

# Spurious Inference in Unidentified Asset-Pricing Models

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## Abstract

This paper studies some seemingly anomalous results that arise in possibly misspecified and unidentified linear asset-pricing models estimated by maximum likelihood and one-step generalized method of moments. Strikingly, when useless factors (that is, factors that are independent of the returns on the test assets) are present, the models exhibit perfect fit, as measured by the squared correlation between the model's fitted expected returns and the average realized returns, and the tests for correct model specification have asymptotic power that is equal to the nominal size. In other words, applied researchers will erroneously conclude that the model is correctly specified even when the degree of misspecification is arbitrarily large. We also derive the highly non-standard limiting behavior of these invariant estimators and their  $t$ -tests in the presence of identification failure. These results reveal the spurious nature of inference as factors that are useless are selected with high probability, while factors that are useful are driven out from the model. The practical relevance of our findings is demonstrated using simulations and an empirical application.

**Keywords:** Asset pricing; Irrelevant risk factors; Unidentified models; Model misspecification; Continuously-updated GMM; Maximum likelihood; Rank test; Test for over-identifying restrictions.

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

# 1 Introduction and Motivation

The search for (theoretically justified or empirically motivated) risk factors that improve the pricing performance of various asset-pricing models has generated a large, and constantly growing, literature in financial economics. A typical empirical strategy involves the development of a structural asset-pricing model and the evaluation of the pricing ability of the proposed factors in the linearized version of the model using actual data. The resulting linear asset-pricing model can be estimated and tested using a beta representation or, alternatively, using a linear stochastic discount factor (SDF) representation. Given the appealing efficiency and invariance properties of the maximum likelihood (ML) and continuously-updated generalized method of moments (CU-GMM) estimators,<sup>1</sup> it seems natural to opt for these estimators when conducting statistical inference (estimation, testing, and model evaluation) in these linear asset-pricing models. It is often the case that a high correlation between the realized and fitted expected returns (in the beta representation framework) or statistically small model pricing errors (in the SDF framework) appear to be sufficient for the applied researcher to conclude that the model is well specified and proceed with testing for statistical significance of the risk premium parameters using the standard tools for inference. Many asset-pricing studies have followed this empirical strategy and collectively, the literature has identified a large set of macroeconomic and financial factors (in a recent paper, Harvey, Liu, and Zhu (2013) catalogue 314 such factors) that are believed to explain the cross-sectional variation of various portfolio returns, such as the returns on the 25 Fama-French size and book-to-market ranked portfolios.

Despite these advances in the asset-pricing literature, two observations that consistently emerge in empirical work might call for a more cautious approach to statistical validation and economic interpretation of asset-pricing models. First, all asset-pricing models should be viewed only as approximations to reality and, hence, potentially misspecified. There is plenty of empirical evidence, mainly based on non-invariant estimators, which suggests that the asset-pricing models used in practice are misspecified. This raises the concern of using standard errors, derived under the assumption of correct model specification, that tend to underestimate the degree of uncertainty that the researcher faces. Second, the macroeconomic factors in several asset-pricing specifications

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<sup>1</sup>See Shanken and Zhou (2007) and Peñaranda and Sentana (2014) for some recent results on the ML and CU-GMM estimators, respectively, for asset-pricing models.

tend to be only weakly correlated with the portfolio returns. As a result, it is plausible to conjecture that many of these macroeconomic factors may be irrelevant for pricing and explaining the cross-sectional variation of stock returns. Importantly, the inclusion of useless factors (that is, factors that are independent of the returns on the test assets) leads to serious identification issues regarding the parameters associated with all risk factors and gives rise to a highly non-standard statistical inference. In a recent paper, Gospodinov, Kan, and Robotti (2014a) analyze the detrimental effects of misspecification and factor irrelevance (lack of identification) in estimation, testing, and evaluation of asset-pricing models using the Hansen and Jagannathan (HJ, 1997) distance. In this study, we show that the use of optimal and invariant estimators does not alleviate these inference problems and, somewhat surprisingly, makes them substantially worse.

The invariant (ML and CU-GMM) estimators considered here have a generic form

$$\hat{\theta} = \operatorname{argmin}_{\theta} \bar{g}(\theta)' \hat{W}(\theta)^{-1} \bar{g}(\theta), \quad (1)$$

with model-implied choices of moment conditions  $\bar{g}(\theta)$ , a weighting matrix  $\hat{W}(\theta)$ , and a parameter vector of interest  $\theta$ . This objective function makes the resulting estimator invariant to data scaling, reparameterizations and normalizations, curvature-altering and stationarity-inducing transformations, etc. (Hall, 2005). Under standard regularity conditions (that include global and local identification as well as correct model specification), these invariant estimators are asymptotically well-behaved and efficient. However, we show in this paper that in the presence of lack of identification and model misspecification, the tests based on these estimators could be highly misleading. In summary, we argue that the standard inference procedures based on the ML and CU-GMM estimators lead to spurious results that suggest that the model is correctly specified and the risk premium parameters are highly significant (that is, the risk factors are priced) when, in fact, the model is misspecified and the factors are irrelevant. The distorted nature of these results bears strong similarities to spurious regressions with nonstationary data (Granger and Newbold, 1974, among many others). Phillips (1989) makes an analogous observation regarding the estimators in partially identified (albeit correctly specified) linear structural models and time series spurious regressions. Phillips (1989, p. 201) points out that “both regressions share a fundamental indeterminacy” due to a contaminated signal arising from either lack of identification or strength of the noise component. We show that allowing for model misspecification further exacerbates the spuriousness of the results and renders them completely unreliable.

To illustrate the seriousness of the problem, we report some representative empirical results from four popular asset-pricing models. The test asset returns are the monthly gross returns on the widely used value-weighted 25 Fama-French size and book-to-market ranked portfolios from February 1959 until December 2012.<sup>2</sup> The first model is the static capital asset-pricing model (CAPM) with the market return (the return on the value-weighted NYSE-AMEX-NASDAQ stock market index in excess of the one-month T-bill rate,  $vw$ ) as a risk factor. The second model is the three-factor model (FF3) of Fama and French (1993) with (i) the market excess return ( $vw$ ), (ii) the return difference between portfolios of stocks with small and large market capitalizations ( $smb$ ), and (iii) the return difference between portfolios of stocks with high and low book-to-market ratios ( $hml$ ) as risk factors. It should be noted that all of these risk factors are traded and exhibit a relatively high correlation with the 25 Fama-French portfolio returns. The last two models are models with macroeconomic factors: the model (C-LAB) proposed by Jagannathan and Wang (1996) which, in addition to the market excess return, includes the growth rate in per capita labor income ( $labor$ ) and the lagged default premium ( $prem$ , the yield spread between Baa and Aaa-rated corporate bonds) as risk factors; and the model (CC-CAY) proposed by Lettau and Ludvigson (2001) with risk factors that include the growth rate in real per capita nondurable consumption ( $cg$ ), the lagged consumption-aggregate wealth ratio ( $cay$ ), and an interaction term between these two factors ( $cg \cdot cay$ ).

Table I about here

The SDF and beta representations of the four asset-pricing models are estimated by CU-GMM and ML, respectively. Table I reports results from the invariant tests of correct model specification (Hansen’s (1982) over-identifying restrictions test,  $\mathcal{J}$ , for CU-GMM and Shanken’s (1985) Wald-type test,  $\mathcal{S}$ , for ML), the  $t$ -statistics for each factor computed using standard errors that assume correct model specification, as well as the pseudo- $R^2$ s from regressing fitted expected returns on average returns. In addition, we include the rank test of Kleibergen and Paap (2006) that the second moment matrix of the returns and the factors is of reduced rank, and two popular specification tests based on non-invariant estimators (the HJ-distance test and the generalized least squares (GLS))

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<sup>2</sup>The results that we report in this section are largely unchanged when we augment the 25 Fama-French portfolio returns with additional test asset returns (for example, the 17 Fama-French industry portfolio returns) as recommended by Lewellen, Nagel, and Shanken (2010).

cross-sectional regression test of Shanken, 1985). Figures 1 and 2 visualize the cross-sectional goodness-of-fit of the models by plotting average realized returns versus fitted (by CU-GMM and ML, respectively) expected returns from each model.

Figures 1 and 2 about here

The results are striking. The models that contain factors that are only weakly correlated with the test asset returns (C-LAB and CC-CAY) exhibit an almost perfect fit. The specification tests based on the invariant estimators cannot reject the null of correct specification, which suggests that the models are well specified and one could proceed with constructing significance tests based on standard errors derived under correct model specification. These  $t$ -tests indicate that the proposed macroeconomic factors (labor growth and default premium in C-LAB and the interaction term in CC-CAY, for example) are highly statistically significant. Interestingly, benchmark models such as CAPM and FF3 do not perform nearly as well according to these statistical measures. The tests for correct model specification based on CU-GMM and ML suggest that both of these models are rejected by the data, and their associated pseudo- $R^2$ s are 0.1999 and 0.7847 for CU-GMM, and 0.1346 and 0.7677 for ML, respectively.

In this paper, we show that, due to the combined effect of identification failure and model misspecification, the results for C-LAB and CC-CAY can be spurious. While some warning signs of these problems are already present in Table I, they are often ignored by applied researchers. For example, the rank test provides strong evidence that C-LAB and CC-CAY are not identified, which violates the regularity conditions for consistency and asymptotic normality of the ML and CU-GMM estimators. Furthermore, the HJ-distance and GLS cross-sectional regression tests, that we show to possess much higher power than the  $\mathcal{J}$  and  $\mathcal{S}$  tests in the presence of identification failure, point to severe misspecification of all the considered asset-pricing models.

Another interesting observation that emerges from these results is that the factors with low correlations with the returns tend to drive out the factors that are highly correlated with the returns. For example, the highly significant market factor in CAPM turns insignificant with the inclusion of the labor growth and default premium in the C-LAB model. To further examine this point, we simulate data for the returns on the test assets and the market factor from a misspecified model that is calibrated to the CAPM as estimated in Table I (for more details on the simulation

design, see Section 5 below). With a sample size of 600 time series observations, the rejection rate (at the 5% significance level) of the  $t$ -test (based on the CU-GMM estimator) of whether the market factor is priced or not is 93.6%, while the test for correct model specification rejects the null of correct specification 100% of the time. In sharp contrast, when a completely useless factor (generated as an independent standard normal random variable) is included in the model, the rejection rate of the  $t$ -test for the market factor drops to 9.5% and the specification test rejects the null of correct specification only 4% of the time. Strikingly, the rejection rate of the  $t$ -test for the useless factor is 100%. This example clearly illustrates the severity of the problem and the perils for inference based on invariant tests in unidentified models. In summary, an arbitrarily poor model with factors that are independent of the test asset returns would be deemed to be correctly specified with a spectacular fit and priced risk factors.

In addition to identifying a serious problem with invariant tests of asset-pricing models, our paper also provides a number of theoretical contributions. First, we demonstrate the numerical equivalence of the invariant (ML and CU-GMM) and rank restriction frameworks for estimation and model specification testing. This equivalence proves to be useful from both a computational and a statistical inference perspective. For instance, it allows us to show that, under model misspecification and rank deficiency, the specification tests have power that is equal to the size. Second, we characterize the limiting behavior of the invariant estimators and their  $t$ -statistics under model misspecification and identification failure. While we show that all estimators are inconsistent and asymptotically non-normal, the estimates associated with the factors that cause the rank deficiency diverge at rate  $\sqrt{T}$  and the  $t$ -tests have a bimodal and heavy-tailed distribution. The explosive behavior of the estimates on the useless factors tends to dominate and forces the goodness-of-fit statistic to approach one.

Finally, it is useful to position our results in the existing literature. In the statistics and econometrics literature, the analysis of rank restrictions, model under-identification, and inference under model misspecification has generated substantial interest since the seminal work of Anderson (1951), Koopmans and Hood (1953), and Maasoumi and Phillips (1982), respectively. We contribute to this literature by developing the appropriate limiting theory for invariant estimators and reduced rank tests in unidentified and possibly misspecified models. On the other hand, some of the recent asset-pricing studies have also expressed concerns about the appropriateness of the pseudo- $R^2$

as a reliable goodness-of-fit measure. In models with excess returns and under some particular normalizations of the SDF, Burnside (2012) derives a similar behavior of the goodness-of-fit statistic for non-invariant GMM estimators. This result, however, is normalization and setup specific and alternative normalizations or models based on gross returns render the non-invariant estimators immune to the perfect fit problem. Furthermore, Kleibergen and Zhan (2013) show that a sizeable unexplained factor structure (generated by a low correlation between the observed proxy factors and the true unobserved factors) in a two-pass cross-sectional regression framework can also produce spuriously large values of the  $R^2$  coefficient. Their results complement the findings of Lewellen, Nagel, and Shanken (2010) who criticize the use of the ordinary least squares  $R^2$  coefficient by showing that it can be large despite the fact that the betas of the observed factors are small. Despite the suggestive nature of these findings, model evaluation tests based on non-invariant estimators, which are the focus of the analysis in these studies, tend to be relatively robust to lack of identification as we show later in the paper. In contrast, for invariant estimators in unidentified asset-pricing models, the spurious perfect fit is pervasive regardless of the model structure (gross or excess returns), estimation framework (SDF or beta pricing), and chosen normalization.

The rest of the paper is organized as follows. Section 2 introduces the main notation and assumptions. Section 3 studies the limiting behavior of the parameter estimates,  $t$ -statistics, goodness-of-fit measures, and model specification tests in the beta-pricing and SDF setups. Section 4 presents results for non-invariant estimators that allow for some comparisons with the limiting behavior of the ML and CU-GMM estimators. Section 5 reports Monte Carlo simulation results. Section 6 summarizes our main conclusions and provides some practical recommendations. All proofs are relegated to the Appendix. Some supplementary results, that we refer to throughout the paper, are available in the Internet Appendix.

## 2 Preliminaries

In this section, we first introduce the SDF and beta representations of an asset-pricing model. Next, we briefly describe the rank test of Cragg and Donald (1997) and lay out our main assumptions.



## 2.1 Stochastic Discount Factor and Beta-Pricing Model Representations

Let

$$y_t(\lambda) = x_t' \lambda \quad (2)$$

be a candidate SDF at time  $t$ , where  $x_t = [1, f_t']'$ ,  $f_t$  is a  $(K - 1)$ -vector of systematic risk factors, and  $\lambda = [\lambda_0, \lambda_1']'$  is a  $K$ -vector of SDF parameters. Also, let  $R_t$  denote the gross returns on  $N$  ( $N > K$ ) test assets and  $e_t(\lambda) = D_t \lambda - 1_N$  be the pricing errors of the model, where  $D_t = R_t x_t'$  and  $1_N$  is an  $N \times 1$  vector of ones.<sup>3</sup> When the asset-pricing model holds and is well identified, there exists a unique  $\lambda^* = [\lambda_0^*, \lambda_1^{*'}]'$  such that

$$E[e_t(\lambda^*)] = D \lambda^* - 1_N = 0_N, \quad (3)$$

where  $D = E[R_t x_t']$ .

Alternatively, we can express the linear asset-pricing model using the beta representation. Let  $Y_t = [f_t', R_t']'$  with

$$E[Y_t] \equiv \begin{bmatrix} \mu_f \\ \mu_R \end{bmatrix} \quad (4)$$

and

$$\text{Var}[Y_t] \equiv V = \begin{bmatrix} V_f & V_{fR} \\ V_{Rf} & V_R \end{bmatrix}, \quad (5)$$

and  $\gamma = [\gamma_0, \gamma_1']'$  be a  $K$ -vector of parameters. When the asset-pricing model holds and is well identified, there exists a unique  $\gamma^* = [\gamma_0^*, \gamma_1^{*'}]'$  such that

$$\mu_R = 1_N \gamma_0^* + \beta \gamma_1^*, \quad (6)$$

where  $\beta = [\beta_1, \dots, \beta_{K-1}] = V_{Rf} V_f^{-1}$  is an  $N \times (K - 1)$  matrix of the betas of the  $N$  assets. Also, define

$$\alpha = \mu_R - \beta \mu_f, \quad (7)$$

and  $\Sigma = V_R - V_{Rf} V_f^{-1} V_{fR}$ .

There are two main reasons why the beta-pricing framework is very popular in the empirical asset-pricing literature. First, unlike the SDF coefficients  $\lambda$ , the parameters  $\gamma_0$  and  $\gamma_1$  have a

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<sup>3</sup>When  $R_t$  is a vector of payoffs with initial cost  $q \neq 0_N$ , we just need to replace  $1_N$  with  $q$ . In addition, the analysis in the paper can be easily adapted to handle the case of excess returns, that is, the  $q = 0_N$  case.

direct interpretation of zero-beta rate and risk premium parameters, respectively. Second, the beta representation allows for conveniently measuring and plotting the goodness-of-fit as a model's expected returns versus average realized returns. To capitalize on these advantages, the SDF parameters can be conveniently transformed into the beta-pricing model parameters using the mapping

$$\gamma_0 = \frac{1}{\lambda_0 + \mu'_f \lambda_1}, \quad (8)$$

$$\gamma_1 = -\frac{V_f \lambda_1}{\lambda_0 + \mu'_f \lambda_1}. \quad (9)$$

The main statistics of interest in evaluating asset-pricing models are the  $t$ -tests for statistical significance of  $\lambda_1$  and  $\gamma_1$ ,<sup>4</sup> the goodness-of-fit statistic defined as the squared correlation between the realized and model-implied expected returns, and the statistics for correct model specification that test the validity of the asset-pricing model restrictions:  $D\lambda = 1_N$  in the SDF representation, and  $\mu_R = 1_N\gamma_0 + \beta\gamma_1$  in the beta-pricing setup. The limiting behavior of these statistics, which is the primary focus of our analysis below, is determined by the rank of the matrices  $H \equiv [1_N, D]$  (in the SDF representation) and  $G \equiv [1_N, B]$ , where  $B = [\alpha, \beta]$  (in the beta-pricing representation).

## 2.2 Rank Restriction Test and Assumptions

In the subsequent analysis, we rely repeatedly on the representation of the rank restriction test of Cragg and Donald (1997) as an invariant test. Let  $\Pi$  be a generic notation for an  $N \times K$  matrix and  $\pi = \text{vec}(\Pi)$ . Under the null that  $\Pi$  is of (reduced) rank  $K - 1$ ,  $H_0 : \text{rank}(\Pi) = K - 1$ , there exists a nonzero  $K$  vector  $c$  such that  $\Pi c = 0_N$  with the normalization  $c'c = 1$ .<sup>5</sup> Suppose  $\hat{\Pi}$  is an estimator of  $\Pi$  and assume that

$$\sqrt{T}\text{vec}(\hat{\Pi} - \Pi) \xrightarrow{d} \mathcal{N}(0_{NK}, M), \quad (10)$$

where  $M$  is a finite and positive-definite matrix. Then, the Cragg and Donald (1997) test of  $H_0 : \text{rank}(\Pi) = K - 1$  can be rewritten as an invariant test of the form (see, for example, Kleibergen

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<sup>4</sup>It should be stressed that in a multi-factor model, testing  $H_0 : \gamma_{1,i} = 0$  is not the same as testing  $H_0 : \lambda_{1,i} = 0$  for  $i = 1, \dots, K - 1$ . More importantly, acceptance or rejection of  $\gamma_{1,i} = 0$  does not tell us whether the  $i$ -th factor makes an incremental contribution to the model's overall explanatory power, given the presence of the other factors. See Kan, Robotti, and Shanken (2013) for a discussion of this subtle point.

<sup>5</sup>See Cragg and Donald (1997), Robin and Smith (2000), and Kleibergen and Paap (2006) for a detailed analysis of rank restriction tests.

and Mavroeidis, 2009, and Arellano, Hansen, and Sentana, 2012)

$$\mathcal{CD} = \min_{c:c=1} T\hat{\pi}'Q(c)'(Q(c)\hat{M}Q(c)')^{-1}Q(c)\hat{\pi}, \tag{11}$$

where  $Q(c) = c' \otimes I_N$  and  $\hat{M}$  is a consistent estimator of  $M$ .

For our main results, some of the following assumptions are needed.

ASSUMPTION 1. Assume that  $Y_t$  is a jointly stationary and ergodic process with finite fourth moments and a positive-definite covariance matrix  $V$ .

ASSUMPTION 2. Assume that  $e_t(\lambda) - E[e_t(\lambda)]$  forms a martingale difference sequence and has a positive-definite covariance matrix  $W_e(\lambda)$ .

ASSUMPTION 3. Assume that  $Y_t$  is *iid* normally distributed.

Assumption 3 is restrictive but it is used only for the ML estimator in the beta-pricing model (Shanken, 1985) and not for the CU-GMM estimator in the SDF framework. Assumption 2, which is used for the CU-GMM estimator, is much weaker; it could be further relaxed to allow for serial correlation in  $e_t(\lambda) - E[e_t(\lambda)]$ , at the cost of a more cumbersome notation. In what follows, the model is said to be correctly specified if the restriction (6) (or (3)) is satisfied, and is said to be misspecified if there does not exist a  $\gamma$  such that (6) holds (or a  $\lambda$  such that (3) holds).

### 3 Main Results for Invariant Estimators

In this section, we establish the numerical equivalence between the tests of correct model specification (in the beta-pricing and SDF setups) and the reduced rank test. In addition, we characterize the limiting behavior of the corresponding parameter estimates and  $t$ -tests under the assumptions of model misspecification and lack of identification (which arises when a useless factor is included in the model).

