual probabilities of rejection for the  $t$ -tests of  $H_0 : \lambda_{1,i} = \lambda_{1,i}^*$  and  $H_0 : \lambda_{1,i} = 0$  ( $i = 1, \dots, K$ ) for different levels of significance. The model includes a constant term and three risk factors (FF3 specification). The true values of the SDF parameters are  $\lambda_{1,1}^* = 1.4497$ ,  $\lambda_{1,2}^* = -3.2283$ , and  $\lambda_{1,3}^* = -3.1090$ . Panel A presents the empirical size and power for  $t$ -tests that are constructed assuming that the model is correctly specified ( $t_c$ ). Panel B reports the empirical size and power for misspecification-robust  $t$ -tests ( $t_m$ ). The factors and the returns are multivariate normally distributed.

		Size			Power		
		Level of Significance			Level of Significance		
$T$		10%	5%	1%	10%	5%	1%
Panel A: $t_c$							
$t_c(\hat{\lambda}_{1,1})$	300	0.276	0.195	0.089	0.142	0.076	0.019
	600	0.171	0.102	0.031	0.227	0.140	0.045
	1200	0.132	0.072	0.018	0.384	0.273	0.113
	3600	0.109	0.056	0.012	0.795	0.695	0.470
$t_c(\hat{\lambda}_{1,2})$	300	0.240	0.162	0.066	0.312	0.206	0.074
	600	0.158	0.094	0.028	0.624	0.500	0.264
	1200	0.126	0.067	0.016	0.914	0.853	0.667
	3600	0.110	0.056	0.012	1.000	1.000	0.997
$t_c(\hat{\lambda}_{1,3})$	300	0.238	0.160	0.065	0.264	0.167	0.052
	600	0.155	0.090	0.026	0.539	0.409	0.191
	1200	0.125	0.068	0.016	0.840	0.751	0.517
	3600	0.108	0.055	0.012	0.999	0.998	0.986
Panel B: $t_m$							
$t_m(\hat{\lambda}_{1,1})$	300	0.079	0.036	0.006	0.145	0.082	0.021
	600	0.090	0.043	0.007	0.230	0.146	0.048
	1200	0.096	0.047	0.009	0.387	0.274	0.114
	3600	0.097	0.049	0.009	0.795	0.695	0.470
$t_m(\hat{\lambda}_{1,2})$	300	0.091	0.043	0.008	0.331	0.225	0.086
	600	0.104	0.052	0.010	0.633	0.511	0.283
	1200	0.102	0.051	0.010	0.915	0.854	0.673
	3600	0.103	0.051	0.011	1.000	1.000	0.997
$t_m(\hat{\lambda}_{1,3})$	300	0.089	0.042	0.007	0.278	0.183	0.067
	600	0.099	0.049	0.009	0.546	0.416	0.199
	1200	0.101	0.051	0.010	0.841	0.754	0.526
	3600	0.101	0.050	0.010	0.999	0.998	0.986

**Table VI**  
**Size and power properties of CU-GMM  $t$ -tests under normality:**  
**Misspecified model**

The table presents the actual probabilities of rejection for the  $t$ -tests of  $H_0 : \lambda_{1,i} = \lambda_{1,i}^*$  and  $H_0 : \lambda_{1,i} = 0$  ( $i = 1, \dots, K$ ) for different levels of significance. The model includes a constant term and three risk factors (FF3 specification). The pseudo-true values of the SDF parameters are  $\lambda_{1,1}^* = 7.3018$ ,  $\lambda_{1,2}^* = -7.3403$ , and  $\lambda_{1,3}^* = -3.5069$ . Panel A presents the empirical size and power for  $t$ -tests that are constructed assuming that the model is correctly specified ( $t_c$ ). Panel B reports the empirical size and power for misspecification-robust  $t$ -tests ( $t_m$ ). The factors and the returns are multivariate normally distributed.

