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ASSET PRICING WITH HETEROGENEOUS AGENTS AND LONG-RUN RISK

Discussion by **Jaroslav Borovička (NYU)**

January 2017

Asset pricing

- Departure from the 'representative agent' paradigm

Dynamics of wealth distribution

- Consumption-saving decisions
- Portfolio choices

Interaction

- Wealth-distribution becomes a new state variable

Rational expectations framework

- Agents, nature, and econometrician share a **common probability measure** (model)
- Source of **cross-equation restrictions** / testable implications
- Source of discipline

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Applications in asset pricing

- **Hansen, Singleton (1982)**
 - simple risk and preference specifications fail to match even elementary asset price moments
- **Long-run risk literature (Bansal, Yaron (2004), ...)**
 - combination of persistent risk and nonseparable preferences helps
 - large martingale component in the stochastic discount factor

Approach 1: 'Dark matter' approach (Chen, Dou, Kogan (2015))

- Persistent risk must exist because asset prices tell us so.
- Use Euler equations as pricing restrictions for identification

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- Nakamura, Sergeyev, Steinsson (2016) — international data
- Schorfheide, Song, Yaron (2016) — careful modeling of measurement errors

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Approach 3: Hansen, Sargent (2001)

- Reinterpret a martingale in the SDF as a 'worst-case model' distortion
- Blur the distinction between beliefs and preferences

An econometrician measuring the persistent component is not enough

- Euler equations involves **investors' expectations**

$$1 = E_t \left[\frac{S_{t+1}}{S_t} R_{t+1} \right]$$

- Investors must have a full understanding of its presence

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Persistent components are **hard to measure**: opens room for

- **Learning / subjective beliefs**
 - Collard, Mukerji, Sheppard, Tallon (2012), Andrei, Carlin, Hasler (2016), Collin-Dufresne, Johannes, Lochstoer (2016a)
- **Disagreement / heterogeneous beliefs**
 - Morris (1995): agree to disagree
 - Andrei, Hasler, Jeanneret (2016): heterogeneous signals
 - Collin-Dufresne, Johannes, Lochstoer (2016b): heterogeneous experiences

Endowment economy, two types of agents, complete markets

- Epstein–Zin preferences
- Consumption dynamics as in the long-run risk literature

$$\Delta C_{t+1} = \mu_c + X_t + \sigma \eta_{c,t+1}$$

$$X_{t+1} = \rho_x X_t + \phi_x \sigma \eta_{x,t+1}$$

$$\Delta d_{t+1} = \mu_d + \Phi X_t + \phi_d \sigma \eta_{d,t+1} + \phi_{d,c} \sigma \eta_{c,t+1}$$

- Agents **disagree about the persistence** of the long-run risk component ρ_x

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Solution approach

- Planner's problem with time-varying Pareto weights
- Incorporates nonseparable preferences (Dumas, Uppal, Wang (2000)) interacted with subjective beliefs (Borovička (2016))

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- These agents offer cheap insurance against shocks to x_t

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Moreover, 'deniers' gain wealth over time \implies risk premia fall further

- This is **in contrast to separable preferences**
- Under separable preferences, agents with incorrect beliefs lose wealth on average

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- Belief in lower ρ_x implies lower required compensation for holding risky asset

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Optimists in the economy gain wealth

- **Risk premium channel**: 'Deniers' invest in risky, high-return assets
 - 'Deniers' are optimistic about long run risk. Strong effect **when risk aversion is high**.
- **Savings channel**: 'Deniers' save more
 - **When $IES > 1$** , agents with high subjective expected return save more.

Risk premia

- attenuation due to presence of long-run risk 'skeptics'

Price-dividend ratio

- more volatile due to fluctuations in the wealth distribution
 - but is it at the right frequency?
 - much of the fluctuation in the data is at the business-cycle frequency
 - long-run risk is about lower frequencies

Return predictability?

- standard tests use P/D as a predictor for returns and consumption growth
- measures of wealth distribution as a predictor?

Sources of wealth heterogeneity / inequality

- income heterogeneity alone not strong enough
- heterogeneity in consumption/saving behavior & portfolio returns

The heterogeneous beliefs model yields **predictions** for

- heterogeneity in **saving rates**
- heterogeneity in **portfolio composition** and **expected and realized returns**
- vis-à-vis equilibrium-determined asset prices

Compare to

- **data on return heterogeneity:** Calvet, Campbell, Sodini (2009), Fagereng, Guiso, Malacrino, Pistaferri (2016)
- **related theories:** Benhabib, Bisin (2016), Kacperczyk, Nosal and Stevens (2015), Bhandari (2015)

Equilibrium model where **belief heterogeneity jointly determines**

- asset price dynamics
- heterogeneity in saving and portfolio decisions
- wealth dynamics

All can (and should!) be **tested in the data**

- departure from rational expectations increases the number of free parameters
- new data provide empirical discipline