Asset Pricing with Heterogeneous Agents and Long-Run Risk

Walter Pohl, University of Zurich

Abstract:

This paper examines the effect of agent belief heterogeneity on long-run risk models. We find that for the long-run risk explanation to adequately explain the equity premium, it is not sufficient for long-run risk to merely exist: agents must all agree that it exists. Agents who believe in a lower persistence level come to dominate the economy rather quickly, even if their belief is wrong. This drives the equity premium down below the level observed in the data.