#### 3.1 Maximum Likelihood

We start with the more restrictive ML estimation of the beta-pricing model that imposes the joint normality assumption on  $Y_t$  (Assumption 3). Combining equations (6) and (7), we arrive at the

restriction

$$\alpha = 1_N \gamma_0^* + \beta(\gamma_1^* - \mu_f). \quad (12)$$

Then, the ML estimator of  $\gamma^*$  is defined as (see Shanken, 1992, and Shanken and Zhou, 2007)

$$\hat{\gamma}^{ML} = \underset{\gamma}{\operatorname{argmin}} \frac{(\hat{\alpha} - 1_N \gamma_0 - \hat{\beta}(\gamma_1 - \hat{\mu}_f))' \hat{\Sigma}^{-1} (\hat{\alpha} - 1_N \gamma_0 - \hat{\beta}(\gamma_1 - \hat{\mu}_f))}{1 + \gamma_1' \hat{V}_f^{-1} \gamma_1}, \quad (13)$$

where  $\hat{\alpha}$ ,  $\hat{\beta}$ ,  $\hat{\mu}_f$ ,  $\hat{V}_f$ , and  $\hat{\Sigma}$  are the sample estimators of  $\alpha$ ,  $\beta$ ,  $\mu_f$ ,  $V_f$ , and  $\Sigma$ , respectively. The test for correct model specification of Shanken (1985) is given by

$$\mathcal{S} = T \min_{\gamma} \frac{(\hat{\alpha} - 1_N \gamma_0 - \hat{\beta}(\gamma_1 - \hat{\mu}_f))' \hat{\Sigma}^{-1} (\hat{\alpha} - 1_N \gamma_0 - \hat{\beta}(\gamma_1 - \hat{\mu}_f))}{1 + \gamma_1' \hat{V}_f^{-1} \gamma_1}, \quad (14)$$

and is asymptotically distributed as  $\mathcal{S} \xrightarrow{d} \chi_{N-K}^2$  under the null  $H_0 : \alpha = 1_N \gamma_0 + \beta(\gamma_1 - \mu_f)$  and Assumptions 1 and 3.<sup>6</sup>

Note that the ML estimator can be recast as the invariant estimator in equation (1) with  $\bar{g}(\gamma) = \sqrt{T}(\hat{\alpha} - 1_N \gamma_0 - \hat{\beta}(\gamma_1 - \hat{\mu}_f))$  and  $\hat{W}(\gamma) = (1 + \gamma_1' \hat{V}_f^{-1} \gamma_1) \hat{\Sigma}$ . Due to the special structure of this objective function, the ML estimator of  $\gamma^*$  can be obtained explicitly as the solution to an eigenvector problem. Let  $v = [-\gamma_0, 1, -(\gamma_1 - \hat{\mu}_f)']'$  and  $\hat{G} = [1_N, \hat{\alpha}, \hat{\beta}]$ , and noting that  $\hat{\alpha} - 1_N \gamma_0 - \hat{\beta}(\gamma_1 - \hat{\mu}_f) = \hat{G}v$ , we can write the objective function of the ML estimator as

$$\min_v \frac{v' \hat{G}' \hat{\Sigma}^{-1} \hat{G} v}{v' A (X' X / T)^{-1} A' v}, \quad (15)$$

where  $A = [0_K, I_K]'$  and  $X$  is a  $T \times K$  matrix with a typical row  $x'_t$ . Let  $\hat{v}$  be the eigenvector associated with the largest eigenvalue of<sup>7</sup>

$$\hat{\Omega} = (\hat{G}' \hat{\Sigma}^{-1} \hat{G})^{-1} [A (X' X / T)^{-1} A']. \quad (16)$$

Then, the ML estimator of  $\gamma^*$  can be constructed as

$$\hat{\gamma}_0^{ML} = -\frac{\hat{v}_1}{\hat{v}_2}, \quad (17)$$

$$\hat{\gamma}_{1,i}^{ML} = \hat{\mu}_{f,i} - \frac{\hat{v}_{i+2}}{\hat{v}_2}, \quad i = 1, \dots, K-1. \quad (18)$$

<sup>6</sup>Our limiting result for the  $\mathcal{S}$  test is also applicable to the asymptotically equivalent likelihood ratio ( $\mathcal{LR}$ ) test, which is given by  $\mathcal{LR} = T \ln(1 + \mathcal{S}/T)$  (Shanken, 1985). Note also that in deriving the asymptotic distribution of  $\mathcal{S}$  (and  $\mathcal{LR}$ ), Assumption 3 can be relaxed to conditional normality of returns (conditional on  $f_t$ ). In fact, the asymptotic result for  $\mathcal{S}$  (and  $\mathcal{LR}$ ) continues to hold under the more general case of conditional homoskedasticity.

<sup>7</sup>See also Zhou (1995) and Bekker, Dobbstein, and Wansbeek (1996) for expressing the beta-pricing model as a reduced rank regression whose parameters are obtained as an eigenvalue problem.

When the model is correctly specified and  $B$  is of full column rank, we have that  $Gv^* = 0_N$  for  $v^* = [-\gamma_0^*, 1, -(\gamma_1^* - \hat{\mu}_f)']'$  and, under Assumptions 1 and 3,

$$\sqrt{T} \begin{bmatrix} \hat{\gamma}_0^{ML} - \gamma_0^* \\ \hat{\gamma}_1^{ML} - \gamma_1^* \end{bmatrix} \xrightarrow{d} \mathcal{N} \left( 0_K, (1 + \gamma_1^{*'} V_f^{-1} \gamma_1^*) (B_1' \Sigma^{-1} B_1)^{-1} + \begin{bmatrix} 0 & 0'_{K-1} \\ 0_{K-1} & V_f \end{bmatrix} \right), \quad (19)$$

where  $B_1 = [1_N, \beta]$ . As a result, the  $t$ -statistics for statistical significance of  $\gamma_0$  and  $\gamma_{1,i}$  ( $i = 1, \dots, K-1$ ) are constructed as

$$t(\hat{\gamma}_0^{ML}) = \frac{\sqrt{T} \hat{\gamma}_0^{ML}}{s(\hat{\gamma}_0^{ML})}, \quad (20)$$

$$t(\hat{\gamma}_{1,i}^{ML}) = \frac{\sqrt{T} \hat{\gamma}_{1,i}^{ML}}{s(\hat{\gamma}_{1,i}^{ML})}, \quad (21)$$

where  $s(\hat{\gamma}_0^{ML}), s(\hat{\gamma}_{1,1}^{ML}), \dots, s(\hat{\gamma}_{1,K-1}^{ML})$  denote the square root of the diagonal elements of

$$(1 + \hat{\gamma}_1^{ML'} \hat{V}_f^{-1} \hat{\gamma}_1^{ML}) (\hat{B}_1' \hat{\Sigma}^{-1} \hat{B}_1)^{-1} + \begin{bmatrix} 0 & 0'_{K-1} \\ 0_{K-1} & \hat{V}_f \end{bmatrix}, \quad (22)$$

and  $\hat{B}_1 = [1_N, \hat{\beta}]$ . Using the ML estimates  $\hat{\gamma}_0^{ML}$  and  $\hat{\gamma}_1^{ML}$ , the ML estimate of  $\beta$ ,  $\hat{\beta}^{ML}$ , and the fitted expected returns on the test assets,  $\hat{\mu}_R^{ML}$ , are obtained as

$$\hat{\beta}^{ML} = \hat{\beta} + \frac{[\hat{\alpha} - 1_N \hat{\gamma}_0^{ML} - \hat{\beta}(\hat{\gamma}_1^{ML} - \hat{\mu}_f)] \hat{\gamma}_1^{ML'} \hat{V}_f^{-1}}{1 + \hat{\gamma}_1^{ML'} \hat{V}_f^{-1} \hat{\gamma}_1^{ML}} \quad (23)$$

and

$$\hat{\mu}_R^{ML} = 1_N \hat{\gamma}_0^{ML} + \hat{\beta}^{ML} \hat{\gamma}_1^{ML}. \quad (24)$$

When the asset-pricing model holds,  $\text{rank}(G) = K$ , that is,  $G$  has a reduced rank. Note that  $\text{rank}(G) = K$  if and only if  $\text{rank}(P_1' B) = K - 1$ , where  $P_1$  is an  $N \times (N - 1)$  orthonormal matrix whose columns are orthogonal to  $1_N$ . Instead of using the  $\mathcal{S}$  test to test the asset-pricing model, one may want to use the Cragg and Donald (1997) rank test to test  $\text{rank}(P_1' B) = K - 1$ . Under Assumptions 1 and 3, the Cragg and Donald (1997) test statistic is given by

$$\begin{aligned} \mathcal{CD}_1 &= T \min_{c: c'c=1} (P_1' \hat{B}c)' [(c' \otimes P_1') ((X'X/T)^{-1} \otimes \hat{\Sigma}) (c \otimes P_1)]^{-1} (P_1' \hat{B}c) \\ &= T \min_{c: c'c=1} \frac{c' \hat{B}' P_1 (P_1' \hat{\Sigma} P_1)^{-1} P_1' \hat{B}c}{c' [(X'X/T)^{-1}] c}, \end{aligned} \quad (25)$$

where  $\hat{B} = [\hat{\alpha}, \hat{\beta}]$ . Under the null  $H_0 : \text{rank}(P_1' B) = K - 1$ , we have

$$\mathcal{CD}_1 \xrightarrow{d} \chi_{N-K}^2. \quad (26)$$

Lemma 1 below establishes the numerical equivalence of the tests  $\mathcal{S}$  and  $\mathcal{CD}_1$  and the relationship between their corresponding estimators.

LEMMA 1. *Consider the  $\mathcal{S}$  and  $\mathcal{CD}_1$  tests defined in (14) and (25), and let  $\hat{\gamma}^{ML} = [\hat{\gamma}_0^{ML}, \hat{\gamma}_1^{ML}]'$  and  $\hat{c} = [\hat{c}_1, \hat{c}_2]'$  denote the estimators that minimize (14) and (25), respectively. Then, under Assumptions 1 and 3, we have  $\mathcal{S} = \mathcal{CD}_1$ ,  $\hat{\gamma}_1^{ML} = -\frac{\hat{c}_2}{\hat{c}_1} + \hat{\mu}_f$ , and  $\hat{\gamma}_0^{ML} = \mathbf{1}'_N \hat{\Sigma}^{-1} (\hat{\mu}_R - \hat{\beta} \hat{\gamma}_1^{ML}) / (\mathbf{1}'_N \hat{\Sigma}^{-1} \mathbf{1}_N)$ .*

**Proof.** See Appendix.

Lemma 1 reveals that the  $\mathcal{S}$  test is in fact a rank test of  $H_0 : \text{rank}(P'_1 B) = K - 1$ , that is,  $G$  has a reduced rank. While  $G$  has a reduced rank when the asset-pricing model is correctly specified, there are also misspecified models that can give rise to a reduced rank of  $G$ . For example,  $G$  can have a reduced rank when the model contains a factor that is independent of the returns (useless factor) or when the model contains two factors that are noisy (due to measurement error, for instance) versions of the same underlying factor. An example of this latter scenario is a consumption-based asset-pricing model whose empirical specification includes several noisy measures of consumption growth. It is of interest to investigate how the ML estimation behaves under these other scenarios. The following theorem characterizes the limiting behavior of the ML estimates  $\hat{\gamma}^{ML}$ , the  $t$ -statistics  $t(\hat{\gamma}_0^{ML})$  and  $t(\hat{\gamma}_{1,i}^{ML})$  ( $i = 1, \dots, K - 1$ ), the pseudo- $R^2$  statistic  $R_{ML}^2 = \text{Corr}(\hat{\mu}_R^{ML}, \hat{\mu}_R)^2$ , and the specification test  $\mathcal{S}$  in misspecified models that contain a useless factor. Without loss of generality, we assume that the useless factor is the last element of the vector  $f_t$  with  $\beta_{K-1} = 0_N$  and is independent of the test asset returns and the other factors. Let  $z = [z_1, z_2, \dots, z_K]'$   $\sim \mathcal{N}(0_K, (G'_1 \Sigma^{-1} G_1)^{-1} / \sigma_{f,K-1}^2)$ , where  $G_1 = [1_N, \alpha, \beta_1, \dots, \beta_{K-2}]$  and  $\sigma_{f,K-1}^2 = \text{Var}[f_{t,K-1}]$ . In addition, let  $\sigma_i^2 = \text{Var}[z_i]$ ,  $\sigma_{ij} \equiv \text{Cov}[z_i, z_j]$ ,  $\rho_{ij} = \sigma_{ij} / (\sigma_i \sigma_j)$ , and define the random variables  $\tilde{z}_2 \equiv z_2 / \sigma_2 \sim \mathcal{N}(0, 1)$ ,  $x \sim \chi_{N-K}^2$ ,  $q_i \sim \mathcal{N}(0, 1)$ , where  $x$  and  $q_i$  are independent of  $\tilde{z}_2$ , and  $b_i = (x + \tilde{z}_2^2) / (x + \tilde{z}_2^2 + q_i^2)$  for  $i = 1, \dots, K - 1$ . We then have the following result.

THEOREM 1. *Suppose that the model is misspecified and it contains a useless factor (that is,  $\text{rank}(B) = K - 1$ ). Then, under Assumptions 1 and 3 and as  $T \rightarrow \infty$ , we have*

$$(a) \quad (i) \hat{\gamma}_0^{ML} \xrightarrow{d} -\frac{z_1}{z_2}; \quad (ii) \hat{\gamma}_{1,i}^{ML} \xrightarrow{d} \mu_{f,i} - \frac{z_{i+2}}{z_2} \text{ for } i = 1, \dots, K - 2; \text{ and } (iii) \frac{\hat{\gamma}_{1,K-1}^{ML}}{\sqrt{T}} \xrightarrow{d} \frac{1}{z_2};$$

$$(b) \text{ (i) } t(\hat{\gamma}_0^{ML}) \xrightarrow{d} - \left( \frac{\rho_{12}|\tilde{z}_2|}{\sqrt{1-\rho_{12}^2}} + q_1 \right) b_1^{\frac{1}{2}}; \text{ (ii) } t(\hat{\gamma}_{1,i}^{ML}) \xrightarrow{d} \left( \frac{\frac{\mu_{f,i}\sigma_2}{\sigma_{i+2}} - \rho_{i+2,2}}{\sqrt{1-\rho_{i+2,2}^2}} |\tilde{z}_2| - q_{i+1} \right) b_{i+1}^{\frac{1}{2}} \text{ for}$$

$$i = 1, \dots, K-2; \text{ and (iii) } t^2(\hat{\gamma}_{1,K-1}^{ML}) \xrightarrow{d} \chi_{N-K+1}^2;$$

$$(c) R_{ML}^2 \rightarrow 1;$$

$$(d) \lim_{T \rightarrow \infty} \Pr\{\mathcal{S} > p_\eta\} = \eta, \text{ where } \eta \text{ denotes the significance level of the specification test and } p_\eta \text{ is the } 100(1-\eta)\text{-th percentile of } \chi_{N-K}^2.$$

**Proof.** See Appendix.

Theorem 1 establishes the limiting behavior of the parameter estimates,  $t$ -tests, and pseudo- $R^2$  statistic,  $R_{ML}^2$ , in misspecified models with identification failure. In addition, it characterizes the asymptotic power of the  $\mathcal{S}$  test under rank deficiency. When a useless factor is present, the estimates on the useful factors are inconsistent and converge to ratios of normal random variables. The estimate for the useless factor ( $\hat{\gamma}_{1,K-1}^{ML}$ ) diverges at rate root- $T$ , and the standardized estimator converges to the reciprocal of a normal random variable.<sup>8</sup> The  $t$ -tests for the useful factors converge to bounded random variables and, hence, are inconsistent. In fact, as our simulations illustrate, the tests  $t(\hat{\gamma}_{1,i}^{ML})$  for  $i = 1, \dots, K-2$  tend to exhibit power that is close to its size. In contrast, the  $t$ -test for the useless factor will over-reject substantially (with the probability of rejection rapidly approaching one as  $N$  increases) when  $\mathcal{N}(0, 1)$  critical values are used. Furthermore, part (c) of Theorem 1 shows that the pseudo- $R^2$  of the misspecified model approaches one when the model contains a useless factor. This leads to completely spurious inference as the useless factors do not contribute to the pricing performance of the model and yet the sample pseudo- $R^2$  would indicate that the model perfectly explains the cross-sectional variations in the expected returns on the test assets.

Finally, part (d) of Theorem 1 demonstrates that the specification test in the beta-pricing model has asymptotic power equal to its size when a useless factor is included in the model. This result follows directly from the numerical equivalence of  $\mathcal{S}$  and  $\mathcal{CD}_1$  and has two main implications. First, it suggests that the test for over-identifying restrictions will erroneously conclude, with a

<sup>8</sup>Kan and Zhang (1999a) and Kleibergen (2009) also show that the estimate for the useless factor diverges at rate root- $T$  when employing non-invariant two-pass cross-sectional regression estimators. Similar results are documented by Kan and Zhang (1999b) and Gospodinov, Kan, and Robotti (2014a) for models estimated via non-invariant (optimal and suboptimal) GMM.

limiting probability of  $1 - \eta$ , that a model with an arbitrarily large degree of misspecification is correctly specified. While this result applies to the case of a model with a useless factor, it also has implications for models with factors that are weakly correlated with the test asset returns. In finite samples, factors with low correlations with returns are indistinguishable from useless factors, so the  $\mathcal{S}$  test has almost no power in rejecting such models.<sup>9</sup> Second, it indicates that the conventional inference on the parameter estimates  $\hat{\gamma}^{ML}$  is likely to be distorted and highly misleading as the standard errors under correct specification will not account for the additional uncertainty arising from model misspecification. It should be stressed that, apart from the rates of convergence and the asymptotic distribution of  $t^2(\hat{\gamma}_{1,K-1}^{ML})$ , these ML results sharply differ from the results for non-invariant estimators. As further emphasized in Section 4 below, the considered non-invariant estimators appear to exhibit less sensitivity to lack of identification.

As previously discussed, the full rank condition on  $G$  may also be violated when the model includes two (or more) factors that are noisy versions of the same underlying factor. In this case (a proof for this result is available in Internet Appendix Section 2), the behavior of the parameter estimates,  $t$ -ratios, and pseudo- $R^2$  is the same as the one described in Theorem 1 with the limiting representations for the noisy factors being the same as the asymptotic distributions for the useless factor in parts (a) and (b) of Theorem 1. In Theorem 2 below, we present a general result for the asymptotic distribution of the specification test that covers both correctly specified and misspecified models that are possibly fully identified or under-identified of arbitrary order (that is,  $G$  has rank  $K + 1 - r$  for an integer  $r \geq 1$ ).

**THEOREM 2:** *Suppose that the matrix  $G$  has a column rank  $K + 1 - r$  ( $r = 1, 2, \dots$ ), that is, there exist  $r$  linear combinations of the columns of  $G$  that are equal to zero vectors. Then, under Assumptions 1 and 3 and as  $T \rightarrow \infty$ , we have*

$$\mathcal{S} \xrightarrow{d} w_r, \tag{27}$$

where  $w_r$  is the smallest eigenvalue of  $W \sim \mathcal{W}_r(N - K - 1 + r, I_r)$ , and  $\mathcal{W}_r(N - K - 1 + r, I_r)$  denotes the Wishart distribution with  $N - K - 1 + r$  degrees of freedom and a scaling matrix  $I_r$ . Furthermore,  $\Pr[w_r < a] \geq \Pr[x < a]$ , where  $x \sim \chi_{N-K}^2$ .

**Proof:** See Appendix.

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<sup>9</sup>The result also suggests that if a model is rejected by the  $\mathcal{S}$  test, one can easily “save” the model by adding measurement errors to the factors in the model.



Theorem 2 nests several cases of interest depending on the value of  $r$ . When  $r = 1$ , that is, the model is correctly specified with a useful factor or the model is misspecified with a useless factor, we have  $\mathcal{S} \xrightarrow{d} \chi_{N-K}^2$ . This case subsumes the standard asymptotic approximation for identified models as well as the result in part (d) of Theorem 1. When the model is correctly specified with a useless factor or when the model is misspecified but it contains two useless factors, we have  $r = 2$  and  $\mathcal{S} \xrightarrow{d} w_2$ , where  $w_2$  is the smallest eigenvalue of  $\mathcal{W}_2(N - K + 1, I_2)$ . In this situation, as the second part of Theorem 2 suggests, the specification test, which is based on critical values from the  $\chi_{N-K}^2$  distribution, will under-reject the null hypothesis. The following figure shows the limiting distribution of  $\mathcal{S}$  for the case of  $N - K = 7$ .

Figure 3 about here

Finally, in Internet Appendix Section 1, we present limiting results for correctly specified models with identification failure. In this case, the parameter estimates for the useful factors ( $\hat{\gamma}_0^{ML}$  and  $\hat{\gamma}_{1,i}^{ML}$  for  $i = 1, \dots, K - 2$ ) are consistent but have non-normal asymptotic distributions. The parameter estimate for the useless factor ( $\hat{\gamma}_{1,K-1}^{ML}$ ) is inconsistent and is asymptotically distributed as a Cauchy random variable. The  $t$ -statistics are also asymptotically non-normal and using  $\mathcal{N}(0, 1)$  critical values will lead to under-rejections for the parameters on the useful factors but to over-rejections for the parameter on the useless factor.

Figure 4 about here

The source for the over-rejection is clearly illustrated in Figure 4 which plots the limiting probability density functions of  $t(\hat{\gamma}_{1,K-1}^{ML})$  for correctly specified and misspecified models ( $N - K = 7$ ), along with the standard normal density. Furthermore, the pseudo- $R^2$  approaches one much faster when a useless factor is present. Hence with lack of identification, misleading inference also arises in correctly specified models although the inference problems are more pronounced in misspecified models.

### 3.2 Continuously-Updated GMM

We now consider the more general GMM estimation of SDF and beta-pricing models. The CU-GMM estimator of the SDF parameters  $\lambda^*$  is defined as (see Hansen, Heaton, and Yaron, 1996)

$$\hat{\lambda} = \underset{\lambda}{\operatorname{argmin}} \bar{e}(\lambda)' \hat{W}_e(\lambda)^{-1} \bar{e}(\lambda), \quad (28)$$

where  $\bar{e}(\lambda) = T^{-1} \sum_{t=1}^T e_t(\lambda)$  and

$$\hat{W}_e(\lambda) = \frac{1}{T} \sum_{t=1}^T (e_t(\lambda) - \bar{e}(\lambda))(e_t(\lambda) - \bar{e}(\lambda))'. \quad (29)$$

The over-identifying restriction test of the asset-pricing model is given by

$$\mathcal{J} = T \min_{\lambda} \bar{e}(\lambda)' \hat{W}_e(\lambda)^{-1} \bar{e}(\lambda), \quad (30)$$

and  $\mathcal{J} \xrightarrow{d} \chi_{N-K}^2$  when the asset-pricing model holds.

