

INVESTOR BELIEFS AND MARKET EQUILIBRIUM

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Alfred Marshall (1920) wrote that “. . . Economics is a study of mankind in the ordinary business of life . . .” It may be that individuals are oblivious to the economic process as they go about their ‘ordinary business.’ On the other hand, most individuals have some beliefs about how the economy works. Whether or not such beliefs have an impact on the economy is not immediately obvious.

In the physical sciences, such beliefs obviously do not matter. Physical laws, such as the law of gravity, are invariant to the beliefs of individuals. The same is not true, however, of economic laws. Economics is a social science, and the laws of economics reflect patterns of human behavior and decision making.

If economic actors have beliefs about how the economy works, it is conceivable that such beliefs may affect their decisions. This may affect not only outcomes such as prices and allocations, but it may affect the very nature of the economic process that determines outcomes. In other words, the true model of the economy may depend on what economic actors believe the true model is.

Economic actors have theories about how the economy works. These are not necessarily the same theories that economists use. They may take the form of sophisticated models or simple heuristic rules. Depending on the context, it may or may not matter whether economic actors have theories of the economy. Consider, for example, a consumer choice model where economic agents purchase consumption good. In this context, the decisions of economic agents

are based strictly on preferences. Their beliefs about how the economy works are inconsequential in this context. The decisions of a consumer at the grocery store, for example, do not depend on whether the consumer is a Keynesian or a Monetarist.

On the other hand, consider a model in which some economic agents implement macroeconomic policy. This type of model requires that these agents have a theory on which to base their policy decisions. It makes a difference in this case whether decision making agents use the Keynesian model or the Monetarist model or some other model of macroeconomic policy. In this context, the economic process itself depends on the models of economic actors.

In other contexts it is not obvious on a priori grounds how the theories of economic actors affect the behavior of the economic system. In particular, it is not clear what the implications are if economic actors have different beliefs regarding which model of the economy is correct.

In finance, most models explicitly or implicitly assume that economic agents make decisions using a common model of the economy. In this dissertation we assume that investors do not share the same beliefs regarding which model is correct. We refer to this assumption as model disagreement. We investigate the implications of this assumption in two different contexts: capital structure theory and the choice between mutual and stock life insurance companies.