

Economics Seminar, Indian Statistical Institute, New Delhi

SPEAKER: Irasema Alonso, Yale University

TITLE: Endogenous Aggregate Beliefs: Equity Trading under Heterogeneity in Ambiguity Aversion

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ABSTRACT

We examine the potential importance of heterogeneity in consumers' ambiguity aversion for asset pricing, portfolio allocation, and the wealth distribution. Ambiguity aversion, which is a way of formalizing preferences that are consistent with the Ellsberg paradox, features first-order effects on utility even in an economy with a small amount of randomness. Thus ambiguity aversion contrasts the standard model, where risk aversion leads to second-order effects on utility, and it has sharp implications for portfolio demand and for equilibrium asset returns. In the context of a simple, Mehra-Prescott-style endowment economy, we consider two types of agents whose ambiguity aversions differ: some agents display ambiguity aversion while others do not. We show that the equilibrium "belief" of the ambiguity-averse consumer will evolve endogenously and nontrivially over time as a result of the equilibrium interaction. Moreover, we show that standard agents will dominate in the pricing of the assets in the long run (but much less so in the short run), unless there is a recurrent influx of new ambiguity-averse consumers. Also, given the heterogeneity, the ambiguity-averse agents become (almost) non-participants in the stock market over time; thus we obtain endogenous limited participation. This occurs as the ambiguity-averse consumers will see their relative wealth decline over time.