When the model is correctly specified and  $D$  is of full column rank, we have, under Assumptions 1 and 2, that (Hansen, 1982; Newey and Smith, 2004)

$$\sqrt{T}(\hat{\lambda} - \lambda^*) \xrightarrow{d} \mathcal{N}(0_K, (D'W_e(\lambda^*)^{-1}D)^{-1}). \quad (31)$$

The  $t$ -statistics for statistical significance of  $\lambda_0$  and  $\lambda_{1,i}$  ( $i = 1, \dots, K-1$ ) are constructed as

$$t(\hat{\lambda}_0) = \frac{\sqrt{T}\hat{\lambda}_0}{s(\hat{\lambda}_0)}, \quad (32)$$

$$t(\hat{\lambda}_{1,i}) = \frac{\sqrt{T}\hat{\lambda}_{1,i}}{s(\hat{\lambda}_{1,i})}, \quad (33)$$

where the quantities  $s(\hat{\lambda}_0), s(\hat{\lambda}_{1,1}), \dots, s(\hat{\lambda}_{1,K-1})$  denote the square root of the diagonal elements of  $(\hat{D}'\hat{W}_e(\hat{\lambda})^{-1}\hat{D})^{-1}$ . Internet Appendix Section 3 describes how to use the CU-GMM estimates of the SDF parameters  $\lambda^*$  to obtain (in a computationally very efficient way) the CU-GMM estimates of  $\gamma^*, \beta, \mu_f$ , and  $V_f$ . More specifically, let

$$w_t(\hat{\lambda}) = \frac{1 - (e_t(\hat{\lambda}) - \bar{e}(\hat{\lambda}))' \hat{W}_e(\hat{\lambda})^{-1} \bar{e}(\hat{\lambda})}{T}. \quad (34)$$

Then, the CU-GMM estimates of  $\mu_f, V_f$ , and  $\beta$  are given by

$$\hat{\mu}_f^{CU} = \sum_{t=1}^T w_t(\hat{\lambda}) f_t, \quad (35)$$

$$\hat{V}_f^{CU} = \sum_{t=1}^T w_t(\hat{\lambda}) f_t (f_t - \hat{\mu}_f^{CU})', \quad (36)$$

and

$$\hat{\beta}^{CU} = \sum_{t=1}^T w_t(\hat{\lambda}) R_t (f_t - \hat{\mu}_f^{CU})' (\hat{V}_f^{CU})^{-1}. \quad (37)$$

These estimates are subsequently used to construct estimates of the risk premium parameters

$$\hat{\gamma}_0^{CU} = \frac{1}{\hat{\lambda}_0 + \hat{\mu}_f^{CU} \hat{\lambda}_1}, \quad (38)$$

$$\hat{\gamma}_1^{CU} = -\frac{\hat{V}_f^{CU} \hat{\lambda}_1}{\hat{\lambda}_0 + \hat{\mu}_f^{CU} \hat{\lambda}_1}. \quad (39)$$

The fitted (model-implied) expected returns,  $\hat{\mu}_R^{CU} = 1_N \hat{\gamma}_0^{CU} + \hat{\beta}^{CU} \hat{\gamma}_1^{CU}$ , are used to compute the pseudo- $R^2$  for CU-GMM.

When the asset-pricing model holds,  $\text{rank}(H) = K$ . Note that  $\text{rank}(H) = K$  if and only if  $\text{rank}(P_1' D) = K - 1$ . Instead of using the  $\mathcal{J}$  test to test the asset-pricing model, one may want to use the Cragg and Donald (1997) rank test to test  $H_0 : \text{rank}(P_1' D) = K - 1$ , which is given by

$$\mathcal{CD}_2 = T \min_{c: c'c=1} (P_1' \hat{D} c)' [(c' \otimes P_1') \hat{V}_d (c \otimes P_1)]^{-1} (P_1' \hat{D} c), \quad (40)$$

where  $\hat{D}$  is the sample estimate of  $D$  and  $\hat{V}_d = \frac{1}{T} \sum_{t=1}^T \text{vec}(D_t - \hat{D}) \text{vec}(D_t - \hat{D})'$ .

The following lemma establishes the numerical equivalence of the  $\mathcal{J}$  and  $\mathcal{CD}_2$  tests so that the CU-GMM specification test of the asset-pricing model is in essence a rank test. The lemma also explains how to obtain the CU-GMM estimator of  $\lambda^*$  from the  $\hat{c}$  that minimizes (40).

LEMMA 2. *Consider the  $\mathcal{J}$  and  $\mathcal{CD}_2$  tests defined in (30) and (40), and let  $\hat{\lambda}$  and  $\hat{c}$  be the estimators that minimize (30) and (40), respectively. Then, under Assumptions 1 and 2, we have  $\mathcal{J} = \mathcal{CD}_2$  and  $\hat{\lambda} = [1_N' \hat{W}_e(\hat{c})^{-1} 1_N / (1_N' \hat{W}_e(\hat{c})^{-1} \hat{D} \hat{c})] \hat{c}$ .*

**Proof.** See Appendix.

As in the MLE case,  $H$  can have a reduced rank when, for example, a misspecified model contains a useless factor. It is of interest to understand how CU-GMM behaves under unidentified and misspecified models. The following theorem describes the limiting behavior of the CU-GMM estimates, their corresponding  $t$ -statistics, the pseudo- $R^2$ , and the  $\mathcal{J}$  test for misspecified

models that contain a useless factor. Without loss of generality, we assume that the useless factor is ordered last with mean  $\mu_{f,K-1}$  and variance  $\sigma_{f,K-1}^2$ . The CU-GMM estimator and the  $t$ -statistic corresponding to the useless factor are  $\hat{\lambda}_{1,K-1}$  and  $t(\hat{\lambda}_{1,K-1})$ , respectively. Let  $z = [z_1, z_2, \dots, z_K]' \sim \mathcal{N}(0_K, \sigma_{f,K-1}^2 (H_1' U^{-1} H_1)^{-1})$ , where  $H_1 = [1_N, D_1]$ ,  $D_1 = [d_1, d_2, \dots, d_{K-1}]$ , and  $d_i$  ( $i = 1, \dots, K-1$ ) is the  $i$ -th column of  $D$ . Also, let  $\sigma_i^2 = \text{Var}[z_i]$ ,  $\sigma_{ij} \equiv \text{Cov}[z_i, z_j]$ ,  $\rho_{ij} = \sigma_{ij}/(\sigma_i \sigma_j)$ , and define the random variables  $\tilde{z}_1 \equiv z_1/\sigma_1 \sim \mathcal{N}(0, 1)$ ,  $x \sim \chi_{N-K}^2$ ,  $q_i \sim \mathcal{N}(0, 1)$ , where  $x$  and  $q_i$  are independent of  $\tilde{z}_1$ , and  $b_i = (x + \tilde{z}_1^2)/(x + \tilde{z}_1^2 + q_i^2)$  for  $i = 1, \dots, K-1$ .

**THEOREM 3.** *Suppose that the model is misspecified and it contains a useless factor (that is,  $\text{rank}(D) = K-1$ ). Then, under Assumptions 1 and 2 and as  $T \rightarrow \infty$ , we have*

- (a) (i)  $\hat{\lambda}_0 \xrightarrow{d} -\frac{z_2}{z_1}$  if  $\mu_{f,K-1} = 0$  or  $\frac{\hat{\lambda}_0}{\sqrt{T}} \xrightarrow{d} \frac{\mu_{f,K-1}}{z_1}$  if  $\mu_{f,K-1} \neq 0$ ; (ii)  $\hat{\lambda}_{1,i} \xrightarrow{d} -\frac{z_{i+2}}{z_1}$  for  $i = 1, \dots, K-2$ ; and (iii)  $\frac{\hat{\lambda}_{1,K-1}}{\sqrt{T}} \xrightarrow{d} -\frac{1}{z_1}$ ;
- (b) (i)  $t(\hat{\lambda}_0) \xrightarrow{d} -\left(\frac{\rho_{1,2}|\tilde{z}_1|}{\sqrt{1-\rho_{1,2}^2}} + q_2\right) b_1^{\frac{1}{2}}$  if  $\mu_{f,K-1} = 0$  or  $t^2(\hat{\lambda}_0) \xrightarrow{d} \chi_{N-K+1}^2$  if  $\mu_{f,K-1} \neq 0$ ; (ii)  $t(\hat{\lambda}_{1,i}) \xrightarrow{d} -\left(\frac{\rho_{1,i+2}|\tilde{z}_1|}{\sqrt{1-\rho_{1,i+2}^2}} + q_{i+2}\right) b_{i+1}^{\frac{1}{2}}$  for  $i = 1, \dots, K-2$ ; and (iii)  $t^2(\hat{\lambda}_{1,K-1}) \xrightarrow{d} \chi_{N-K+1}^2$ ;
- (c)  $R_{CU}^2 = \text{Corr}(\hat{\mu}_R^{CU}, \hat{\mu}_R)^2 \rightarrow 1$ ;
- (d)  $\lim_{T \rightarrow \infty} \Pr\{\mathcal{J} > p_\eta\} = \eta$ , where  $\eta$  denotes the significance level of the test for over-identifying restrictions and  $p_\eta$  is the  $100(1-\eta)$ -th percentile of  $\chi_{N-K}^2$ .

**Proof.** See Appendix.

While the limiting distributions in Theorem 3 for the CU-GMM estimator are broadly consistent with those in Theorem 1 for MLE, some interesting differences emerge. In particular, the asymptotic behavior of  $\hat{\lambda}_0$  and  $t(\hat{\lambda}_0)$  depends on whether the population mean of the useless factor is zero or not. In the practically relevant case when this mean is nonzero,  $\hat{\lambda}_0$  and  $t(\hat{\lambda}_0)$  inherit the limiting properties of  $\hat{\lambda}_{1,K-1}$  and  $t(\hat{\lambda}_{1,K-1})$  for the useless factor. This provides another example of the highly irregular behavior of the invariant estimators in misspecified and unidentified models. Similarly to the beta-pricing setup, parts (c) and (d) of Theorem 3 show that the pseudo- $R^2$

measure converges to one and the asymptotic power of the CU-GMM specification test is equal to its size when one or more factors are independent of the test asset returns.

As for the beta-pricing model, it is desirable to characterize the asymptotic behavior of the specification test when the model is possibly unidentified of arbitrary order, that is, the matrix  $H$  has rank  $K + 1 - r$  for an integer  $r \geq 1$ . Theorem 4 below establishes that the  $\mathcal{J}$  test shares the same limiting distribution as the  $\mathcal{S}$  test under some additional restrictions on the data.

ASSUMPTION 3'. Assume that

$$\sqrt{T}\text{vec}(\hat{B} - B) \xrightarrow{d} \mathcal{N}(0_{NK}, E[x_t x_t']^{-1} \otimes \Sigma). \quad (41)$$

Note that Assumption 3' imposes weaker restrictions on the data than Assumption 3. For example, the result in Assumption 3' holds under conditional homoskedasticity without any distributional requirements on the data.

THEOREM 4: *Suppose that the matrix  $H$  has a column rank  $K + 1 - r$  ( $r = 1, 2, \dots$ ), that is, there exist  $r$  linear combinations of the columns of  $H$  that are equal to zero vectors. Then, under Assumptions 1, 2, and 3' and as  $T \rightarrow \infty$ , we have*

$$\mathcal{J} \xrightarrow{d} w_r, \quad (42)$$

where  $w_r$  is the smallest eigenvalue of  $W \sim \mathcal{W}_r(N - K - 1 + r, I_r)$ , and  $\mathcal{W}_r(N - K - 1 + r, I_r)$  denotes the Wishart distribution with  $N - K - 1 + r$  degrees of freedom and a scaling matrix  $I_r$ . Furthermore,  $\Pr[w_r < a] \geq \Pr[x < a]$ , where  $x \sim \chi_{N-K}^2$ .

**Proof:** See Appendix.

Theorem 4 nests the standard asymptotic approximation for identified models (Hansen, 1982) as well as the result in part (d) of Theorem 3. Note, however, that the  $\chi_{N-K}^2$  limiting distribution in these two cases is a more general result and does not hinge on the validity of Assumption 3'. When the model is correctly specified with a useless factor or when the model is misspecified but it contains two useless factors, we have  $\mathcal{J} \xrightarrow{d} w_2$  and the specification test, which is based on critical values from the  $\chi_{N-K}^2$  distribution, tends to under-reject.

## 4 Non-Invariant Estimators

The results so far suggest that the invariant estimators (ML and CU-GMM) are extremely sensitive to model misspecification and lack of identification. It is instructive to investigate whether the non-invariant estimators (two-pass cross-sectional regression estimators in the beta-pricing setup and the HJ-distance estimators in the SDF setup) share similar or more robust properties in misspecified and unidentified models. It is well known (see, for example, Shanken and Zhou, 2007) that the GLS cross-sectional regression estimator is the argument that minimizes the numerator of the ML objective function

$$\min_{\gamma} \frac{(\hat{\mu}_R - 1_N\gamma_0 - \hat{\beta}\gamma_1)' \hat{\Sigma}^{-1} (\hat{\mu}_R - 1_N\gamma_0 - \hat{\beta}\gamma_1)}{1 + \gamma_1' \hat{V}_f^{-1} \gamma_1}, \quad (43)$$

which suggests that the non-standard behavior of the ML estimator and test statistics documented above can be due to or exacerbated by the “denominator” problem.

Specifically, the GLS cross-sectional regression estimator of  $\gamma^*$  is given by

$$\hat{\gamma}^{GLS} = (\hat{B}_1' \hat{\Sigma}^{-1} \hat{B}_1)^{-1} \hat{B}_1' \hat{\Sigma}^{-1} \hat{\mu}_R. \quad (44)$$

The cross-sectional regression (CSR) test of Shanken (1985) for correct model specification is based on the statistic

$$\mathcal{Q} = (\hat{\mu}_R - \hat{B}_1 \hat{\gamma}^{GLS})' \hat{\Sigma}^{-1} (\hat{\mu}_R - \hat{B}_1 \hat{\gamma}^{GLS}) = (\hat{\mu}_R - \hat{B}_1 \hat{\gamma}^{GLS})' \hat{V}_R^{-1} (\hat{\mu}_R - \hat{B}_1 \hat{\gamma}^{GLS}), \quad (45)$$

where  $\hat{V}_R$  is the sample estimate of  $V_R$ . To characterize the asymptotic distribution of the CSR test, let

$$l_t(\gamma) = [R_t - \mu_R - \beta(f_t - \mu_f)][1 - \gamma_1' V_f^{-1} (f_t - \mu_f)], \quad (46)$$

$$S_l = E[l_t(\gamma^*) l_t(\gamma^*)'], \quad (47)$$

and  $P_{\tilde{V}}$  be an  $N \times (N - K)$  orthonormal matrix with columns orthogonal to  $\tilde{V} = V_R^{-\frac{1}{2}} [1_N, V_{Rf}]$ . Then, under Assumptions 1 and 2 and when the asset-pricing model is correctly specified and well identified, the asymptotic distribution of the CSR test is given by (Kan, Robotti, and Shanken, 2013)

$$T\mathcal{Q} \xrightarrow{d} \sum_{i=1}^{N-K} \xi_i x_i, \quad (48)$$

where the  $x_i$ 's are independent  $\chi_1^2$  random variables and the  $\xi_i$ 's are the eigenvalues of the matrix

$$P_{\hat{V}}' V_R^{-\frac{1}{2}} S_l V_R^{-\frac{1}{2}} P_{\hat{V}}. \quad (49)$$

Similarly, define the HJ-distance estimator of  $\lambda^*$  as

$$\hat{\lambda}^{HJ} = \underset{\lambda}{\operatorname{argmin}} \bar{e}(\lambda)' \hat{V}_R^{-1} \bar{e}(\lambda) = (\hat{D}' \hat{V}_R^{-1} \hat{D})^{-1} \hat{D}' \hat{V}_R^{-1} \mathbf{1}_N, \quad (50)$$

and let

$$\hat{\delta}^2 = \bar{e}(\hat{\lambda}^{HJ})' \hat{V}_R^{-1} \bar{e}(\hat{\lambda}^{HJ}) \quad (51)$$

denote the sample squared HJ-distance.<sup>10</sup> Then, under Assumptions 1 and 2 and when the asset-pricing model is correctly specified and well identified, the HJ-distance test,  $T\hat{\delta}^2$ , follows a weighted chi-squared limiting distribution (Jagannathan and Wang, 1996):

$$T\hat{\delta}^2 \xrightarrow{d} \sum_{i=1}^{N-K} \psi_i x_i, \quad (52)$$

where the  $x_i$ 's are independent  $\chi_1^2$  random variables, the  $\psi_i$ 's are the nonzero eigenvalues of the matrix

$$S_d^{\frac{1}{2}} V_R^{-1} S_d^{\frac{1}{2}} - S_d^{\frac{1}{2}} V_R^{-1} D (D' V_R^{-1} D)^{-1} D' V_R^{-1} S_d^{\frac{1}{2}}, \quad (53)$$

and  $S_d = E[e_t(\lambda^*) e_t(\lambda^*)']$ . The next theorem characterizes the limiting behavior of the sample squared HJ-distance and CSR tests in the presence of a useless factor.

**THEOREM 5.** *Let  $\mathcal{B} \sim \text{Beta}(\frac{N-K}{2}, \frac{1}{2})$  with density  $f_{\mathcal{B}}(\cdot)$ ,  $p_\eta$  be the  $100(1 - \eta)$ -th percentile of  $\chi_{N-K}^2$ ,  $\tilde{Q}_0 = e_0' V_R^{-1} e_0$ , and  $e_0 = [I_N - \mathbf{1}_N (\mathbf{1}_N' V_R^{-1} \mathbf{1}_N)^{-1} \mathbf{1}_N' V_R^{-1}] \mu_R$ .*

- (a) *Suppose that Assumptions 1 and 2 hold, the asset-pricing model is misspecified and it contains a useless factor. Then, we have*

$$\hat{\delta}^2 \xrightarrow{d} \delta^2 \mathcal{B}, \quad (54)$$

where  $\delta$  denotes the population HJ-distance, and the limiting probability of rejecting the null hypothesis of correct model specification by the HJ-distance test of size  $\eta$  is

$$\int_0^1 P \left[ \chi_{N-K+1}^2 > \frac{p_\eta s}{1-s} \right] f_{\mathcal{B}}(s) ds < 1. \quad (55)$$

<sup>10</sup> Although the standard definition of the HJ-distance uses the inverse of the second moment matrix of the asset returns as the weighting matrix, Kan and Zhou (2004) show that for linear factor models, using the inverse of the covariance matrix of the asset returns as the weighting matrix would produce mathematically identical results for the SDF parameters and the HJ-distance.

(b) *Suppose that Assumption 1 holds and  $l_t(\gamma) - E[l_t(\gamma)]$  forms a martingale difference sequence. In addition, suppose that the beta-pricing model is misspecified and it contains a useless factor. Then, we have*

$$\mathcal{Q} \xrightarrow{d} \tilde{\mathcal{Q}}_0 \mathcal{B}, \quad (56)$$

*and the limiting probability of rejecting the null hypothesis of correct model specification by the CSR test of size  $\eta$  is*

$$\int_0^1 P \left[ \chi_{N-K+1}^2 > \frac{p\eta s}{1-s} \right] f_{\mathcal{B}}(s) ds < 1. \quad (57)$$

**Proof.** See Appendix.

While Theorem 5 shows that the HJ-distance and CSR tests are inconsistent under identification failure, the limiting probability of rejection of the null hypothesis is different from the ones for the invariant estimator-based tests. In particular, this limiting probability is a function of  $N - K$  and is very close to one when  $N - K$  is of the magnitude typically encountered in empirical work. Consider again the same test assets and asset-pricing models described in Section 1. Figures 5 and 6 visualize the cross-sectional goodness-of-fit of the models by plotting average realized returns versus fitted (by HJ-distance and GLS, respectively) expected returns from each model.

Figures 5 and 6 about here

In sharp contrast to the results for invariant estimators in Figures 1 and 2, the models that contain factors that are only weakly correlated with the test asset returns (C-LAB and CC-CAY) no longer exhibit a perfect fit, and the HJ-distance and CSR tests strongly reject the null of correct specification (see Panel A of Table I). As a result, these non-invariant tests appear to be more robust to lack of identification and can detect model misspecification with higher probability than their invariant counterparts.

## 5 Simulation Results

In this section, we undertake a Monte Carlo simulation experiment to study the empirical rejection rates of the specification and  $t$ -tests for the CU-GMM and ML estimators as well as the finite-sample distribution of the goodness-of-fit measure. We consider three linear models: (i) a model



with a constant term and a useful factor, (ii) a model with a constant term and a useless factor, and (iii) a model with a constant term, a useful, and a useless factor. All three models are misspecified.

The returns on the test assets and the useful factor are drawn from a multivariate normal distribution. In all simulation designs, the covariance matrix of the simulated test asset returns is set equal to the sample covariance matrix from the 1959:2–2012:12 sample of monthly gross returns on the 25 Fama-French size and book-to-market ranked portfolios (from Kenneth French’s website). The means of the simulated returns are set equal to the sample means of the actual returns, which leads to a misspecified model in all three cases. The mean and variance of the simulated useful factor are calibrated to the sample mean and variance of the value-weighted market excess return. The covariances between the useful factor and the returns are chosen based on the sample covariances estimated from the data. The useless factor is generated as a standard normal random variable which is independent of the returns and the useful factor. The time series sample size is  $T = 200, 400, 600, 800, 1000,$  and  $3600$ , and all results are based on 100,000 Monte Carlo replications. We also report the limiting rejection probabilities (denoted by  $T = \infty$ ) for the specification and  $t$ -tests based on our asymptotic results in Sections 3 and 4.

Table II about here

Table II presents the probabilities of rejection of the model specification tests based on invariant (CU-GMM and ML) and non-invariant (HJ-distance and GLS) estimators at the 10%, 5%, and 1% nominal levels. Table II.a reports the rejection probabilities of the  $\mathcal{J}$  and HJ-distance tests for the SDF representation, while Table II.b includes the  $\mathcal{S}$  and CSR tests for the beta-pricing model. Consistent with our theoretical results, the specification tests based on invariant estimators do not exhibit any power in the presence of a useless factor and the empirical rejection probabilities approach the nominal size under the alternative of a misspecified model. As a result, when a useless factor is included in the model, the researcher will conclude erroneously (with probability one minus the nominal size of the test) that the model is correctly specified even when the misspecification of the model is arbitrarily large. In contrast, the HJ-distance and the CSR tests, albeit still inconsistent, prove to be much more successful at detecting model misspecification.

Table III about here

An alternative and popular way to look at the performance of the model is to compute the squared correlation between the expected fitted returns of the model and the average realized returns. The distribution of this pseudo- $R^2$  is reported in Table III (III.a for CU-GMM and III.b for ML). Again, as our theoretical analysis suggests, the empirical distribution of the pseudo- $R^2$  in models with a useless factor collapses to 1 as the sample size gets large. For example, this measure will indicate a perfect fit for models that include a factor that is independent of the returns on the test assets. These spurious results should serve as a warning signal in applied work where many macroeconomic factors are only weakly correlated with the returns on the test assets.

