2005 台灣財務學術研討會
April 2005

Optimal Portfolio Choice of Institutional Investors with Event Risk

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Abstract

The risk of a sudden large shock to security price is one of the inherent hazards of investing in financial markets. We determine the risk of flow via empirical results and analyze the optimal portfolio choice problem of institutional investors in economy with infrequent events. We find that the optimal asset allocation strategy contains three components: the benchmark hedge component, the return hedge component, and the jump hedge component. The first one component indicates that the volatility of relative benchmark portfolio is an important factor for holding risky assets. The second one is consistent with common sense of investment decision. Finally, the last one captures the impact of mean percentage change in risky asset price.

Key words：Dynamic asset allocation; Institutional investor; Jump