		Size			Power		
		Level of Significance			Level of Significance		
$T$		10%	5%	1%	10%	5%	1%
Panel A: $t_c$							
$t_c(\hat{\lambda}_{1,1})$	300	0.683	0.623	0.509	0.352	0.239	0.071
	600	0.601	0.531	0.406	0.578	0.458	0.232
	1200	0.537	0.461	0.332	0.873	0.797	0.579
	3600	0.490	0.411	0.280	1.000	0.999	0.995
$t_c(\hat{\lambda}_{1,2})$	300	0.531	0.454	0.321	0.391	0.274	0.109
	600	0.442	0.360	0.228	0.755	0.637	0.368
	1200	0.387	0.303	0.174	0.981	0.960	0.855
	3600	0.345	0.261	0.140	1.000	1.000	1.000
$t_c(\hat{\lambda}_{1,3})$	300	0.549	0.477	0.351	0.139	0.079	0.022
	600	0.456	0.375	0.247	0.208	0.119	0.029
	1200	0.396	0.311	0.185	0.414	0.288	0.108
	3600	0.356	0.271	0.147	0.869	0.791	0.567
Panel B: $t_m$							
$t_m(\hat{\lambda}_{1,1})$	300	0.178	0.104	0.029	0.320	0.230	0.108
	600	0.127	0.068	0.015	0.537	0.433	0.249
	1200	0.105	0.053	0.011	0.835	0.763	0.581
	3600	0.100	0.049	0.010	0.999	0.998	0.991
$t_m(\hat{\lambda}_{1,2})$	300	0.119	0.062	0.013	0.391	0.287	0.137
	600	0.100	0.048	0.008	0.755	0.662	0.445
	1200	0.097	0.046	0.008	0.979	0.961	0.889
	3600	0.099	0.048	0.009	1.000	1.000	1.000
$t_m(\hat{\lambda}_{1,3})$	300	0.134	0.075	0.020	0.143	0.081	0.024
	600	0.100	0.050	0.010	0.235	0.153	0.053
	1200	0.092	0.045	0.008	0.432	0.320	0.150
	3600	0.094	0.046	0.009	0.867	0.794	0.588

**Table VII**  
**Size and power properties of CU-GMM  $t$ -tests under non-normality:**  
**Correctly specified model**

The table presents the actual probabilities of rejection for the  $t$ -tests of  $H_0 : \lambda_{1,i} = \lambda_{1,i}^*$  and  $H_0 : \lambda_{1,i} = 0$  ( $i = 1, \dots, K$ ) for different levels of significance. The model includes a constant term and three risk factors (FF3 specification). The true values of the SDF parameters are  $\lambda_{1,1}^* = 1.4497$ ,  $\lambda_{1,2}^* = -3.2283$ , and  $\lambda_{1,3}^* = -3.1090$ . Panel A presents the empirical size and power for  $t$ -tests that are constructed assuming that the model is correctly specified ( $t_c$ ). Panel B reports the empirical size and power for misspecification-robust  $t$ -tests ( $t_m$ ). The factors and the returns are multivariate  $t$ -distributed. The number of degrees of freedom of the  $t$ -distribution is set equal to eight.

		Size			Power		
		Level of Significance			Level of Significance		
$T$		10%	5%	1%	10%	5%	1%
Panel A: $t_c$							
$t_c(\hat{\lambda}_{1,1})$	300	0.349	0.265	0.144	0.133	0.073	0.018
	600	0.207	0.132	0.048	0.213	0.130	0.038
	1200	0.148	0.084	0.023	0.369	0.257	0.101
	3600	0.116	0.061	0.013	0.780	0.677	0.448
$t_c(\hat{\lambda}_{1,2})$	300	0.312	0.229	0.114	0.274	0.178	0.058
	600	0.197	0.124	0.043	0.580	0.454	0.230
	1200	0.146	0.082	0.022	0.895	0.824	0.610
	3600	0.115	0.060	0.014	1.000	1.000	0.997
$t_c(\hat{\lambda}_{1,3})$	300	0.313	0.230	0.114	0.235	0.147	0.045
	600	0.193	0.122	0.042	0.488	0.363	0.164
	1200	0.144	0.080	0.021	0.818	0.723	0.497
	3600	0.112	0.059	0.013	0.999	0.997	0.983
Panel B: $t_m$							
$t_m(\hat{\lambda}_{1,1})$	300	0.099	0.052	0.012	0.134	0.073	0.019
	600	0.088	0.043	0.008	0.217	0.135	0.040
	1200	0.095	0.045	0.008	0.370	0.261	0.105
	3600	0.100	0.050	0.009	0.780	0.678	0.450
$t_m(\hat{\lambda}_{1,2})$	300	0.110	0.057	0.013	0.278	0.184	0.064
	600	0.108	0.055	0.011	0.591	0.468	0.244
	1200	0.108	0.054	0.011	0.897	0.829	0.622
	3600	0.104	0.053	0.011	1.000	1.000	0.997
$t_m(\hat{\lambda}_{1,3})$	300	0.108	0.057	0.013	0.235	0.151	0.052
	600	0.105	0.053	0.011	0.496	0.372	0.177
	1200	0.105	0.053	0.010	0.822	0.732	0.501
	3600	0.102	0.052	0.010	0.999	0.997	0.983

**Table VIII**  
**Size and power properties of CU-GMM  $t$ -tests under non-normality:**  
**Misspecified model**

The table presents the actual probabilities of rejection for the  $t$ -tests of  $H_0 : \lambda_{1,i} = \lambda_{1,i}^*$  and  $H_0 : \lambda_{1,i} = 0$  ( $i = 1, \dots, K$ ) for different levels of significance. The model includes a constant term and three risk factors (FF3 specification). The pseudo-true values of the SDF parameters are  $\lambda_{1,1}^* = 10.5708$ ,  $\lambda_{1,2}^* = -9.2721$ , and  $\lambda_{1,3}^* = -3.1034$ . Panel A presents the empirical size and power for  $t$ -tests that are constructed assuming that the model is correctly specified ( $t_c$ ). Panel B reports the empirical size and power for misspecification-robust  $t$ -tests ( $t_m$ ). The factors and the returns are multivariate  $t$ -distributed. The number of degrees of freedom of the  $t$ -distribution is set equal to eight.