Table IV about here

Finally, Table IV (IV.a for CU-GMM and IV.b for ML) presents the rejection probabilities of the  $t$ -tests of  $H_0 : \lambda_{1,i} = 0$  and  $H_0 : \gamma_{1,i} = 0$  (tests of statistical significance) for the useful and the useless factor in the SDF and beta representations of models (i), (ii), and (iii). The  $t$ -statistics are computed under the assumption that the model is correctly specified and are compared against the critical values from the standard normal distribution. The computation of the  $t$ -statistics under the assumption of a correctly specified model is justified by the results from the pre-tests for correct model specification in Table II. These pre-tests indicate that the researcher will conclude with high probability that the model is correctly specified when a useless factor is included. Table IV reveals that for models with a useless factor, the  $t$ -tests will give rise to spurious results, suggesting that these completely irrelevant factors are priced (especially in the SDF representation and for small sample sizes). Moreover, the useless factor (which, by construction, does not contribute to the pricing performance of the model) drives out the useful factor and leads to the grossly misleading conclusion to keep the useless factor and drop the useful factor from the model (see Panel C of Table IV.a and IV.b).

## 6 Concluding Remarks

In this paper, we show that the results from many popular empirical asset pricing models could be spurious. In particular, we demonstrate that, in the presence of factors that are independent of the returns on the test assets (useless factors), the power of the specification tests based on invariant estimators is equal to its size, and the pseudo- $R^2$  that measures the distance between the

fitted and realized average returns approaches one. As a consequence, an applied researcher would conclude with high probability that the model is correctly specified and proceed with constructing standard errors and test statistics that assume correct model specification. Since these statistics would not take into the account the extra uncertainty arising from potential model misspecification, the inference on the model parameters would be highly distorted and would manifest in highly significant estimates for factors that do not contribute to improved pricing.

The spurious results in these models arise from the combined effect of identification failure and model misspecification. It is important to stress that this is not an isolated problem limited to a particular sample (data frequency), test assets, and asset-pricing models. This suggests that the statistical evidence on the pricing ability of many macro factors and their usefulness in explaining the cross-section of asset returns should be interpreted with caution. Some warning signs about this problem (for example, the outcome of a rank test) are often ignored by applied researchers. While non-invariant estimators (HJ-distance non-optimal GMM and GLS two-pass cross-sectional regressions) also suffer from similar problems, the invariant (CU-GMM and ML) estimators turn out to be much more sensitive to model misspecification and lack of identification.

Given the severity of the inference problems associated with invariant estimators of possibly unidentified and misspecified asset-pricing models that we document in this paper, our recommendations for empirical practice can be summarized as follows. The lack of power of the specification tests in unidentified models suggests that the decision regarding the model specification should be augmented with additional diagnostics. For instance, the tests developed by Arellano, Hansen, and Sentana (2012) and Peñaranda and Sentana (2014) can detect if the lack of rejection of the model specification tests is genuine or is due to the presence of a useless factor. Importantly, any model should be subjected to a rank test which will provide evidence on whether the model parameters are identified or not. If the null hypothesis of a reduced rank is rejected, the researcher can proceed with the standard tools for inference in analyzing and evaluating the model. If the null of a reduced rank is not rejected, there are two possible ways to proceed. A first possibility is to work with non-invariant estimators (HJ-distance and cross-sectional regression estimators, for example) and pursue misspecification-robust inference that is asymptotically valid regardless of the degree of identification (see Gospodinov, Kan, and Robotti, 2014a). Second, if there is a strong preference for using invariant estimators, the researcher needs to estimate consistently the reduced rank of

the model (as in Ahn, Horenstein, and Wang, 2010, for instance) and select a subset of the original factors such that its dimension is equal to the estimated rank, and the resulting model is identified. For example, one could perform a rank test for each possible combination of factors and choose the combination that delivers the largest rejection of the reduced rank hypothesis. This procedure would restore the standard inference although it may still need to be robustified against possible model misspecification as in Gospodinov, Kan, and Robotti (2013).

While the results in this paper are developed in the context of linear factor models, we conjecture that similar results characterize the limiting behavior of specification tests in a different or more general setup. For example, Cragg and Donald (1996) establish the inconsistency of the Anderson-Rubin test for over-identifying restrictions in unidentified linear instrumental variable models while Dovonon and Renault (2013) derive the asymptotic distribution of the test for over-identifying restrictions under lack of first-order identification. Furthermore, the CU-GMM is a member of the class of generalized empirical likelihood (GEL) estimators (Newey and Smith, 2004) that provides a unifying framework for assessing asset-pricing models (Almeida and Garcia, 2012). To the best of our knowledge, the statistical properties of the GEL estimators under model misspecification (Schennach, 2007) and potential identification failure (Otsu, 2006; Guggenberger and Smith, 2008) have been analyzed only in isolation. Establishing whether the results in this paper for the CU-GMM estimator carry over to other GEL estimators or constructing GEL-based tests of correct model specification that are robust to a complete or partial lack of identification is a promising direction for future research.

## Appendix: Proofs of Lemmas and Theorems

### A.1 Proof of Lemma 1

Note that the  $\hat{c}$  that minimizes (25) can be analytically obtained as the eigenvector associated with the smallest eigenvalue of

$$\tilde{\Omega} = (X'X/T)\hat{B}'P_1(P_1'\hat{\Sigma}P_1)^{-1}P_1'\hat{B}. \quad (\text{A.1})$$

For the numerical equivalence of  $\mathcal{S}$  and  $\mathcal{CD}_1$  to hold, it is sufficient to show that  $\hat{\Omega}$  and  $\tilde{\Omega}^{-1}$  share the same nonzero eigenvalues. Using the formula for the inverse of a partitioned matrix, we obtain

$$\hat{\Omega} = (\hat{G}'\hat{\Sigma}^{-1}\hat{G})^{-1} \begin{bmatrix} 0 & 0'_K \\ 0_K & (X'X/T)^{-1} \end{bmatrix} = \begin{bmatrix} 0 & -(1'_N\hat{\Sigma}^{-1}1_N)^{-1}(1'_N\hat{\Sigma}^{-1}\hat{B})C \\ 0_K & C \end{bmatrix},$$

where

$$C = [\hat{B}'\hat{\Sigma}^{-1}\hat{B} - \hat{B}'\hat{\Sigma}^{-1}1_N(1'_N\hat{\Sigma}^{-1}1_N)^{-1}1'_N\hat{\Sigma}^{-1}\hat{B}]^{-1}(X'X/T)^{-1}. \quad (\text{A.2})$$

Note that

$$I_N - \hat{\Sigma}^{-\frac{1}{2}}1_N(1'_N\hat{\Sigma}^{-1}1_N)^{-1}1'_N\hat{\Sigma}^{-\frac{1}{2}} = \hat{\Sigma}^{\frac{1}{2}}P_1(P_1'\hat{\Sigma}P_1)^{-1}P_1'\hat{\Sigma}^{\frac{1}{2}} \quad (\text{A.3})$$

since  $P_1'\hat{\Sigma}^{\frac{1}{2}}\hat{\Sigma}^{-\frac{1}{2}}1_N = 0_{N-1}$ . It then follows that

$$\begin{aligned} \hat{B}'\hat{\Sigma}^{-1}\hat{B} - \hat{B}'\hat{\Sigma}^{-1}1_N(1'_N\hat{\Sigma}^{-1}1_N)^{-1}1'_N\hat{\Sigma}^{-1}\hat{B} &= \hat{B}'\hat{\Sigma}^{-\frac{1}{2}}[I_N - \hat{\Sigma}^{-\frac{1}{2}}1_N(1'_N\hat{\Sigma}^{-1}1_N)^{-1}1'_N\hat{\Sigma}^{-\frac{1}{2}}]\hat{\Sigma}^{-\frac{1}{2}}\hat{B} \\ &= \hat{B}'P_1(P_1'\hat{\Sigma}P_1)^{-1}P_1'\hat{B} \end{aligned} \quad (\text{A.4})$$

and

$$\hat{\Omega} = \begin{bmatrix} 0 & -(1'_N\hat{\Sigma}^{-1}1_N)^{-1}(1'_N\hat{\Sigma}^{-1}\hat{B})\tilde{\Omega}^{-1} \\ 0_K & \tilde{\Omega}^{-1} \end{bmatrix}. \quad (\text{A.5})$$

If  $\xi$  is a nonzero eigenvalue of  $\tilde{\Omega}^{-1}$  and  $c$  is the corresponding eigenvector, then we have

$$\hat{\Omega}v = \xi v, \quad (\text{A.6})$$

where  $v = [-(1'_N\hat{\Sigma}^{-1}1_N)^{-1}(1'_N\hat{\Sigma}^{-1}\hat{B}c), c']'$ . Therefore,  $\hat{\Omega}$  and  $\tilde{\Omega}^{-1}$  share the same nonzero eigenvalues. In particular, if  $\hat{c} = [\hat{c}_1, \hat{c}_2]'$  is the eigenvector associated with the largest eigenvalue of  $\tilde{\Omega}^{-1}$  or equivalently the eigenvector associated with the smallest eigenvalue of  $\tilde{\Omega}$ , then  $\hat{v} = [-(1'_N\hat{\Sigma}^{-1}1_N)^{-1}(1'_N\hat{\Sigma}^{-1}\hat{B}\hat{c}), \hat{c}]'$  is proportional to the eigenvector associated with the largest

eigenvalue of  $\hat{\Omega}$ . Finally, using (17) and (18), we obtain

$$\hat{\gamma}_1^{ML} = -\frac{\hat{c}_2}{\hat{c}_1} + \hat{\mu}_f, \quad (\text{A.7})$$

$$\hat{\gamma}_0^{ML} = \frac{1'_N \hat{\Sigma}^{-1} \hat{B} \hat{c}}{(1'_N \hat{\Sigma}^{-1} 1_N) \hat{c}_1} = \frac{1'_N \hat{\Sigma}^{-1} (\hat{\mu}_R - \hat{\beta} \hat{\gamma}_1^{ML})}{1'_N \hat{\Sigma}^{-1} 1_N}. \quad (\text{A.8})$$

This completes the proof.

## A.2 Proof of Theorem 1

**part (a):** When the model is misspecified and contains a useless factor (ordered last), we have  $Gv^* = 0_N$  for  $v^* = [0'_K, 1]'$ . Let  $\hat{v}$  be the eigenvector associated with the largest eigenvalue of

$$\hat{\Omega} = (\hat{G}' \hat{\Sigma}^{-1} \hat{G})^{-1} [A(X'X/T)^{-1} A']. \quad (\text{A.9})$$

Define  $\hat{\psi} = [\hat{\psi}_1, \hat{\psi}_2, \dots, \hat{\psi}_K]'$  as

$$\hat{\psi}_i = -\frac{\hat{v}_i}{\hat{v}_{K+1}}, \quad i = 1, \dots, K, \quad (\text{A.10})$$

which is asymptotically equivalent to the estimator

$$\tilde{\psi} = (\hat{G}'_1 \hat{\Sigma}^{-1} \hat{G}_1)^{-1} (\hat{G}'_1 \hat{\Sigma}^{-1} \hat{\beta}_{K-1}). \quad (\text{A.11})$$

Since  $\sqrt{T} \hat{\beta}_{K-1} \xrightarrow{d} \mathcal{N}(0_N, \Sigma / \sigma_{f,K-1}^2)$ , we have

$$\sqrt{T} \tilde{\psi} \xrightarrow{d} \mathcal{N} \left( 0_K, \frac{1}{\sigma_{f,K-1}^2} (G'_1 \Sigma^{-1} G_1)^{-1} \right), \quad (\text{A.12})$$

and  $\hat{\psi}$  also has the same asymptotic distribution.

Specifically, using that fact that

$$\sqrt{T} \hat{\sigma}_{f,K-1} \hat{\Sigma}^{-\frac{1}{2}} \hat{\beta}_{K-1} \xrightarrow{d} u \sim \mathcal{N}(0_N, I_N), \quad (\text{A.13})$$

we obtain

$$\sqrt{T} \hat{\psi} \xrightarrow{d} z \sim \mathcal{N}(0_K, (G'_1 \Sigma^{-1} G_1)^{-1} / \sigma_{f,K-1}^2). \quad (\text{A.14})$$

Therefore, we can write

$$\hat{\gamma}_0^{ML} = -\frac{\sqrt{T}\hat{\psi}_1}{\sqrt{T}\hat{\psi}_2} \xrightarrow{d} -\frac{z_1}{z_2}, \quad (\text{A.15})$$

$$\hat{\gamma}_{1,i}^{ML} = \hat{\mu}_{f,i} - \frac{\sqrt{T}\hat{\psi}_{i+2}}{\sqrt{T}\hat{\psi}_2} \xrightarrow{d} \mu_{f,i} - \frac{z_{i+2}}{z_2}, \quad i = 1, \dots, K-2, \quad (\text{A.16})$$

$$\frac{\hat{\gamma}_{1,K-1}^{ML}}{\sqrt{T}} = \frac{\hat{\mu}_{f,K-1}}{\sqrt{T}} + \frac{1}{\sqrt{T}\hat{\psi}_2} \xrightarrow{d} \frac{1}{z_2}. \quad (\text{A.17})$$

This completes the proof of part (a).

**part (b):** We start with the squared  $t$ -ratio of the useless factor,  $t^2(\hat{\gamma}_{1,K-1}^{ML})$ . Let  $G_2 = [1_N, \beta_1, \dots, \beta_{K-2}]$  and  $\hat{G}_2 = [1_N, \hat{\beta}_1, \dots, \hat{\beta}_{K-2}]$ . Using the formula for the inverse of a partitioned matrix, we obtain

$$\begin{aligned} s^2(\hat{\gamma}_{1,K-1}^{ML}) &= (1 + \hat{\gamma}_1^{ML} \hat{V}_f^{-1} \hat{\gamma}_1^{ML}) \left( \hat{\beta}'_{K-1} [\hat{\Sigma}^{-1} - \hat{\Sigma}^{-1} \hat{G}_2 (\hat{G}'_2 \hat{\Sigma}^{-1} \hat{G}_2)^{-1} \hat{G}'_2 \hat{\Sigma}^{-1}] \hat{\beta}_{K-1} \right)^{-1} + \hat{\sigma}_{f,K-1}^2 \\ &= \left( \frac{\hat{\gamma}_{1,K-1}^{ML}}{\hat{\sigma}_{f,K-1}} \right)^2 \left( \hat{\beta}'_{K-1} [\hat{\Sigma}^{-1} - \hat{\Sigma}^{-1} \hat{G}_2 (\hat{G}'_2 \hat{\Sigma}^{-1} \hat{G}_2)^{-1} \hat{G}'_2 \hat{\Sigma}^{-1}] \hat{\beta}_{K-1} \right)^{-1} + O_p(T^{\frac{1}{2}}) \end{aligned} \quad (\text{A.18})$$

by using the fact that  $\hat{\gamma}_{1,i}^{ML} = O_p(1)$  for  $i = 1, \dots, K-2$  and  $\hat{\gamma}_{1,K-1}^{ML} = O_p(T^{\frac{1}{2}})$ . It follows that

$$\begin{aligned} t^2(\hat{\gamma}_{1,K-1}^{ML}) &= \frac{T(\hat{\gamma}_{1,K-1}^{ML})^2 \hat{\beta}'_{K-1} [\hat{\Sigma}^{-1} - \hat{\Sigma}^{-1} \hat{G}_2 (\hat{G}'_2 \hat{\Sigma}^{-1} \hat{G}_2)^{-1} \hat{G}'_2 \hat{\Sigma}^{-1}] \hat{\beta}_{K-1}}{(\hat{\gamma}_{1,K-1}^{ML} / \hat{\sigma}_{f,K-1})^2} + O_p(T^{-\frac{1}{2}}) \\ &= u' [I_N - \hat{\Sigma}^{-\frac{1}{2}} \hat{G}_2 (\hat{G}'_2 \hat{\Sigma}^{-1} \hat{G}_2)^{-1} \hat{G}'_2 \hat{\Sigma}^{-\frac{1}{2}}] u + O_p(T^{-\frac{1}{2}}) \\ &\xrightarrow{d} u' [I_N - \Sigma^{-\frac{1}{2}} G_2 (G'_2 \Sigma^{-1} G_2)^{-1} G'_2 \Sigma^{-\frac{1}{2}}] u \sim \chi_{N-K+1}^2. \end{aligned} \quad (\text{A.19})$$

For the limiting distributions of  $t(\hat{\gamma}_0^{ML})$  and  $t(\hat{\gamma}_{1,i}^{ML})$ ,  $i = 1, \dots, K-2$ , we use the formula for the inverse of a partitioned matrix to obtain the upper left  $(K-1) \times (K-1)$  block of  $(\hat{B}'_1 \hat{\Sigma}^{-1} \hat{B}_1)^{-1}$  as

$$\begin{aligned} &(\hat{G}'_2 \hat{\Sigma}^{-1} \hat{G}_2)^{-1} + \frac{(\hat{G}'_2 \hat{\Sigma}^{-1} \hat{G}_2)^{-1} \hat{G}'_2 \hat{\Sigma}^{-1} \hat{\beta}_{K-1} \hat{\beta}'_{K-1} \hat{\Sigma}^{-1} \hat{G}_2 (\hat{G}'_2 \hat{\Sigma}^{-1} \hat{G}_2)^{-1}}{\hat{\beta}'_{K-1} \hat{\Sigma}^{-1} \hat{\beta}_{K-1} - \hat{\beta}'_{K-1} \hat{\Sigma}^{-1} \hat{G}_2 (\hat{G}'_2 \hat{\Sigma}^{-1} \hat{G}_2)^{-1} \hat{G}'_2 \hat{\Sigma}^{-1} \hat{\beta}_{K-1}} \\ &= (G'_2 \Sigma^{-1} G_2)^{-1} + \frac{(G'_2 \Sigma^{-1} G_2)^{-1} G'_2 \Sigma^{-\frac{1}{2}} u u' \Sigma^{-\frac{1}{2}} G_2 (G'_2 \Sigma^{-1} G_2)^{-1}}{u' [I_N - \Sigma^{-\frac{1}{2}} G_2 (G'_2 \Sigma^{-1} G_2)^{-1} G'_2 \Sigma^{-\frac{1}{2}}] u} + O_p(T^{-\frac{1}{2}}). \end{aligned} \quad (\text{A.20})$$

Note that we can write

$$I_N - \Sigma^{-\frac{1}{2}} G_1 (G'_1 \Sigma^{-1} G_1)^{-1} G'_1 \Sigma^{-\frac{1}{2}} = I_N - \Sigma^{-\frac{1}{2}} G_2 (G'_2 \Sigma^{-1} G_2)^{-1} G'_2 \Sigma^{-\frac{1}{2}} - h h', \quad (\text{A.21})$$

where

$$h = \frac{[I_N - \Sigma^{-\frac{1}{2}}G_2(G'_2\Sigma^{-1}G_2)^{-1}G'_2\Sigma^{-\frac{1}{2}}]\Sigma^{-\frac{1}{2}}\alpha}{\left(\alpha'\Sigma^{-\frac{1}{2}}[I_N - \Sigma^{-\frac{1}{2}}G_2(G'_2\Sigma^{-1}G_2)^{-1}G'_2\Sigma^{-\frac{1}{2}}]\Sigma^{-\frac{1}{2}}\alpha\right)^{\frac{1}{2}}}. \quad (\text{A.22})$$

With this expression, we can write

$$\begin{aligned} u'[I_N - \Sigma^{-\frac{1}{2}}G_2(G'_2\Sigma^{-1}G_2)^{-1}G'_2\Sigma^{-\frac{1}{2}}]u &= u'[I_N - \Sigma^{-\frac{1}{2}}G_1(G'_1\Sigma^{-1}G_1)^{-1}G'_1\Sigma^{-\frac{1}{2}}]u + (h'u)^2 \\ &= x + \tilde{z}_2^2, \end{aligned} \quad (\text{A.23})$$

where  $x \sim \chi_{N-K}^2$  and it is independent of  $\tilde{z}_2 \sim \mathcal{N}(0, 1)$ . To establish the last equality, we need to show that  $h'u = \tilde{z}_2$ . Denote by  $\boldsymbol{\iota}_{m,i}$  an  $m$ -vector with its  $i$ -th element equals to one and zero elsewhere, and let  $\sigma_{ij} \equiv \text{Cov}[z_i, z_j] = \boldsymbol{\iota}'_{K,i}(G'_1\Sigma^{-1}G_1)^{-1}\boldsymbol{\iota}_{K,j}/\sigma_{f,K-1}^2$ . Using the formula for the inverse of a partitioned matrix, we obtain

$$\begin{aligned} z_2 &= \frac{1}{\sigma_{f,K-1}}\boldsymbol{\iota}'_{K,2}(G_1^{-1}G_1)^{-1}G_1^{-\frac{1}{2}}u \\ &= \frac{1}{\sigma_{f,K-1}}\frac{\alpha'^{-\frac{1}{2}}[I_N - \Sigma^{-\frac{1}{2}}G_2(G'_2\Sigma^{-1}G_2)^{-1}G'_2\Sigma^{-\frac{1}{2}}]u}{\alpha'\Sigma^{-\frac{1}{2}}[I_N - \Sigma^{-\frac{1}{2}}G_2(G'_2\Sigma^{-1}G_2)^{-1}G'_2\Sigma^{-\frac{1}{2}}]\Sigma^{-\frac{1}{2}}\alpha}. \end{aligned} \quad (\text{A.24})$$

It follows that

$$\sigma_2^2 = \frac{1}{\sigma_{f,K-1}^2\alpha'\Sigma^{-\frac{1}{2}}[I_N - \Sigma^{-\frac{1}{2}}G_2(G'_2\Sigma^{-1}G_2)^{-1}G'_2\Sigma^{-\frac{1}{2}}]\Sigma^{-\frac{1}{2}}\alpha} \quad (\text{A.25})$$

and  $h'u = \tilde{z}_2$ .

