

Title: Risk Aversion or Mistaken Beliefs?

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Abstract:

The title of this paper used to be “Three Martingales and More”. That title tells the whole story. The paper uses multiplicative martingales to represent likelihood ratios that can capture two possible forces that make returns on some assets higher than on others: (1) risk aversion and (2) mistaken beliefs. We describe observation sets under which these two forces are observationally equivalent and richer observations sets in which they can be distinguished. These richer data sets include observations on agents’ forecasts. What are the “three martingales and more”? They are changes of measure that represent (1) risk aversion, (2) biased beliefs, (3) concerns about particular forms of model misspecification, and (4) vaguer and more general concerns about many types of possible model misspecifications. Applications are to equations that are central to models of consumption and asset prices.