		Size			Power		
		Level of Significance			Level of Significance		
$T$		10%	5%	1%	10%	5%	1%
Panel A: $t_c$							
$t_c(\hat{\lambda}_{1,1})$	300	0.713	0.661	0.558	0.374	0.243	0.057
	600	0.675	0.617	0.508	0.576	0.424	0.135
	1200	0.661	0.601	0.492	0.808	0.685	0.330
	3600	0.676	0.620	0.516	0.995	0.985	0.867
$t_c(\hat{\lambda}_{1,2})$	300	0.592	0.520	0.394	0.376	0.256	0.091
	600	0.528	0.454	0.325	0.670	0.519	0.223
	1200	0.501	0.423	0.295	0.940	0.873	0.586
	3600	0.516	0.439	0.311	1.000	0.999	0.994
$t_c(\hat{\lambda}_{1,3})$	300	0.625	0.560	0.443	0.130	0.072	0.017
	600	0.566	0.496	0.377	0.146	0.081	0.021
	1200	0.533	0.459	0.333	0.211	0.117	0.027
	3600	0.519	0.445	0.321	0.464	0.323	0.098
Panel B: $t_m$							
$t_m(\hat{\lambda}_{1,1})$	300	0.225	0.151	0.069	0.381	0.292	0.153
	600	0.173	0.112	0.047	0.565	0.468	0.297
	1200	0.154	0.097	0.038	0.786	0.703	0.510
	3600	0.148	0.093	0.035	0.983	0.969	0.905
$t_m(\hat{\lambda}_{1,2})$	300	0.155	0.091	0.028	0.392	0.294	0.143
	600	0.119	0.067	0.018	0.689	0.583	0.362
	1200	0.113	0.063	0.017	0.930	0.886	0.756
	3600	0.123	0.070	0.022	0.997	0.996	0.988
$t_m(\hat{\lambda}_{1,3})$	300	0.200	0.128	0.046	0.126	0.069	0.019
	600	0.153	0.092	0.029	0.160	0.092	0.025
	1200	0.129	0.072	0.020	0.242	0.156	0.053
	3600	0.117	0.062	0.015	0.481	0.377	0.190

**Table IX**  
**Test statistics for various asset-pricing models**

The table reports test statistics for the three asset-pricing models (CAPM, FF3, and FF5) described in Section 5. CSR and HJD denote the GLS cross-sectional regression and Hansen-Jagannathan distance estimators, respectively.  $t(x)$  denotes the  $t$ -test of statistical significance for the parameter associated with factor  $x$ , with standard errors computed under the assumption of correct model specification ( $t_c$ ) and model misspecification ( $t_m$ ).

	$t_c$			$t_m$		
	CAPM	FF3	FF5	CAPM	FF3	FF5
Panel A: Beta-Pricing Representation						
<b>MLE</b>						
$t(mkt)$	-2.92	-3.05	-1.34	-2.38	-2.43	-0.75
$t(smb)$		2.04	1.93		2.04	1.90
$t(hml)$		2.85	2.54		2.84	2.45
$t(rmw)$			-0.85			-0.44
$t(cma)$			5.09			1.63
 <b>CSR</b>						
$t(mkt)$	-2.53	-2.61	-1.99	-2.37	-2.39	-1.74
$t(smb)$		2.04	2.02		2.04	2.03
$t(hml)$		2.86	2.72		2.86	2.70
$t(rmw)$			0.08			0.06
$t(cma)$			3.05			2.39
Panel B: SDF Representation						
<b>CU-GMM</b>						
$t(mkt)$	4.00	4.84	-1.74	2.07	1.68	-0.84
$t(smb)$		-4.97	-4.92		-1.53	-2.10
$t(hml)$		-3.51	5.14		-1.25	1.62
$t(rmw)$			-5.68			-1.46
$t(cma)$			-7.15			-1.86
 <b>HJD</b>						
$t(mkt)$	2.72	2.57	0.87	2.49	2.33	0.71
$t(smb)$		-3.03	-2.90		-2.98	-2.70
$t(hml)$		-1.85	0.78		-1.86	0.58
$t(rmw)$			-1.15			-1.02
$t(cma)$			-1.80			-1.30