Denote by  $w_i$  the  $i$ -th diagonal element of  $(\hat{B}_1\hat{\Sigma}^{-1}\hat{B}_1)^{-1}$ ,  $i = 1, \dots, K-1$ . Using (A.20), we have

$$\begin{aligned} w_i &\stackrel{d}{\rightarrow} \boldsymbol{\iota}'_{K-1,i}(G'_2\Sigma^{-1}G_2)^{-1}\boldsymbol{\iota}_{K-1,i} + \frac{\boldsymbol{\iota}'_{K-1,i}(G'_2\Sigma^{-1}G_2)^{-1}G'_2\Sigma^{-\frac{1}{2}}uu'\Sigma^{-\frac{1}{2}}G_2(G'_2\Sigma^{-1}G_2)^{-1}\boldsymbol{\iota}_{K-1,i}}{x + \tilde{z}_2^2} \\ &= \boldsymbol{\iota}'_{K-1,i}(G'_2\Sigma^{-1}G_2)^{-1}\boldsymbol{\iota}_{K-1,i} \left(1 + \frac{q_i^2}{x + \tilde{z}_2^2}\right), \end{aligned} \quad (\text{A.26})$$

where

$$q_i = \frac{\boldsymbol{\iota}'_{K-1,i}(G'_2\Sigma^{-1}G_2)^{-1}G'_2\Sigma^{-\frac{1}{2}}u}{[\boldsymbol{\iota}'_{K-1,i}(G'_2\Sigma^{-1}G_2)^{-1}\boldsymbol{\iota}_{K-1,i}]^{\frac{1}{2}}} \sim \mathcal{N}(0, 1). \quad (\text{A.27})$$

Using the fact that  $\text{Var}[u] = I_N$  and

$$(G'_1\Sigma^{-1}G_1)^{-1}G'_1\Sigma^{-1}G_2 = [\boldsymbol{\iota}_{K,1}, \boldsymbol{\iota}_{K,3}, \dots, \boldsymbol{\iota}_{K,K}], \quad (\text{A.28})$$



it is straightforward to show that

$$\begin{aligned}\text{Cov}[z_1, q_1] &= \frac{\boldsymbol{\nu}'_{K,1}(G'_1\Sigma^{-1}G_1)^{-1}G'_1\Sigma^{-1}G_2(G'_2\Sigma^{-1}G_2)^{-1}\boldsymbol{\nu}_{K-1,1}}{\sigma_{f,K-1}[\boldsymbol{\nu}'_{K-1,1}(G'_2\Sigma^{-1}G_2)^{-1}\boldsymbol{\nu}_{K-1,1}]^{\frac{1}{2}}} \\ &= [\boldsymbol{\nu}'_{K-1,1}(G'_2\Sigma^{-1}G_2)^{-1}\boldsymbol{\nu}_{K-1,1}/\sigma_{f,K-1}^2]^{\frac{1}{2}},\end{aligned}\quad (\text{A.29})$$

$$\text{Cov}[z_2, q_1] = \frac{\boldsymbol{\nu}'_{K,2}(G'_1\Sigma^{-1}G_1)^{-1}G'_1\Sigma^{-1}G_2(G'_2\Sigma^{-1}G_2)^{-1}\boldsymbol{\nu}_{K-1,1}}{\sigma_{f,K-1}[\boldsymbol{\nu}'_{K-1,1}(G'_2\Sigma^{-1}G_2)^{-1}\boldsymbol{\nu}_{K-1,1}]^{\frac{1}{2}}} = 0. \quad (\text{A.30})$$

From the formula for the inverse of a partitioned matrix, we have

$$\frac{1}{\sigma_{f,K-1}^2}\boldsymbol{\nu}'_{K-1,1}(G'_2\Sigma^{-1}G_2)^{-1}\boldsymbol{\nu}_{K-1,1} = \sigma_1^2 - \frac{\sigma_{12}^2}{\sigma_2^2} = \sigma_1^2(1 - \rho_{12}^2). \quad (\text{A.31})$$

It follows that

$$\text{Cov}\left[z_1 - \frac{\sigma_{12}}{\sigma_2^2}z_2, q_1\right] = [\boldsymbol{\nu}'_{K-1,1}(G'_2\Sigma^{-1}G_2)^{-1}\boldsymbol{\nu}_{K-1,1}/\sigma_{f,K-1}^2]^{\frac{1}{2}} = \sigma_1\sqrt{1 - \rho_{12}^2}. \quad (\text{A.32})$$

Therefore,  $z_1 - (\sigma_{12}/\sigma_2^2)z_2$  is perfectly correlated with  $q_1$  and we can write

$$z_1 = \frac{\sigma_{12}}{\sigma_2^2}z_2 + \sqrt{1 - \rho_{12}^2}\sigma_1q_1 = \sigma_1\left(\rho_{12}\tilde{z}_2 + \sqrt{1 - \rho_{12}^2}q_1\right). \quad (\text{A.33})$$

Similarly,

$$z_{i+1} = \frac{\sigma_{i+1,2}}{\sigma_2^2}z_2 + \sqrt{1 - \rho_{i+1,2}^2}\sigma_{i+1}q_i = \sigma_{i+1}\left(\rho_{i+1,2}\tilde{z}_2 + \sqrt{1 - \rho_{i+1,2}^2}q_i\right), \quad i = 2, \dots, K-1. \quad (\text{A.34})$$

Let

$$b_i = \frac{x + \tilde{z}_2^2}{x + \tilde{z}_2^2 + q_i^2}, \quad i = 1, \dots, K-1. \quad (\text{A.35})$$

With the above results, we can now write the limiting distribution of the  $t$ -ratios as

$$\begin{aligned}t(\hat{\gamma}_0^{ML}) &\xrightarrow{d} -\frac{z_1|z_2|b_1^{\frac{1}{2}}}{z_2[\boldsymbol{\nu}'_{K-1,1}(G'_2\Sigma^{-1}G_2)^{-1}\boldsymbol{\nu}_{K-1,1}/\sigma_{f,K-1}^2]^{\frac{1}{2}}} \\ &= -\left(\frac{\rho_{12}|\tilde{z}_2|}{\sqrt{1 - \rho_{12}^2}} + q_1\right)b_1^{\frac{1}{2}},\end{aligned}\quad (\text{A.36})$$

$$\begin{aligned}t(\hat{\gamma}_{1,i}^{ML}) &\xrightarrow{d} \frac{\left(\mu_{f,i} - \frac{z_{i+2}}{z_2}\right)|z_2|b_{i+1}^{\frac{1}{2}}}{[\boldsymbol{\nu}'_{K-1,i+1}(G'_2\Sigma^{-1}G_2)^{-1}\boldsymbol{\nu}_{K-1,i+1}/\sigma_{f,K-1}^2]^{\frac{1}{2}}} \\ &= \left(\frac{\mu_{f,i}\sigma_2}{\sigma_{i+2}} - \rho_{i+2,2}\right)|\tilde{z}_2| - q_{i+1} \Big) b_{i+1}^{\frac{1}{2}}, \quad i = 1, \dots, K-2.\end{aligned}\quad (\text{A.37})$$

This completes the proof of part (b).

**part (c):** Let  $\hat{e} = \hat{\mu}_R - 1_N \hat{\gamma}_0^{ML} - \hat{\beta} \hat{\gamma}_1^{ML}$  and note that the fitted (model-implied) expected returns can be rewritten as

$$\begin{aligned}
\hat{\mu}_R^{ML} &= 1_N \hat{\gamma}_0^{ML} + \hat{\beta}^{ML} \hat{\gamma}_1^{ML} \\
&= 1_N \hat{\gamma}_0^{ML} + \hat{\beta} \hat{\gamma}_1^{ML} + \hat{e} \frac{\hat{\gamma}_1^{ML'} \hat{V}_f^{-1} \hat{\gamma}_1^{ML}}{1 + \hat{\gamma}_1^{ML'} \hat{V}_f^{-1} \hat{\gamma}_1^{ML}} \\
&= \hat{\mu}_R - \hat{e} + \hat{e} \frac{\hat{\gamma}_1^{ML'} \hat{V}_f^{-1} \hat{\gamma}_1^{ML}}{1 + \hat{\gamma}_1^{ML'} \hat{V}_f^{-1} \hat{\gamma}_1^{ML}} \\
&= \hat{\mu}_R - \hat{e} \frac{1}{1 + \hat{\gamma}_1^{ML'} \hat{V}_f^{-1} \hat{\gamma}_1^{ML}}. \tag{A.38}
\end{aligned}$$

Using the result from part (a) that  $\hat{\gamma}_{1,i}^{ML} = O_p(1)$  for  $i = 1, \dots, K-2$  and  $\hat{\gamma}_{1,K-1}^{ML} = O_p(T^{\frac{1}{2}})$ , we have

$$\hat{\gamma}_1^{ML'} \hat{V}_f^{-1} \hat{\gamma}_1^{ML} \rightarrow \infty \text{ as } T \rightarrow \infty. \tag{A.39}$$

Therefore, in misspecified and unidentified models, it follows that  $\hat{\mu}_R^{ML} \rightarrow \hat{\mu}_R$  and

$$R_{ML}^2 = \text{Corr}(\hat{\mu}_R^{ML}, \hat{\mu}_R)^2 \rightarrow 1 \tag{A.40}$$

as  $T \rightarrow \infty$ . This completes the proof of part (c).

**part (d):** Because  $B$  is of reduced rank due to the presence of a useless factor,  $\mathcal{CD}_1 \xrightarrow{d} \chi_{N-K}^2$ . From the numerical equivalence of  $\mathcal{S}$  and  $\mathcal{CD}_1$  in Lemma 1, it follows that  $\mathcal{S} \xrightarrow{d} \chi_{N-K}^2$  even though the model is misspecified. This completes the proof of part (d).

### A.3 Proof of Theorem 2

It follows from Lemma 1 that the  $\mathcal{S}$  test is asymptotically distributed as  $T$  times the smallest eigenvalue of

$$\tilde{\Omega} = (X'X/T) \hat{B}' P_1 (P_1' \hat{\Sigma} P_1)^{-1} P_1' \hat{B}. \tag{A.41}$$

Let  $L_f$  be a lower triangular matrix such that  $L_f L_f' = V_f$  and define

$$L = \begin{bmatrix} 1 & 0'_{K-1} \\ \mu_f & L_f \end{bmatrix}. \tag{A.42}$$

Using that  $(X'X)/T \rightarrow LL'$  and  $\hat{\Sigma} \rightarrow \Sigma$ , the  $\mathcal{S}$  test has the same distribution as the smallest eigenvalue of

$$W_0 = TLL'\hat{B}'P_1(P_1'\Sigma P_1)^{-1}P_1'\hat{B}. \quad (\text{A.43})$$

Let  $\tilde{P}_1$  be an  $N \times (N-1)$  orthonormal matrix such that  $\tilde{P}_1'\Sigma^{-\frac{1}{2}}\mathbf{1}_N = \mathbf{0}_{N-1}$ . Then, we have

$$P_1(P_1'\Sigma P_1)^{-1}P_1' = \Sigma^{-\frac{1}{2}}\tilde{P}_1\tilde{P}_1'\Sigma^{-\frac{1}{2}} \quad (\text{A.44})$$

and

$$W_0 = TLL'\hat{B}'\Sigma^{-\frac{1}{2}}\tilde{P}_1\tilde{P}_1'\Sigma^{-\frac{1}{2}}\hat{B}. \quad (\text{A.45})$$

Define

$$Z = \sqrt{T}\tilde{P}_1'\Sigma^{-\frac{1}{2}}\hat{B}L \quad (\text{A.46})$$

and

$$M = E[Z] = \sqrt{T}\tilde{P}_1'\Sigma^{-\frac{1}{2}}BL. \quad (\text{A.47})$$

Then, under Assumptions 1 and 3,

$$\text{vec}(Z) \sim \mathcal{N}(\text{vec}(M), I_{(N-1)K}). \quad (\text{A.48})$$

Since  $W_0$  and  $Z'Z$  share the same eigenvalues, the smallest eigenvalue of  $W_0$  has the same limiting distribution as the smallest eigenvalue of  $W_1 = Z'Z \sim \mathcal{W}_K(N-1, I_K, M'M)$ , which has a noncentral Wishart distribution. Since  $B$  has rank  $K-r$ , there exists a  $K \times r$  orthonormal matrix  $C_1$  such that  $MC_1 = \mathbf{0}_{(N-1) \times r}$ . Let  $C = [C_1, C_2]$  be a  $K \times K$  orthonormal matrix, and define  $\tilde{Z} = [\tilde{Z}_1, \tilde{Z}_2] = [ZC_1, ZC_2]$ . We then have  $E[\tilde{Z}_1] = \mathbf{0}_{(N-1) \times r}$  and  $E[\tilde{Z}_2] \equiv \tilde{M}_2 = MC_2$ . Using the fact that  $W_1 = Z'Z$  and  $W_2 = \tilde{Z}'\tilde{Z}$  share the same eigenvalues, it is sufficient to obtain the limiting distribution of the smallest eigenvalue of  $W_2$  which is equal to the reciprocal of the largest eigenvalue of

$$W_2^{-1} = \begin{bmatrix} W_2^{11} & W_2^{12} \\ W_2^{21} & W_2^{22} \end{bmatrix}. \quad (\text{A.49})$$

Using the formula for the inverse of a partitioned matrix, we have

$$W_2^{11} = \left( \tilde{Z}_1'[I_{N-1} - \tilde{Z}_2(\tilde{Z}_2'\tilde{Z}_2)^{-1}\tilde{Z}_2']\tilde{Z}_1 \right)^{-1} \sim \mathcal{W}_r(N-K-1+r, I_r)^{-1}, \quad (\text{A.50})$$

$$W_2^{12} = -W_2^{11}\tilde{Z}_1'\tilde{Z}_2(\tilde{Z}_2'\tilde{Z}_2)^{-1} = O_p(T^{-\frac{1}{2}}), \quad (\text{A.51})$$

$$W_2^{22} = (\tilde{Z}_2'\tilde{Z}_2)^{-1} + (\tilde{Z}_2'\tilde{Z}_2)^{-1}(\tilde{Z}_2'\tilde{Z}_1)W_2^{11}(\tilde{Z}_1'\tilde{Z}_2)(\tilde{Z}_2'\tilde{Z}_2)^{-1} = O_p(T^{-1}). \quad (\text{A.52})$$

Therefore, the limiting distribution of the largest eigenvalue of  $W_2^{-1}$  is the same as the limiting distribution of the largest eigenvalue of  $W_2^{11}$ . Equivalently, the smallest eigenvalue of  $T\tilde{\Omega}$  has the same limiting distribution as the smallest eigenvalue of  $W \sim \mathcal{W}_r(N - K - 1 + r, I_r)$ .

We now show that  $\Pr[w_r < a] \geq \Pr[x < a]$ , where  $w_r$  is the smallest eigenvalue of  $W$  and  $x \sim \chi_{N-K}^2$ . By the Bartlett decomposition of a Wishart matrix, we can write

$$W = \begin{bmatrix} W_1 & W_1^{\frac{1}{2}} z \\ z' W_1^{\frac{1}{2}} & x + z' z \end{bmatrix}, \quad (\text{A.53})$$

where  $W_1 \sim \mathcal{W}_{r-1}(N - K - 2 + r, I_{r-1})$ ,  $z \sim \mathcal{N}(0_{r-1}, I_{r-1})$ , and they are independent of each other and  $x$ . Using the fact that the eigenvalues of  $W$  are the same as the reciprocal of the eigenvalues of  $W^{-1}$ , it follows that

$$w_r = \min_{\omega: \omega' \omega = 1} \omega' W \omega = \left( \max_{\omega: \omega' \omega = 1} \omega' W^{-1} \omega \right)^{-1} \leq ([0'_{r-1}, 1] W^{-1} [0'_{r-1}, 1]')^{-1} = x \sim \chi_{N-K}^2. \quad (\text{A.54})$$

This completes the proof.

#### A.4 Proof of Lemma 2

Let  $H_t = [1_N, D_t]$ ,  $\hat{H} = \frac{1}{T} \sum_{t=1}^T H_t = [1_N, \hat{D}]$ ,  $\hat{V}_h = \frac{1}{T} \sum_{t=1}^T \text{vec}(H_t - \hat{H}) \text{vec}(H_t - \hat{H})'$ , and  $Q(\lambda) = [-1, \lambda'] \otimes I_N$ . We then have

$$e_t(\lambda) = Q(\lambda) \text{vec}(H_t), \quad (\text{A.55})$$

$$\hat{W}_e(\lambda) = Q(\lambda) \hat{V}_h Q(\lambda)' = (\lambda' \otimes I_N) \hat{V}_d (\lambda \otimes I_N), \quad (\text{A.56})$$

and

$$\mathcal{J}(\lambda) = T(\hat{D}\lambda - 1_N)' [(\lambda' \otimes I_N) \hat{V}_d (\lambda \otimes I_N)]^{-1} (\hat{D}\lambda - 1_N). \quad (\text{A.57})$$

Let  $P = [1_N/\sqrt{N}, P_1]$  be an orthonormal matrix. We can then write

$$\begin{aligned} \mathcal{J}(\lambda) &= T(\hat{D}\lambda - 1_N)' [(\lambda' \otimes I_N) \hat{V}_d (\lambda \otimes I_N)]^{-1} (\hat{D}\lambda - 1_N) \\ &= T(\hat{D}\lambda - 1_N)' P (P' \hat{W}_e(\lambda) P)^{-1} P' (\hat{D}\lambda - 1_N) \\ &= T \begin{bmatrix} \frac{1'_N(\hat{D}\lambda - 1_N)}{\sqrt{N}} \\ P'_1 \hat{D}\lambda \end{bmatrix}' \begin{bmatrix} \frac{1'_N \hat{W}_e(\lambda) 1_N}{N} & \frac{1'_N \hat{W}_e(\lambda) P_1}{\sqrt{N}} \\ \frac{P'_1 \hat{W}_e(\lambda) 1_N}{\sqrt{N}} & P'_1 \hat{W}_e(\lambda) P_1 \end{bmatrix}^{-1} \begin{bmatrix} \frac{1'_N(\hat{D}\lambda - 1_N)}{\sqrt{N}} \\ P'_1 \hat{D}\lambda \end{bmatrix}. \end{aligned} \quad (\text{A.58})$$

Denote the matrix in the middle as

$$A \equiv \begin{bmatrix} \frac{1'_N \hat{W}_e(\lambda) 1_N}{N} & \frac{1'_N \hat{W}_e(\lambda) P_1}{\sqrt{N}} \\ \frac{P'_1 \hat{W}_e(\lambda) 1_N}{\sqrt{N}} & P'_1 \hat{W}_e(\lambda) P_1 \end{bmatrix} = \begin{bmatrix} A_{11} & A_{12} \\ A_{21} & A_{22} \end{bmatrix}. \quad (\text{A.59})$$

Using the following formula for the inverse of a partitioned matrix

$$A^{-1} = \begin{bmatrix} 0 & 0'_{N-1} \\ 0_{N-1} & A_{22}^{-1} \end{bmatrix} + \frac{1}{A_{11} - A_{12} A_{22}^{-1} A_{21}} \begin{bmatrix} -1 \\ A_{22}^{-1} A_{21} \end{bmatrix} \begin{bmatrix} -1 \\ A_{22}^{-1} A_{21} \end{bmatrix}', \quad (\text{A.60})$$

we obtain

$$\mathcal{J}(\lambda) = \mathcal{CD}_2(\lambda) + \frac{T}{N(A_{11} - A_{12} A_{22}^{-1} A_{21})} [1'_N \hat{W}_e(\lambda)^{-1} P_1 (P'_1 \hat{W}_e(\lambda)^{-1} P_1)^{-1} P'_1 \hat{D} \lambda - 1'_N (\hat{D} \lambda - 1_N)]^2, \quad (\text{A.61})$$

where

$$\mathcal{CD}_2(\lambda) = T \lambda' \hat{D}' P_1 [(\lambda' \otimes P'_1) \hat{V}_d(\lambda \otimes P_1)]^{-1} P'_1 \hat{D} \lambda. \quad (\text{A.62})$$

The above identity suggests that  $\mathcal{J}(\lambda) \leq \mathcal{CD}_2(\lambda)$ , with the equality holding if and only if

$$1'_N \hat{W}_e(\lambda)^{-1} P_1 (P'_1 \hat{W}_e(\lambda)^{-1} P_1)^{-1} P'_1 \hat{D} \lambda = 1'_N (\hat{D} \lambda - 1_N). \quad (\text{A.63})$$

Note that  $\mathcal{CD}_2(\lambda)$  is invariant to multiplying  $\lambda$  by a nonzero constant and, hence, we can only identify the  $\lambda$  that minimizes  $\mathcal{CD}_2(\lambda)$  up to a scalar multiple. Consider the following normalization:

$$\hat{c} = \operatorname{argmin}_{c: c'c=1} \mathcal{CD}_2(c). \quad (\text{A.64})$$

We then have

$$\mathcal{CD}_2 \equiv \mathcal{CD}_2(\hat{c}) = \mathcal{CD}_2(a\hat{c}) \geq \mathcal{J}(a\hat{c}) \quad (\text{A.65})$$

for any nonzero scalar  $a$ . To satisfy the equality in (A.63), we need to set  $a$  equal to

$$\hat{a} = \frac{N}{[1_N - P_1 (P'_1 \hat{W}_e(\hat{c}) P_1)^{-1} P'_1 \hat{W}_e(\hat{c}) 1_N]' \hat{D} \hat{c}} = \frac{1'_N \hat{W}_e(\hat{c})^{-1} 1_N}{1'_N \hat{W}_e(\hat{c})^{-1} \hat{D} \hat{c}}, \quad (\text{A.66})$$

where the last equality follows from

$$\begin{aligned} 1_N - P_1 (P'_1 \hat{W}_e(\hat{c}) P_1)^{-1} P'_1 \hat{W}_e(\hat{c}) 1_N &= \hat{W}_e(\hat{c})^{-\frac{1}{2}} [I_N - \hat{W}_e(\hat{c})^{\frac{1}{2}} P_1 (P'_1 \hat{W}_e(\hat{c}) P_1)^{-1} P'_1 \hat{W}_e(\hat{c})^{\frac{1}{2}}] \hat{W}_e(\hat{c})^{\frac{1}{2}} 1_N \\ &= \hat{W}_e(\hat{c})^{-\frac{1}{2}} [\hat{W}_e(\hat{c})^{-\frac{1}{2}} 1_N (1'_N \hat{W}_e(\hat{c})^{-1} 1_N)^{-1} 1'_N \hat{W}_e(\hat{c})^{-\frac{1}{2}}] \hat{W}_e(\hat{c})^{\frac{1}{2}} 1_N \\ &= \frac{\hat{W}_e(\hat{c})^{-1} 1_N (1'_N 1_N)}{1'_N \hat{W}_e(\hat{c})^{-1} 1_N} \\ &= \frac{N \hat{W}_e(\hat{c})^{-1} 1_N}{1'_N \hat{W}_e(\hat{c})^{-1} 1_N}. \end{aligned} \quad (\text{A.67})$$

With this choice of  $a$ , we have  $\mathcal{J} \equiv \mathcal{J}(\hat{a}\hat{c}) = \mathcal{CD}_2 \leq \mathcal{J}(\lambda)$  and hence  $\hat{\lambda} = \hat{a}\hat{c}$ . This completes the proof.

