Learning and Asset Prices Under Ambiguous Information

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ABSTRACT

In a Lucas exchange economy with standard power utility, we study asset prices under learning and ambiguous information. In contrast with models featuring only learning or ambiguity, our model is successful in matching the equity premium, the interest rate, and the volatility of stock returns under empirically reasonable parameters. Our closed form formulas also show that a severe downward bias arises in the empirical relation between stock returns and return volatility. We quantify this bias in simulations and show that our model can explain why such a relation is difficult to detect in the data.