

Economic Implications of Bull and Bear Regimes in UK Stock and Bond Returns*

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Abstract

This paper presents evidence of persistent ‘bull’ and ‘bear’ regimes in UK stock and bond returns and considers their economic implications from the perspective of an investor’s portfolio allocation. We find that the perceived state probability has a large effect on the optimal asset allocation, particularly at short and medium-term investment horizons. If ignored, the presence of such regimes gives rise to substantial welfare costs. Parameter estimation uncertainty, while clearly important, does not overturn the conclusion that predictability in the return distribution linked to the presence of bull and bear states has a significant effect on investors’ strategic asset allocation.

Key words: Strategic Asset Allocation, Regime Switching, Bull and Bear Markets, Model Specification.

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