## A.5 Proof of Theorem 3

**part (a):** We first perform an alternative parameterization of the problem. Let

$$g_t(c) = H_t \begin{bmatrix} c \\ 1 \end{bmatrix}. \quad (\text{A.68})$$

When the useless factor is ordered last, we have that  $E[R_t f_{t,K-1}] = \mu_R \mu_{f,K-1}$  and  $H[c^*, 1]' = 0_N$ , where

$$c^* = \begin{bmatrix} 0 \\ -\mu_{f,K-1} \\ 0_{K-2} \end{bmatrix}. \quad (\text{A.69})$$

Consider the CU-GMM estimator of  $c^*$ :

$$\hat{c} = \operatorname{argmin}_c \bar{g}(c)' \hat{W}_g(c)^{-1} \bar{g}(c), \quad (\text{A.70})$$

where  $\bar{g}(c) = \sum_{t=1}^T g_t(c)/T$  and

$$\hat{W}_g(c) = \frac{1}{T} \sum_{t=1}^T [g_t(c) - \bar{g}(c)][g_t(c) - \bar{g}(c)]'. \quad (\text{A.71})$$

The asymptotic distribution of  $\hat{c}$  is given by

$$\sqrt{T}(\hat{c} - c^*) \xrightarrow{d} \mathcal{N}(0_K, (H_1' S_g^{-1} H_1)^{-1}), \quad (\text{A.72})$$

where  $D_1$  denotes the first  $K - 1$  columns of  $D$ ,  $H_1 = [1_N, D_1]$ ,

$$S_g = E[g_t(c^*)g_t(c^*)'] = E[R_t R_t' (f_{t,K-1} - \mu_{f,K-1})^2] = U \sigma_{f,K-1}^2, \quad (\text{A.73})$$

and  $U = E[R_t R_t']$ . Let  $\hat{H}_1 = [1_N, \hat{D}_1]$  and  $\hat{d}_K$  be the last column of  $\hat{D}$ . Note that  $\hat{c}$  has the same asymptotic distribution as the estimator

$$\tilde{c} = (\hat{H}_1' \hat{U}^{-1} \hat{H}_1)^{-1} \hat{H}_1' \hat{U}^{-1} \hat{d}_K. \quad (\text{A.74})$$

Let

$$z \sim \mathcal{N}(0_K, \sigma_{f,K-1}^2 (H_1' U^{-1} H_1)^{-1}). \quad (\text{A.75})$$

Then, we have

$$\sqrt{T}\hat{c}_1 \xrightarrow{d} z_1, \quad (\text{A.76})$$

$$\sqrt{T}(\hat{c}_2 + \mu_{f,K-1}) \xrightarrow{d} z_2, \quad (\text{A.77})$$

$$\sqrt{T}\hat{c}_i \xrightarrow{d} z_i, \quad i = 3, \dots, K. \quad (\text{A.78})$$

Due to the invariance property of CU-GMM, we know that  $[-1, \hat{\lambda}']$  is proportional to  $[\mathcal{C}', 1]$ . It then follows that

$$\hat{\lambda}_0 = -\frac{\hat{c}_2}{\hat{c}_1}, \quad (\text{A.79})$$

$$\hat{\lambda}_{1,i} = -\frac{\hat{c}_{i+2}}{\hat{c}_1}, \quad i = 1, \dots, K-2, \quad (\text{A.80})$$

$$\hat{\lambda}_{1,K-1} = -\frac{1}{\hat{c}_1}. \quad (\text{A.81})$$

Therefore, the limiting distributions of the  $K-1$  elements of  $\hat{\lambda}_1$  are given by

$$\hat{\lambda}_{1,i} \xrightarrow{d} -\frac{z_{i+2}}{z_1}, \quad i = 1, \dots, K-2, \quad (\text{A.82})$$

$$\frac{\hat{\lambda}_{1,K-1}}{\sqrt{T}} \xrightarrow{d} -\frac{1}{z_1}. \quad (\text{A.83})$$

The limiting distribution of  $\hat{\lambda}_0$  depends on whether  $\mu_{f,K-1} = 0$ . If  $\mu_{f,K-1} = 0$ , we have  $\hat{\lambda}_0 \xrightarrow{d} -z_2/z_1$ . If  $\mu_{f,K-1} \neq 0$ , we have  $\hat{\lambda}_0/\sqrt{T} \xrightarrow{d} \mu_{f,K-1}/z_1$ . This completes the proof of part (a).

**part (b):** It is easy to show that

$$\sigma_1^2 = \frac{\sigma_{f,K-1}^2}{1'_N[U^{-1} - U^{-1}D_1(D'_1U^{-1}D_1)^{-1}D'_1U^{-1}]1_N} = \frac{\sigma_{f,K-1}^2}{\delta^2}, \quad (\text{A.84})$$

where  $\delta$  is the HJ-distance of the misspecified model. Then,

$$\frac{\hat{\lambda}_{1,K-1}}{\sqrt{T}} \xrightarrow{d} -\frac{1}{\sigma_1\tilde{z}_1} = -\frac{\delta}{\sigma_{f,K-1}\tilde{z}_1}, \quad (\text{A.85})$$

where  $\tilde{z}_1 = z_1/\sigma_1 \sim \mathcal{N}(0, 1)$ . In addition, using the same proof as in Theorem 1 part (b), we can write

$$z_{i+1} = \sigma_{i+1} \left( \rho_{1,i+1}\tilde{z}_1 + \sqrt{1 - \rho_{1,i+1}^2}q_{i+1} \right), \quad (\text{A.86})$$

where  $q_{i+1} \sim \mathcal{N}(0, 1)$  and it is independent of  $\tilde{z}_1$ .

Using the fact that

$$\frac{e_t(\hat{\lambda})}{\sqrt{T}} = -\frac{R_t(f_{t,K-1} - \mu_{f,K-1})}{z_1} + O_p(T^{-\frac{1}{2}}), \quad (\text{A.87})$$

we can show that

$$\frac{\hat{W}_e(\hat{\lambda})}{T} = \frac{\sigma_{f,K-1}^2}{z_1^2} U + o_p(1). \quad (\text{A.88})$$

This allows us to show that the squared  $t$ -ratio of  $\hat{\lambda}_{1,K-1}$  can be expressed as

$$t^2(\hat{\lambda}_{1,K-1}) = \frac{T\hat{\lambda}_{1,K-1}^2}{\boldsymbol{\iota}'_{K,K}(\hat{D}'\hat{W}_e(\hat{\lambda})^{-1}\hat{D})^{-1}\boldsymbol{\iota}_{K,K}} = \frac{T\hat{d}'_K[U^{-1} - U^{-1}D_1(D'_1U^{-1}D_1)^{-1}D'_1U^{-1}]\hat{d}_K}{\sigma_{f,K-1}^2} + o_p(1). \quad (\text{A.89})$$

Since  $\sqrt{T}U^{-\frac{1}{2}}(\hat{d}_K - \mu_{R\mu_{f,K-1}})/\sigma_{f,K-1} \xrightarrow{d} \mathcal{N}(0_N, I_N)$  and  $\mu_{R\mu_{f,K-1}} = D_1[\mu_{f,K-1}, \mathbf{0}'_{K-2}]'$ , we have

$$\frac{1}{\sigma_{f,K-1}}\sqrt{T}P'_U U^{-\frac{1}{2}}\hat{d}_K \xrightarrow{d} \mathcal{N}(0_{N-K+1}, I_{N-K+1}), \quad (\text{A.90})$$

where  $P_U$  is an  $N \times (N - K + 1)$  orthonormal matrix with its columns orthogonal to  $U^{-\frac{1}{2}}D_1$ . It then follows that

$$t^2(\hat{\lambda}_{1,K-1}) \xrightarrow{d} \chi_{N-K+1}^2. \quad (\text{A.91})$$

For the derivation of the limiting distributions for  $t(\hat{\lambda}_0)$  and  $t(\hat{\lambda}_{1,i})$  ( $i = 1, \dots, K - 2$ ), we use the identity

$$I_N - U^{-\frac{1}{2}}H_1(H'_1U^{-1}H_1)^{-1}H'_1U^{-\frac{1}{2}} = I_N - U^{-\frac{1}{2}}D_1(D'_1U^{-1}D_1)^{-1}D'_1U^{-\frac{1}{2}} - hh', \quad (\text{A.92})$$

where

$$h = \frac{[I_N - U^{-\frac{1}{2}}D_1(D'_1U^{-1}D_1)^{-1}D'_1U^{-\frac{1}{2}}]U^{-\frac{1}{2}}\mathbf{1}_N}{\delta} = \frac{P_U P'_U U^{-\frac{1}{2}}\mathbf{1}_N}{\delta} \quad (\text{A.93})$$

and  $h'h = 1$ . Note that

$$\sqrt{T}h'U^{-\frac{1}{2}}\hat{d}_K/\sigma_{f,K-1} = \sqrt{T}\mathbf{1}'_N U^{-\frac{1}{2}}P_U P'_U U^{-\frac{1}{2}}\hat{d}_K/(\sigma_{f,K-1}\delta) \xrightarrow{d} \tilde{z}_1 \sim \mathcal{N}(0, 1), \quad (\text{A.94})$$

$$T\hat{d}'_K[I_N - U^{-\frac{1}{2}}H_1(H'_1U^{-1}H_1)^{-1}H'_1U^{-\frac{1}{2}}]\hat{d}_K/\sigma_{f,K-1}^2 \xrightarrow{d} x \sim \chi_{N-K}^2, \quad (\text{A.95})$$

and they are independent of each other. Using the formula for the inverse of a partitioned matrix, we can show that

$$\sigma_{f,K-1}^2 \boldsymbol{\iota}'_{K-1,i} (D'_1U^{-1}D_1)^{-1} \boldsymbol{\iota}_{K-1,i} = \sigma_{i+1}^2 - \frac{\sigma_{1,i+1}}{\sigma_1^2} = \sigma_{i+1}^2 (1 - \rho_{1,i+1}^2). \quad (\text{A.96})$$



In addition, we can easily show that for  $i = 2, \dots, K-1$

$$\frac{\sqrt{T}\boldsymbol{\nu}'_{K-1,i}(D'_1U^{-1}D_1)^{-1}D'_1U^{-1}\hat{d}_K}{\sigma_{f,K-1}[\boldsymbol{\nu}'_{K-1,i}(D'_1U^{-1}D_1)^{-1}\boldsymbol{\nu}_{K-1,i}]^{\frac{1}{2}}} \xrightarrow{d} q_{i+1} \sim \mathcal{N}(0, 1). \quad (\text{A.97})$$

For  $i = 1$ , the result depends on whether  $\mu_{f,K-1} = 0$ . If  $\mu_{f,K-1} = 0$ , we have  $\sqrt{T}U^{-\frac{1}{2}}\hat{d}_K/\sigma_{f,K-1} \xrightarrow{d} \mathcal{N}(0_N, I_N)$  and hence

$$\frac{\sqrt{T}\boldsymbol{\nu}'_{K-1,1}(D'_1U^{-1}D_1)^{-1}D'_1U^{-1}\hat{d}_K}{\sigma_{f,K-1}[\boldsymbol{\nu}'_{K-1,1}(D'_1U^{-1}D_1)^{-1}\boldsymbol{\nu}_{K-1,1}]^{\frac{1}{2}}} \xrightarrow{d} q_2 \sim \mathcal{N}(0, 1). \quad (\text{A.98})$$

If  $\mu_{f,K-1} \neq 0$ , we have  $\hat{d}_K \rightarrow \mu_R\mu_{f,K-1} = D_1[\mu_{f,K-1}, 0'_{K-2}]'$  and hence

$$\begin{aligned} \boldsymbol{\nu}'_{K-1,1}(D'_1U^{-1}D_1)^{-1}D'_1U^{-1}\hat{d}_K/\sigma_{f,K-1} &\rightarrow \boldsymbol{\nu}'_{K-1,1}(D'_1U^{-1}D_1)^{-1}D'_1U^{-1}D_1[\mu_{f,K-1}, 0'_{K-2}]'/\sigma_{f,K-1} \\ &= \mu_{f,K-1}/\sigma_{f,K-1}. \end{aligned} \quad (\text{A.99})$$

Note that the  $q_i$ 's are independent of  $\tilde{z}_1$  and  $x$ .

Consider the upper left  $(K-1) \times (K-1)$  submatrix of  $(\hat{D}'\hat{W}_e(\hat{\lambda})^{-1}\hat{D})^{-1}/T$ , which has the same limit as

$$\frac{\sigma_{f,K-1}^2}{z_1^2} \left[ (D'_1U^{-1}D_1)^{-1} + \frac{(D'_1U^{-1}D_1)^{-1}D'_1U^{-1}\hat{d}_K\hat{d}'_KU^{-1}D_1(D'_1U^{-1}D_1)^{-1}}{\hat{d}'_KU^{-\frac{1}{2}}[I_N - U^{-\frac{1}{2}}D_1(D'_1U^{-1}D_1)^{-1}D'_1U^{-\frac{1}{2}}]U^{-\frac{1}{2}}\hat{d}_K} \right]. \quad (\text{A.100})$$

In particular, for  $i = 2, \dots, K-1$ , the  $i$ -th diagonal element of this matrix has a limiting distribution

$$\frac{\sigma_{f,K-1}^2\boldsymbol{\nu}'_{K-1,i}(D'_1U^{-1}D_1)^{-1}\boldsymbol{\nu}_{K-1,i}}{z_1^2} \left( 1 + \frac{q_{i+1}^2}{x + \tilde{z}_1^2} \right) = \frac{\sigma_{i+1}^2(1 - \rho_{1,i+1}^2)}{z_1^2} \left( 1 + \frac{q_{i+1}^2}{x + \tilde{z}_1^2} \right). \quad (\text{A.101})$$

Let

$$b_{i+1} = \frac{x + \tilde{z}_1^2}{q_{i+1}^2 + x + \tilde{z}_1^2}. \quad (\text{A.102})$$

Then, we can write the limiting distribution of  $t(\hat{\lambda}_{1,i})$  for  $i = 1, \dots, K-2$  as

$$\begin{aligned} t(\hat{\lambda}_{1,i}) &\xrightarrow{d} -\frac{z_{i+2}/z_1}{\sigma_{i+2}\sqrt{1 - \rho_{1,i+2}^2}|z_1|b_{i+1}^{-\frac{1}{2}}} \\ &= -\frac{|\tilde{z}_1| \left( \rho_{1,i+2}\tilde{z}_1 + \sqrt{1 - \rho_{1,i+2}^2}q_{i+2} \right) b_{i+1}^{\frac{1}{2}}}{\tilde{z}_1 \sqrt{1 - \rho_{1,i+2}^2}} \\ &= -\left( \frac{\rho_{1,i+2}|\tilde{z}_1|}{\sqrt{1 - \rho_{1,i+2}^2}} + q_{i+2} \right) b_{i+1}^{\frac{1}{2}}. \end{aligned} \quad (\text{A.103})$$

The limiting distribution of  $t(\hat{\lambda}_0)$  depends on whether  $\mu_{f,K-1} = 0$ . If  $\mu_{f,K-1} = 0$ , we have a similar limiting expression

$$t(\hat{\lambda}_0) \xrightarrow{d} - \left( \frac{\rho_{1,2} |\tilde{z}_1|}{\sqrt{1 - \rho_{1,2}^2}} + q_2 \right) b_1^{\frac{1}{2}}. \quad (\text{A.104})$$

If  $\mu_{f,K-1} \neq 0$ , we have

$$t^2(\hat{\lambda}_0) \xrightarrow{d} \frac{\frac{\mu_{f,K-1}^2}{z_1^2}}{\frac{\sigma_{f,K-1}^2}{z_1^2} \left[ \frac{\mu_{f,K-1}^2}{\sigma_{f,K-1}^2 (x + z_1^2)} \right]} = x + z_1^2 \sim \chi_{N-K+1}^2. \quad (\text{A.105})$$

This completes the proof of part (b).

**part (c):** The proof follows similar arguments as the proof of part (c) in Theorem 1 by replacing the expression for  $\hat{\beta}^{ML}$  with the expression for  $\hat{\beta}^{CU}$  and, to conserve space, is omitted.

**part (d):** Because  $D$  is of reduced rank due to the presence of a useless factor,  $\mathcal{CD}_2 \xrightarrow{d} \chi_{N-K}^2$ . From the numerical equivalence of the  $\mathcal{J}$  and  $\mathcal{CD}_2$  tests in Lemma 2, we have  $\mathcal{J} \xrightarrow{d} \chi_{N-K}^2$  even when the model is misspecified. This completes the proof of part (d).

## A.6 Proof of Theorem 4

First, note that

$$\hat{B} = \hat{D} \left( \frac{X'X}{T} \right)^{-1} \quad (\text{A.106})$$

and the  $\mathcal{CD}_1$  specification test in Section 3.1 can be rewritten as

$$\mathcal{CD}_1 = T \min_c \frac{c' \hat{B}' P_1 (P_1' \hat{\Sigma} P_1)^{-1} P_1' \hat{B} c}{c' [(X'X/T)^{-1}] c} = T \min_c \frac{c' \hat{D}' P_1 (P_1' \hat{\Sigma} P_1)^{-1} P_1' \hat{D} c}{c' (X'X/T) c}. \quad (\text{A.107})$$

Also, recall that  $\mathcal{CD}_1$  is numerically equivalent to  $\mathcal{S}$  whose asymptotic distribution is presented in Theorem 2.

Using (A.106) and Assumption 3', we obtain

$$\sqrt{T} \text{vec}(P_1' \hat{D} - P_1' D) \xrightarrow{d} \mathcal{N} \left( 0_{(N-1)K}, E[x_t x_t'] \otimes P_1' \Sigma P_1 + (I_K \otimes P_1' B) V_x (I_K \otimes B' P_1) \right), \quad (\text{A.108})$$

where  $V_x$  is the asymptotic variance of  $\sqrt{T} \text{vec}((X'X)/T - E[x_t x_t'])$ . For any  $c$  such that  $P_1' D c = 0_{N-1}$ , we have

$$\sqrt{T} P_1' \hat{D} c \xrightarrow{d} \mathcal{N} \left( 0_{N-1}, c' E[x_t x_t'] c P_1' \Sigma P_1 \right) \quad (\text{A.109})$$

since

$$\lim_{T \rightarrow \infty} P_1' B \left( \frac{X'X}{T} \right) c = P_1' B E[x_t x_t'] c = P_1' D c = 0_{N-1}. \quad (\text{A.110})$$

Hence, under Assumption 3' and when  $H$  (or equivalently  $P_1' D$ ) has a reduced rank, we have

$$\begin{aligned} \mathcal{CD}_2 &= T \min_c (P_1' \hat{D} c)' [(c' \otimes P_1') \hat{V}_d (c \otimes P_1)]^{-1} (P_1' \hat{D} c) \\ &= T \min_c \frac{c' \hat{D}' P_1 (P_1' \hat{\Sigma} P_1)^{-1} P_1' \hat{D} c}{c' (X'X/T) c} + o_p(1) = \mathcal{CD}_1 + o_p(1). \end{aligned} \quad (\text{A.111})$$

Therefore, the  $\mathcal{J}$  test, which is numerically equivalent to the  $\mathcal{CD}_2$  test (see Lemma 2), shares the same asymptotic distribution of the  $\mathcal{S}$  test in Theorem 2. This completes the proof.

## A.7 Proof of Theorem 5

**part (a):** The proof closely follows the proof of part (b) of Theorem 3 in Gospodinov, Kan, and Robotti (2014b) and is provided here for completeness. Let  $\tilde{D} = V_R^{-\frac{1}{2}} D_1$ ,  $\tilde{1}_N = V_R^{-\frac{1}{2}} 1_N$ ,  $P_{\tilde{D}}$  be an  $N \times (N - K + 1)$  orthonormal matrix whose columns are orthogonal to  $\tilde{D}$  so that  $P_{\tilde{D}} P_{\tilde{D}}' = I_N - \tilde{D} (\tilde{D}' \tilde{D})^{-1} \tilde{D}'$ ,  $z \sim \mathcal{N}(0_N, I_N)$ , and  $w = P_{\tilde{D}}' z \sim \mathcal{N}(0_{N-K+1}, I_{N-K+1})$ . Using that (see Gospodinov, Kan, and Robotti, 2014b)

$$-\hat{V}_R^{-\frac{1}{2}} \bar{e}(\hat{\lambda}^{HJ}) \xrightarrow{d} P_{\tilde{D}} [I_{N-K+1} - w(w'w)^{-1} w'] P_{\tilde{D}}' \tilde{1}_N, \quad (\text{A.112})$$

the limiting distribution of  $\hat{\delta}^2$  is given by

$$\begin{aligned} \hat{\delta}^2 &\xrightarrow{d} \tilde{1}_N' P_{\tilde{D}} [I_{N-K+1} - w(w'w)^{-1} w'] P_{\tilde{D}}' \tilde{1}_N \\ &= (\tilde{1}_N' P_{\tilde{D}} P_{\tilde{D}}' \tilde{1}_N) \frac{w' [I_{N-K+1} - P_{\tilde{D}}' \tilde{1}_N (\tilde{1}_N' P_{\tilde{D}} P_{\tilde{D}}' \tilde{1}_N)^{-1} \tilde{1}_N' P_{\tilde{D}}] w}{w'w} = \delta^2 \mathcal{B}, \end{aligned} \quad (\text{A.113})$$

where

$$\mathcal{B} = \frac{w' [I_{N-K+1} - P_{\tilde{D}}' \tilde{1}_N (\tilde{1}_N' P_{\tilde{D}} P_{\tilde{D}}' \tilde{1}_N)^{-1} \tilde{1}_N' P_{\tilde{D}}] w}{w'w} \sim \text{Beta} \left( \frac{N-K}{2}, \frac{1}{2} \right) \quad (\text{A.114})$$

and it is independent of  $w$ .

