An Approach To Asset-Pricing Under Incomplete and Diverse Perceptions

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ABSTRACT

We model a competitive market where risk-neutral traders trade one risk-free and one risky asset and face limits to short-selling. Traders use "incomplete theories" that give statistically correct beliefs about the distribution of next-period market prices conditional upon the information inside of their theories; they neither condition upon information outside of their theories nor upon current market prices. The more theories are present in the market, the higher is the equilibrium price of the risky asset, which exceeds the most optimistic trader's expectation of its present-discounted value. Prices may depend upon irrelevant information and become noiser functions of fundamentals when all traders become more sophisticated. When dividends are sufficiently persistent, low asset prices are more volatile than high ones.
Investors with more complete theories do not necessarily earn higher returns than those with less complete theories, who can earn more than the risk-free rate, despite perfect competition.

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