Understanding why investors disagree is crucial to understanding how financial markets function. The traditional approach assumes rational expectations (RE), where investors share a common prior over the joint distribution of payoffs and signals and, so, can only disagree if they privately observe different information. The alternative approach assumes investors have heterogenous priors, or a difference of opinions (DO), over the joint distribution of payoffs and signals. Because they have different models of the world, investors in these settings can “agree to disagree” even after observing the same information. In this lecture, I will review a subset of DO models and describe how they have been useful in explaining empirical regularities that are difficult to reconcile in the RE framework. These include over-valuation and speculative bubbles, trading volume and volatility dynamics around public announcements, and return predictability.

Readings

We will focus on the readings marked (*)


Snehal Banerjee, Jesse Davis and Naveen Gondhi (2019), Choosing to Disagree in Financial Markets, working paper