Furthermore, the weights  $\psi_i$  for the weighted chi-squared distribution are asymptotically distributed as (Gospodinov, Kan, and Robotti, 2014b)

$$\frac{\psi_i}{T} \xrightarrow{d} \frac{\delta^2 (1 - \mathcal{B})}{w'w}. \quad (\text{A.115})$$

When comparing  $T\hat{\delta}^2$  with the distribution of  $\sum_{i=1}^{N-K} \psi_i x_i$ , we are effectively comparing  $\mathcal{B}$  with  $(1 - \mathcal{B})/(w'w)\chi_{N-K}^2$ , and we will reject  $H_0 : \delta^2 = 0$  when

$$w'w > \frac{p_\eta \mathcal{B}}{1 - \mathcal{B}}. \quad (\text{A.116})$$

Note that  $w'w \sim \chi_{N-K+1}^2$  and it is independent of  $\mathcal{B}$ , so the limiting probability of rejection for a test with size  $\eta$  is

$$\int_0^1 P \left[ \chi_{N-K+1}^2 > \frac{p_\eta s}{1-s} \right] f_{\mathcal{B}}(s) ds. \quad (\text{A.117})$$

This completes the proof of part (a).

**part (b):** In proving the result, it is useful to invoke the relationship between the CSR test and the GLS cross-sectional  $R^2$  (Kandel and Stambaugh, 1995) whose sample version is given by

$$R_{GLS}^2 = 1 - \frac{\mathcal{Q}}{\mathcal{Q}_0}, \quad (\text{A.118})$$

where  $\mathcal{Q}_0 = \hat{e}'_0 \hat{V}_R^{-1} \hat{e}_0$  and  $\hat{e}_0 = [I_N - 1_N(1'_N \hat{V}_R^{-1} 1_N)^{-1} 1'_N \hat{V}_R^{-1}] \hat{\mu}_R$ . Hence,

$$\mathcal{Q} = \mathcal{Q}_0(1 - R_{GLS}^2). \quad (\text{A.119})$$

Kan and Zhang (1999a) show that when the model is misspecified and unidentified (that is, one or more useless factors are present in the model), the asymptotic distribution of  $R_{GLS}^2$  has the form

$$R_{GLS}^2 \xrightarrow{d} 1 - \mathcal{B}, \quad (\text{A.120})$$

where  $\mathcal{B} \sim \text{Beta} \left( \frac{N-K}{2}, \frac{1}{2} \right)$ . Using that  $\mathcal{Q}_0 \rightarrow \tilde{\mathcal{Q}}_0 > 0$ , we have

$$\mathcal{Q} \xrightarrow{d} \tilde{\mathcal{Q}}_0 \mathcal{B}. \quad (\text{A.121})$$

Using similar arguments as in the proof of part (a), the limiting probability of rejection for the CSR test at the nominal level  $\eta$  is

$$\int_0^1 P \left[ \chi_{N-K+1}^2 > \frac{p_\eta s}{1-s} \right] f_{\mathcal{B}}(s) ds. \quad (\text{A.122})$$

This completes the proof of part (b).

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**Table I**  
**Test Statistics for Various Asset-Pricing Models**

The table reports test statistics for four asset-pricing models. CAPM, FF3, C-LAB, and CC-CAY denote the static CAPM and the models of Fama and French (1993), Jagannathan and Wang (1996), and Lettau and Ludvigson (2001), respectively. KP denotes the rank test of Kleibergen and Paap (2006). HJD and CSR denote the tests of correct model specification based on the distance measure of Hansen and Jagannathan (1997) and on the GLS cross-sectional regression test of Shanken (1985).  $\mathcal{J}$  denotes Hansen's (1982) test for over-identifying restrictions based on the CU-GMM estimator.  $\mathcal{S}$  denotes Shanken's (1985) Wald-type test of correct model specification based on the ML estimator.  $t_x$  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. Finally,  $R^2$  denotes the squared correlation coefficient between the fitted expected returns and the average realized returns. The models are estimated using monthly returns on the 25 Fama-French size and book-to-market ranked portfolios. The data are from February 1959 to December 2012 (647 observations).

Panel A: Rank, HJD, and CSR Tests				
	CAPM	FF3	C-LAB	CC-CAY
KP	136.16	87.69	23.26	10.78
( $p$ -value)	(0.0000)	(0.0000)	(0.3873)	(0.9778)
HJD	67.67	51.15	66.36	69.15
( $p$ -value)	(0.0000)	(0.0024)	(0.0000)	(0.0005)
CSR	69.96	53.00	68.60	70.56
( $p$ -value)	(0.0000)	(0.0020)	(0.0000)	(0.0005)
Panel B: CU-GMM				
	CAPM	FF3	C-LAB	CC-CAY
$\mathcal{J}$	64.58	45.10	20.58	10.57
( $p$ -value)	(0.0000)	(0.0017)	(0.4848)	(0.9705)
$t_{vw}$	4.29	3.92	-0.93	
$t_{smb}$		-4.23		
$t_{hml}$		-2.01		
$t_{labor}$			4.32	
$t_{prem}$			2.82	
$t_{cg}$				1.46
$t_{cay}$				0.85
$t_{cg-cay}$				-3.22
$R^2$	0.1999	0.7847	0.9595	0.9952
Panel C: ML				
	CAPM	FF3	C-LAB	CC-CAY
$\mathcal{S}$	67.66	49.06	23.10	11.58
( $p$ -value)	(0.0000)	(0.0005)	(0.3388)	(0.9503)
$t_{vw}$	-3.24	-3.43	-1.34	
$t_{smb}$		2.08		
$t_{hml}$		2.33		
$t_{labor}$			2.81	
$t_{prem}$			4.21	
$t_{cg}$				-0.90
$t_{cay}$				0.76
$t_{cg-cay}$				3.45
$R^2$	0.1346	0.7677	0.9997	0.9994

**Table II.a**  
**Rejection Rates of Specification Tests (SDF Setup)**

The table presents the rejection rates of specification tests under misspecified models.  $\mathcal{J}$  denotes Hansen's (1982) test for over-identifying restrictions based on the CU-GMM estimator. HJD denotes the Hansen and Jagannathan's (1997) distance test of correct model specification. The results are reported for different levels of significance (10%, 5%, and 1%) and for different values of the number of time series observations ( $T$ ) using 100,000 simulations, assuming that the returns are generated from a multivariate normal distribution with means and covariance matrix calibrated to the 25 size and book-to-market Fama-French portfolio returns for the period 1959:2–2012:12. The  $\mathcal{J}$  test statistic is compared with the critical values from a  $\chi^2_{N-K}$  distribution. The HJ-distance test is compared with the critical values from a weighted chi-squared distribution as in Jagannathan and Wang (1996). The rejection rates for the limiting case ( $T = \infty$ ) in Panels B and C are based on the results in part (d) of Theorem 3 and part (a) of Theorem 5.

$T$	$\mathcal{J}$ Test			HJD Test		
	10%	5%	1%	10%	5%	1%
Panel A: Model with a Useful Factor Only						
200	0.900	0.831	0.635	0.915	0.856	0.690
400	0.996	0.991	0.963	0.997	0.992	0.967
600	1.000	1.000	0.999	1.000	1.000	0.999
800	1.000	1.000	1.000	1.000	1.000	1.000
1000	1.000	1.000	1.000	1.000	1.000	1.000
3600	1.000	1.000	1.000	1.000	1.000	1.000
$\infty$	1.000	1.000	1.000	1.000	1.000	1.000
Panel B: Model with a Useless Factor Only						
200	0.130	0.063	0.011	0.877	0.810	0.637
400	0.118	0.058	0.011	0.976	0.961	0.910
600	0.113	0.057	0.011	0.990	0.984	0.965
800	0.111	0.055	0.011	0.994	0.990	0.979
1000	0.110	0.055	0.011	0.995	0.993	0.985
3600	0.103	0.052	0.010	0.998	0.997	0.995
$\infty$	0.100	0.050	0.010	0.999	0.998	0.997
Panel C: Model with a Useful and a Useless Factor						
200	0.101	0.046	0.006	0.829	0.747	0.548
400	0.111	0.054	0.009	0.963	0.940	0.864
600	0.110	0.054	0.010	0.985	0.976	0.950
800	0.108	0.054	0.010	0.991	0.986	0.971
1000	0.105	0.053	0.011	0.993	0.990	0.980
3600	0.102	0.051	0.010	0.997	0.997	0.993
$\infty$	0.100	0.050	0.010	0.999	0.998	0.996

**Table II.b**  
**Rejection Rates of Specification Tests (Beta-Pricing Setup)**

The table presents the rejection rates of specification tests under misspecified models.  $\mathcal{S}$  denotes Shanken's (1985) Wald-type test of correct model specification based on the ML estimator. CSR denotes Shanken's (1985) cross-sectional regression test of correct model specification based on the non-invariant GLS estimator. The results are reported for different levels of significance (10%, 5%, and 1%) and for different values of the number of time series observations ( $T$ ) using 100,000 simulations, assuming that the returns are generated from a multivariate normal distribution with means and covariance matrix calibrated to the 25 size and book-to-market Fama-French portfolio returns for the period 1959:2–2012:12. The  $\mathcal{S}$  test statistic is compared with the critical values from a  $\chi^2_{N-K}$  distribution. The CSR test is compared with the critical values from a weighted chi-squared distribution as shown in Section 4. The rejection rates for the limiting case ( $T = \infty$ ) in Panels B and C are based on the results in part (d) of Theorem 1 and part (b) of Theorem 5.

$T$	$\mathcal{S}$ Test			CSR Test		
	10%	5%	1%	10%	5%	1%
Panel A: Model with a Useful Factor Only						
200	0.914	0.857	0.697	0.920	0.864	0.703
400	0.997	0.992	0.968	0.997	0.993	0.970
600	1.000	1.000	0.999	1.000	1.000	0.999
800	1.000	1.000	1.000	1.000	1.000	1.000
1000	1.000	1.000	1.000	1.000	1.000	1.000
3600	1.000	1.000	1.000	1.000	1.000	1.000
$\infty$	1.000	1.000	1.000	1.000	1.000	1.000
Panel B: Model with a Useless Factor Only						
200	0.168	0.096	0.025	0.882	0.818	0.649
400	0.135	0.073	0.018	0.977	0.961	0.911
600	0.124	0.066	0.015	0.990	0.984	0.966
800	0.117	0.062	0.014	0.994	0.991	0.980
1000	0.114	0.060	0.013	0.996	0.993	0.985
3600	0.105	0.052	0.011	0.998	0.998	0.995
$\infty$	0.100	0.050	0.010	0.999	0.998	0.997
Panel C: Model with a Useful and a Useless Factor						
200	0.148	0.082	0.020	0.832	0.752	0.561
400	0.128	0.068	0.016	0.964	0.941	0.867
600	0.119	0.063	0.014	0.986	0.978	0.951
800	0.113	0.058	0.013	0.991	0.986	0.972
1000	0.112	0.057	0.012	0.993	0.990	0.980
3600	0.104	0.052	0.010	0.998	0.997	0.994
$\infty$	0.100	0.050	0.010	0.999	0.998	0.996

**Table III.a**  
**Empirical Distribution of the  $R^2$  Coefficient (CU-GMM)**

The table presents the empirical distribution of the pseudo- $R^2$  computed as the squared correlation between the realized and fitted expected returns based on the CU-GMM estimator. The results are based on 100,000 simulations, assuming that the returns are generated from a multivariate normal distribution with means and covariance matrix calibrated to the 25 size and book-to-market Fama-French portfolio returns for the period 1959:2–2012:12.

$T$	mean	std	1%	5%	10%	25%	50%	75%	90%	95%	99%
Panel A: Model with a Useful Factor Only											
200	0.298	0.247	0.000	0.003	0.012	0.073	0.251	0.483	0.669	0.755	0.871
400	0.237	0.204	0.000	0.002	0.010	0.056	0.188	0.378	0.543	0.628	0.757
600	0.214	0.181	0.000	0.003	0.011	0.058	0.176	0.335	0.481	0.563	0.692
800	0.203	0.164	0.000	0.004	0.013	0.063	0.171	0.311	0.443	0.518	0.638
1000	0.196	0.152	0.000	0.004	0.017	0.069	0.169	0.295	0.414	0.483	0.600
3600	0.172	0.089	0.012	0.041	0.062	0.105	0.164	0.230	0.293	0.332	0.404
Panel B: Model with a Useless Factor Only											
200	0.900	0.125	0.342	0.658	0.770	0.883	0.944	0.971	0.983	0.988	0.993
400	0.973	0.040	0.809	0.912	0.942	0.970	0.985	0.992	0.995	0.996	0.998
600	0.989	0.015	0.929	0.966	0.976	0.987	0.993	0.996	0.998	0.998	0.999
800	0.994	0.008	0.963	0.982	0.987	0.993	0.996	0.998	0.999	0.999	0.999
1000	0.996	0.005	0.978	0.989	0.992	0.995	0.997	0.999	0.999	0.999	1.000
3600	1.000	0.000	0.999	0.999	0.999	1.000	1.000	1.000	1.000	1.000	1.000
Panel C: Model with a Useful and a Useless Factor											
200	0.903	0.125	0.325	0.667	0.779	0.889	0.946	0.973	0.984	0.988	0.993
400	0.974	0.039	0.810	0.916	0.945	0.972	0.986	0.992	0.995	0.996	0.998
600	0.989	0.015	0.933	0.968	0.978	0.988	0.993	0.996	0.998	0.998	0.999
800	0.994	0.007	0.967	0.983	0.988	0.993	0.996	0.998	0.999	0.999	0.999
1000	0.996	0.004	0.980	0.989	0.993	0.996	0.998	0.999	0.999	0.999	1.000
3600	1.000	0.000	0.999	0.999	0.999	1.000	1.000	1.000	1.000	1.000	1.000

**Table III.b**  
**Empirical Distribution of the  $R^2$  Coefficient (ML)**

The table presents the empirical distribution of the pseudo- $R^2$  computed as the squared correlation between the realized and fitted expected returns based on the ML estimator. The results are based on 100,000 simulations, assuming that the returns are generated from a multivariate normal distribution with means and covariance matrix calibrated to the 25 size and book-to-market Fama-French portfolio returns for the period 1959:2–2012:12.

$T$	mean	std	1%	5%	10%	25%	50%	75%	90%	95%	99%
Panel A: Model with a Useful Factor Only											
200	0.231	0.220	0.000	0.002	0.006	0.040	0.161	0.376	0.577	0.674	0.806
400	0.194	0.188	0.000	0.001	0.005	0.034	0.135	0.309	0.482	0.578	0.719
600	0.178	0.167	0.000	0.002	0.006	0.036	0.130	0.280	0.429	0.514	0.651
800	0.169	0.152	0.000	0.002	0.007	0.040	0.130	0.263	0.393	0.469	0.601
1000	0.163	0.140	0.000	0.002	0.009	0.045	0.131	0.249	0.367	0.438	0.561
3600	0.143	0.082	0.006	0.026	0.043	0.081	0.133	0.195	0.256	0.294	0.367
Panel B: Model with a Useless Factor Only											
200	0.940	0.141	0.150	0.703	0.852	0.955	0.988	0.998	1.000	1.000	1.000
400	0.989	0.035	0.877	0.958	0.976	0.991	0.998	1.000	1.000	1.000	1.000
600	0.996	0.009	0.961	0.985	0.991	0.997	0.999	1.000	1.000	1.000	1.000
800	0.998	0.004	0.981	0.992	0.995	0.998	0.999	1.000	1.000	1.000	1.000
1000	0.999	0.003	0.988	0.995	0.997	0.999	1.000	1.000	1.000	1.000	1.000
3600	1.000	0.000	0.999	1.000	1.000	1.000	1.000	1.000	1.000	1.000	1.000
Panel C: Model with a Useful and a Useless Factor											
200	0.942	0.135	0.216	0.701	0.852	0.956	0.989	0.998	1.000	1.000	1.000
400	0.989	0.036	0.873	0.959	0.977	0.992	0.998	1.000	1.000	1.000	1.000
600	0.996	0.010	0.963	0.986	0.991	0.997	0.999	1.000	1.000	1.000	1.000
800	0.998	0.004	0.983	0.993	0.996	0.998	1.000	1.000	1.000	1.000	1.000
1000	0.999	0.002	0.990	0.996	0.997	0.999	1.000	1.000	1.000	1.000	1.000
3600	1.000	0.000	0.999	1.000	1.000	1.000	1.000	1.000	1.000	1.000	1.000

**Table IV.a**  
**Rejection Rates of  $t$ -tests (CU-GMM)**

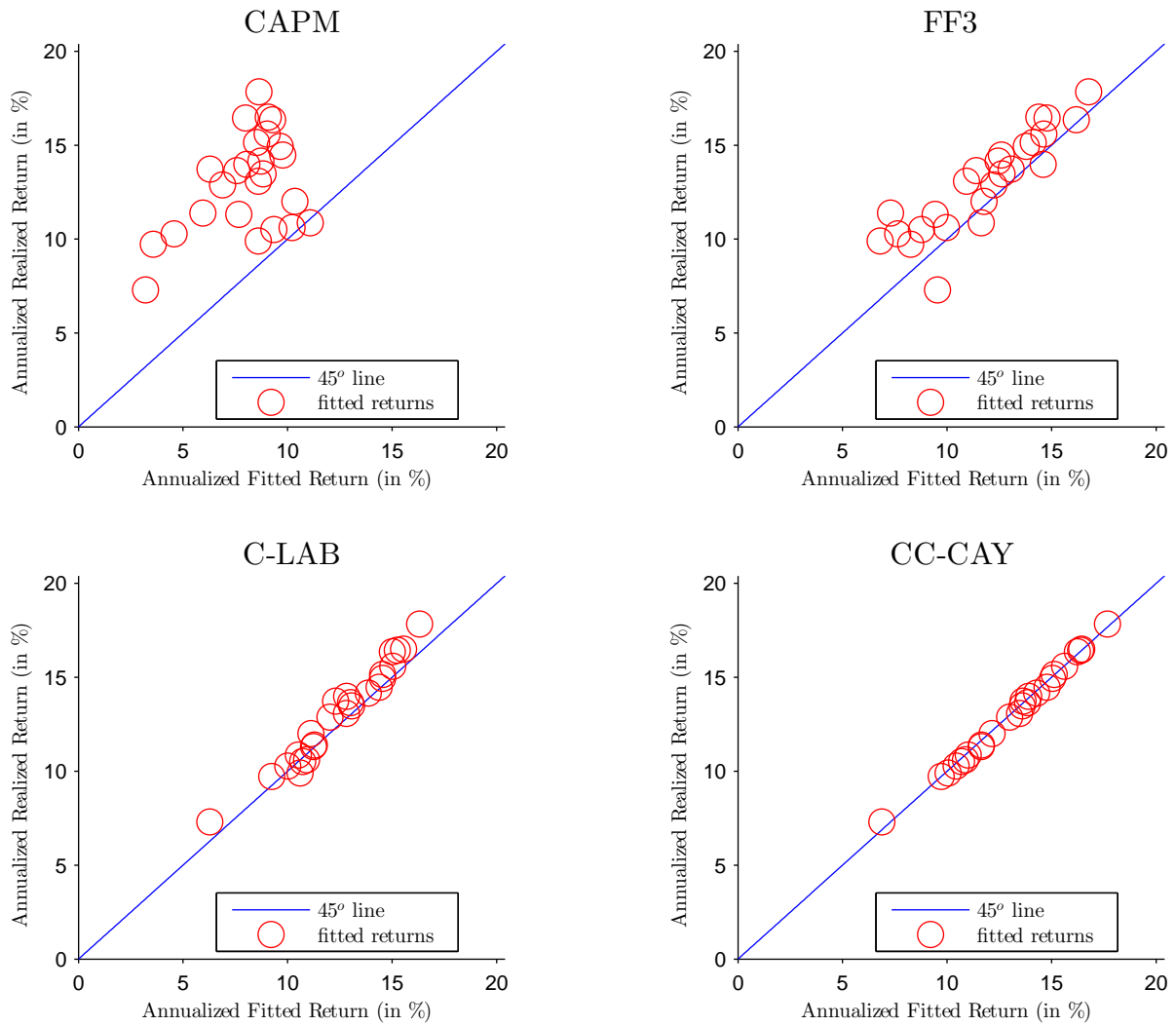
The table presents the rejection rates of  $t$ -tests of statistical significance under misspecified models in the SDF setup. The null hypothesis is that the parameter of interest is equal to zero. The results are reported for different levels of significance (10%, 5%, and 1%) and for different values of the number of time series observations ( $T$ ) using 100,000 simulations, assuming that the returns are generated from a multivariate normal distribution with means and covariance matrix calibrated to the 25 size and book-to-market Fama-French portfolio returns for the period 1959:2–2012:12. The  $t$ -statistics are compared with the critical values from a standard normal distribution. The rejection rates for the limiting case ( $T = \infty$ ) in Panels B and C are based on the asymptotic distributions in part (b) of Theorem 3.

