

Abstract: This paper applies a two-stage evaluation procedure to study investors' portfolio selection and asset pricing consequences in the presence of risk and ambiguity. The two-stage evaluation procedure represents investors' attitudes towards risk and ambiguity. Investors optimally hold a combination of three funds: a risk-free, a solely risky, and a risky and ambiguous fund. In equilibrium, the risk premia on all assets are determined by their exposure to systemic risk and ambiguity. The results are straightforward to implement and test and well-suited for many types of applications. The results theoretically explain the asset allocation puzzle and the size effect.