$T$	useful			useless		
	10%	5%	1%	10%	5%	1%
Panel A: Model with a Useful Factor Only						
200	0.849	0.814	0.732	–	–	–
400	0.906	0.879	0.812	–	–	–
600	0.953	0.936	0.889	–	–	–
800	0.977	0.968	0.939	–	–	–
1000	0.989	0.985	0.969	–	–	–
3600	1.000	1.000	1.000	–	–	–
$\infty$	1.000	1.000	1.000	–	–	–
Panel B: Model with a Useless Factor Only						
200	–	–	–	0.997	0.996	0.994
400	–	–	–	1.000	1.000	1.000
600	–	–	–	1.000	1.000	1.000
800	–	–	–	1.000	1.000	1.000
1000	–	–	–	1.000	1.000	1.000
3600	–	–	–	1.000	1.000	1.000
$\infty$	–	–	–	1.000	1.000	1.000
Panel C: Model with a Useful and a Useless Factor						
200	0.330	0.239	0.114	0.993	0.992	0.986
400	0.210	0.130	0.041	1.000	1.000	0.999
600	0.167	0.095	0.023	1.000	1.000	1.000
800	0.148	0.080	0.017	1.000	1.000	1.000
1000	0.136	0.070	0.014	1.000	1.000	1.000
3600	0.108	0.051	0.007	1.000	1.000	1.000
$\infty$	0.100	0.045	0.006	1.000	1.000	1.000

**Table IV.b**  
**Rejection Rates of  $t$ -tests (ML)**

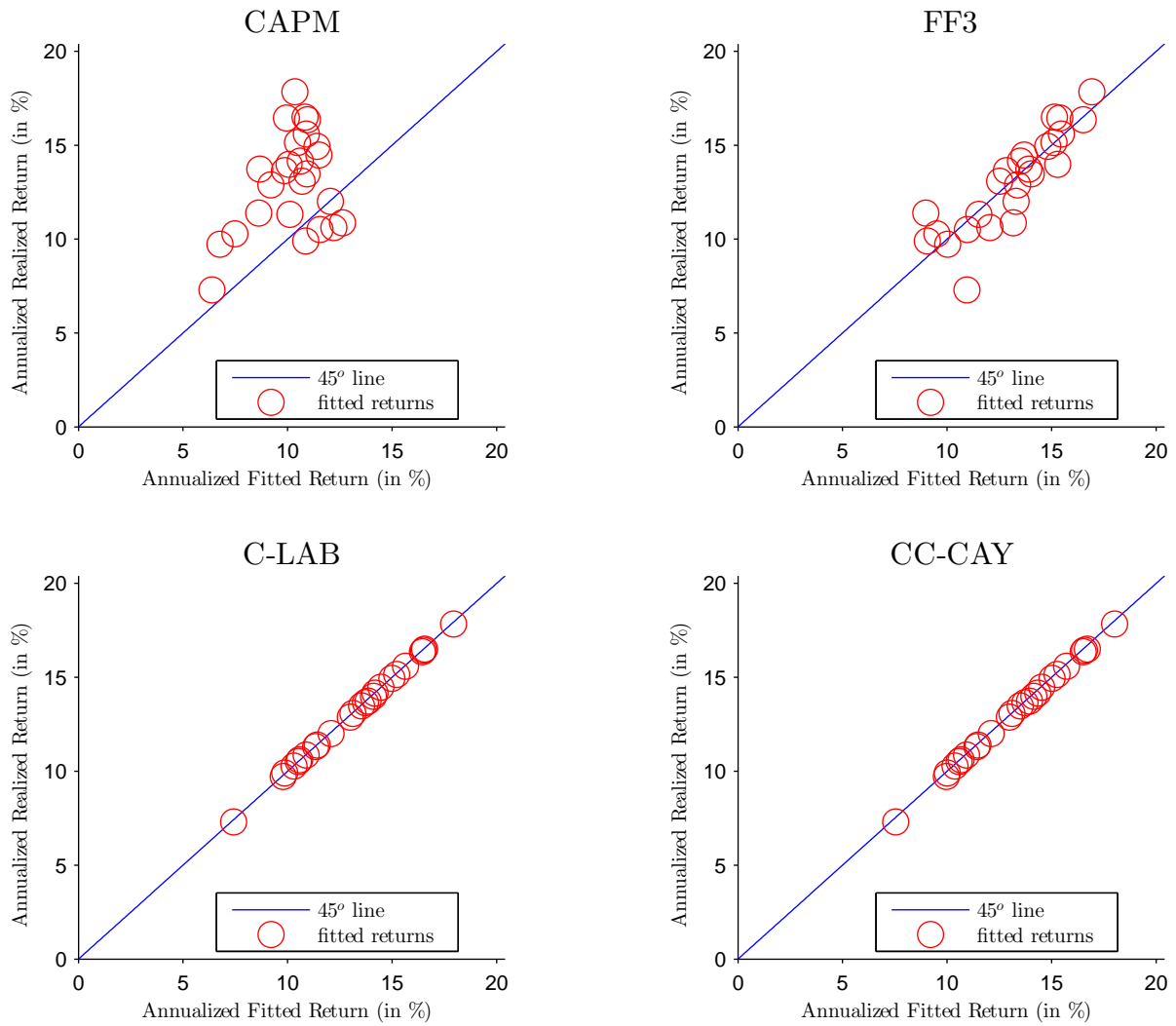
The table presents the rejection rates of  $t$ -tests of statistical significance under misspecified models in the beta-pricing setup. The null hypothesis is that the parameter of interest is equal to zero. The results are reported for different levels of significance (10%, 5%, and 1%) and for different values of the number of time series observations ( $T$ ) using 100,000 simulations, assuming that the returns are generated from a multivariate normal distribution with means and covariance matrix calibrated to the 25 size and book-to-market Fama-French portfolio returns for the period 1959:2–2012:12. The  $t$ -statistics are compared with the critical values from a standard normal distribution. The rejection rates for the limiting case ( $T = \infty$ ) in Panels B and C are based on the asymptotic distributions in part (b) of Theorem 1.

$T$	useful			useless		
	10%	5%	1%	10%	5%	1%
Panel A: Model with a Useful Factor Only						
200	0.597	0.508	0.336	–	–	–
400	0.778	0.703	0.527	–	–	–
600	0.887	0.834	0.690	–	–	–
800	0.944	0.913	0.810	–	–	–
1000	0.974	0.955	0.887	–	–	–
3600	1.000	1.000	1.000	–	–	–
$\infty$	1.000	1.000	1.000	–	–	–
Panel B: Model with a Useless Factor Only						
200	–	–	–	0.992	0.990	0.985
400	–	–	–	1.000	1.000	1.000
600	–	–	–	1.000	1.000	1.000
800	–	–	–	1.000	1.000	1.000
1000	–	–	–	1.000	1.000	1.000
3600	–	–	–	1.000	1.000	1.000
$\infty$	–	–	–	1.000	1.000	1.000
Panel C: Model with a Useful and a Useless Factor						
200	0.261	0.176	0.070	0.987	0.984	0.976
400	0.189	0.113	0.033	1.000	0.999	0.999
600	0.163	0.090	0.022	1.000	1.000	1.000
800	0.149	0.080	0.017	1.000	1.000	1.000
1000	0.142	0.076	0.016	1.000	1.000	1.000
3600	0.120	0.058	0.010	1.000	1.000	1.000
$\infty$	0.113	0.054	0.008	1.000	1.000	1.000

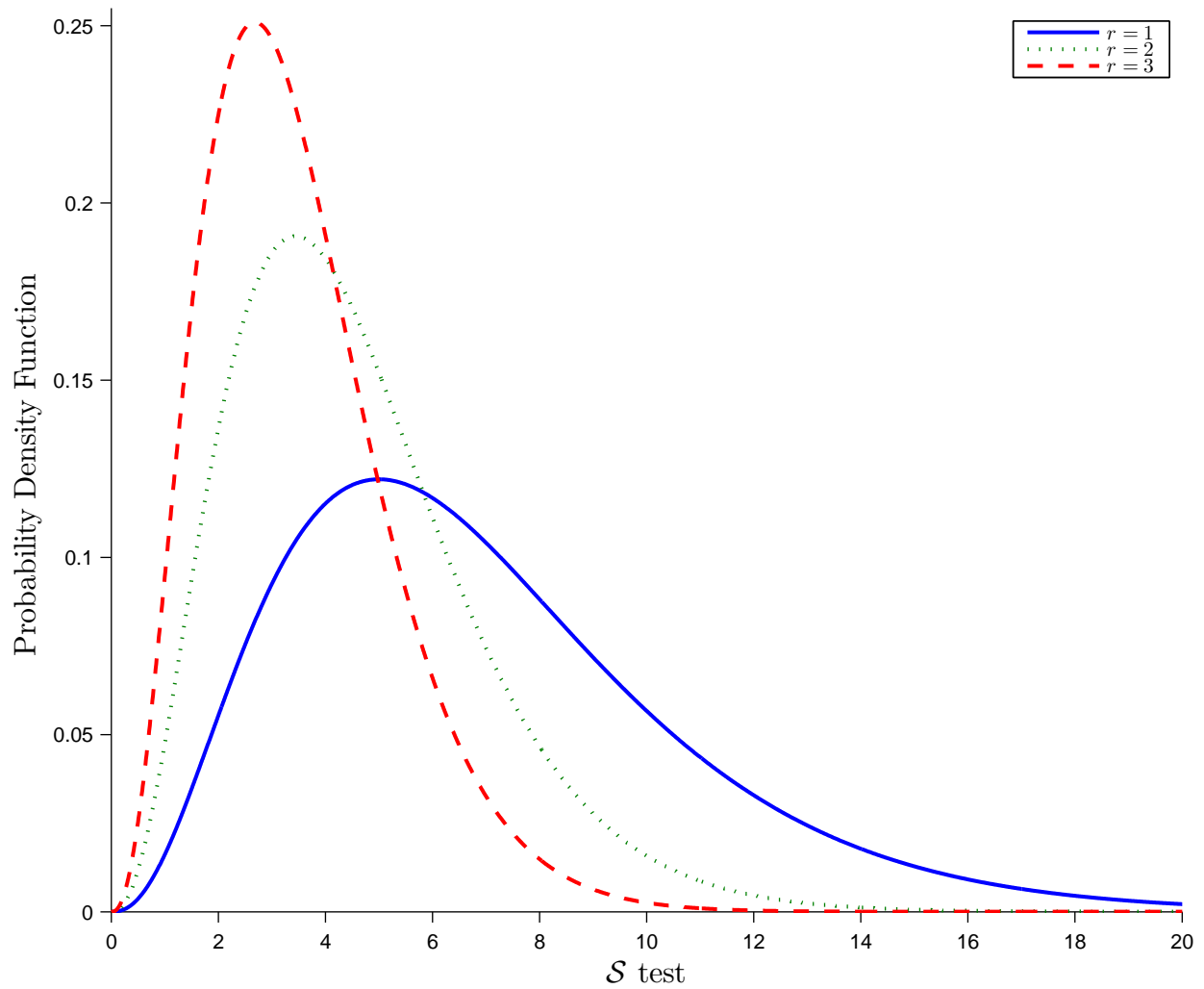


**Figure 1. Realized vs. Fitted (by CU-GMM) Returns: 25 Fama-French Portfolios.** The figure shows the average realized returns versus fitted expected returns (by CU-GMM) for each of the 25 Fama-French portfolios for CAPM, FF3, C-LAB, and CC-CAY.

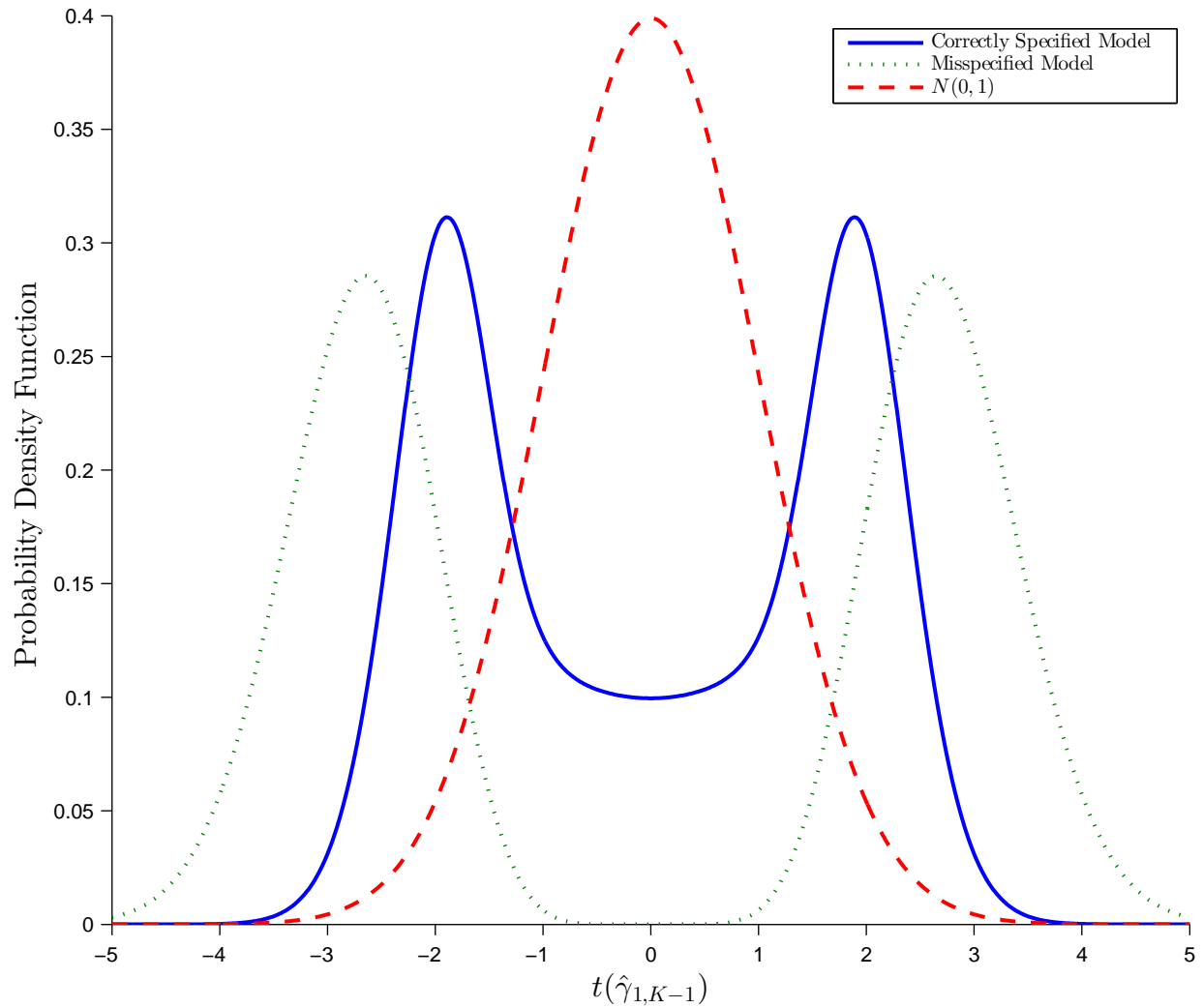




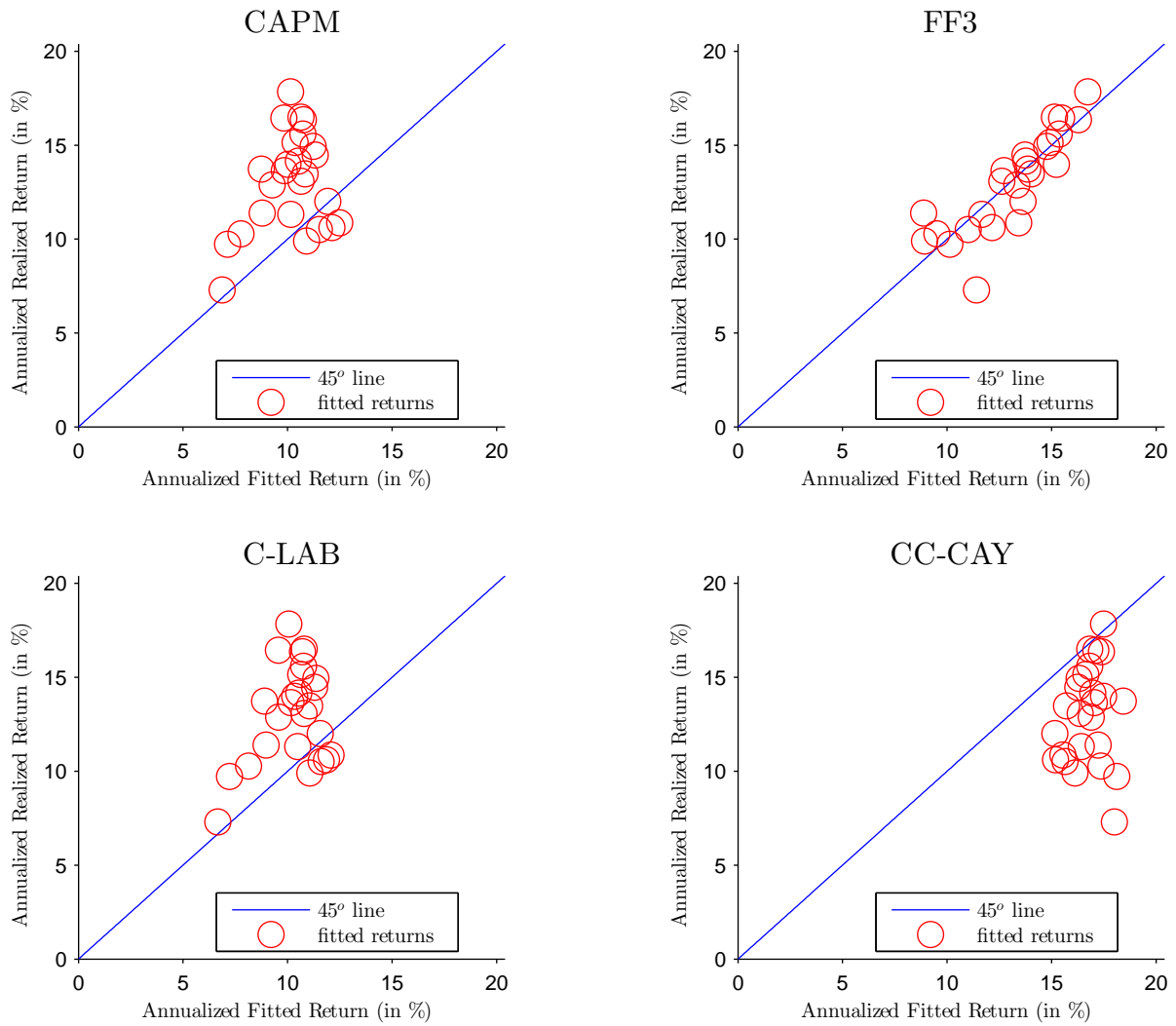
**Figure 2. Realized vs. Fitted (by ML) Returns: 25 Fama-French Portfolios.** The figure shows the average realized returns versus fitted expected returns (by ML) for each of the 25 Fama-French portfolios for CAPM, FF3, C-LAB, and CC-CAY.



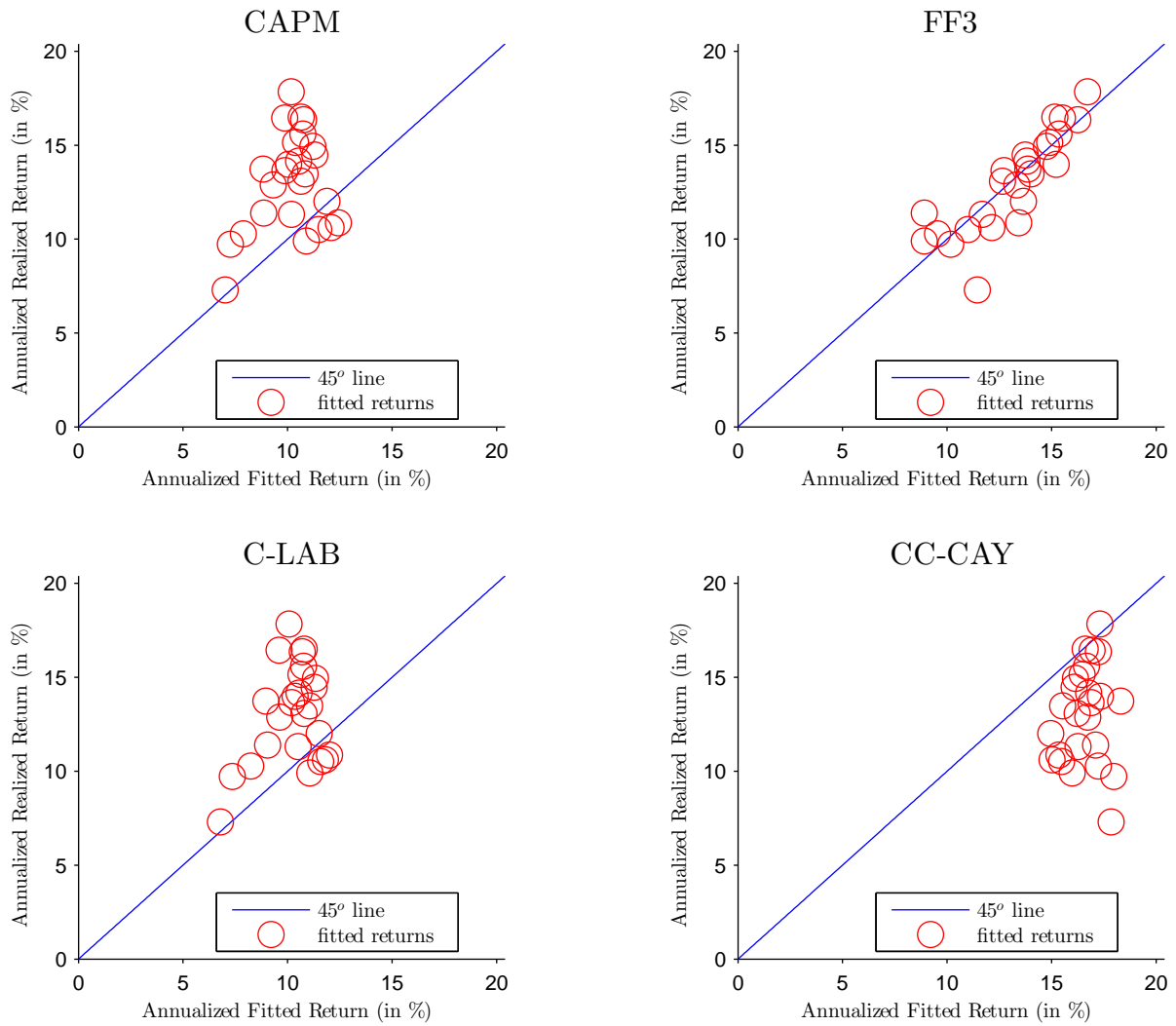
**Figure 3. Limiting distribution of the specification test  $\mathcal{S}$  for  $N - K = 7$ .** The figure plots the asymptotic distributions of  $\mathcal{S}$  presented in Theorem 2 for  $r = 1, 2$ , and 3.



**Figure 4. Limiting distributions of the  $t$ -test of  $H_0 : \gamma_{1,K-1} = 0$  for correctly and misspecified models with a useless factor ( $N - K = 7$ ).** The figure plots the limiting densities of  $t(\hat{\gamma}_{1,K-1})$  for correctly specified and misspecified models that contain a useless factor, along with the standard normal density.



**Figure 5. Realized vs. Fitted (by HJ-Distance) Returns: 25 Fama-French Portfolios.** The figure shows the average realized returns versus fitted expected returns (by HJ-distance) for each of the 25 Fama-French portfolios for CAPM, FF3, C-LAB, and CC-CAY.



**Figure 6. Realized vs. Fitted (by GLS) Returns: 25 Fama-French Portfolios.** The figure shows the average realized returns versus fitted expected returns (by GLS) for each of the 25 Fama-French portfolios for CAPM, FF3, C-LAB, and CC-CAY.