Discussion
‘Financial Risk: A Tragedy of the Commons’
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ASSA Meetings, January 2011, Denver
What is the paper about?

Develop a noisy rational expectations model of ‘market sentiment’

‘Market sentiment’ being random deviations from the rationally expected pay-offs of risky assets (optimism/pessimism)

The amount of ‘market sentiment’ appears endogenously, i.e investors decides to alter their expectations.
Set-up

Two assets: one risky in positive supply and one riskless.

Investors make two decisions:

- portfolio decisions

- how much they alter their expectations from the rational one

Taking decisions of other investors as given.
Set-up

Two key ingredients:

Utility cost of ignoring market sentiment (psychological cost)

Portfolio decisions depend on investors’ private information. Private signals are dispersed around a mean.
Findings

Utility cost makes sure that ’market sentiment’ appears in equilibrium

Tiny cost can still generate a large amount of ’market sentiment’

’Market sentiment’ is amplified by investors decisions when information is sufficiently dispersed among them
Findings

If private information sufficiently dispersed (and small utility cost)

- Large amount of ’market sentiment’ in equilibrium

- Asset prices do not aggregate information

- Excess volatility

Why is it so?
Intuition

Suppose private info is not dispersed and investor $i$ gets a ’bad’ private signal:

- If asset prices are going up, this must be due to ’market sentiment’

- Potentially large losses for the investor to load on ’market sentiment’

- Small amount of sentiment in equilibrium
Intuition

Suppose private info is very dispersed and investor $i$ gets a ’bad’ private signal:

- If asset prices are going up, this must be either due to ’market sentiment’ or good signal of others

- Potential small losses for the investor to load on ’market sentiment’

- Revise upwards his expectations and asset prices go up further

- This encourages others to do the same. ’Market sentiment’ destroys the informational content of prices.
Intuition

Hence if private information sufficiently dispersed:

- Asset prices do not aggregate information

- Asset prices are dominated by ‘market sentiment’

- ‘Market sentiment’ increases the volatility of asset prices
Comments

1. Clarifications

- Need to clarify how authors solve for ’market sentiment’ in equilibrium. Choice variable for investor $i$ is $\mu_i$. Should be more transparent to solve for $\mu_i$ and impose due to investors ex-ante homogeneity $\mu_i = \mu$ for a given (normalized) volatility $\sigma_\varepsilon$.

- ’Excessive’ amount of ’sentiment’. How ’excessive’? Should measure the impact of the ’amplification mechanism’? Welfare costs compared to utility costs?
Comments

1. Clarifications

- Timing:
Investors choose $\mu_i$ \textbf{before} observing private signals. Makes sure that loadings on 'market sentiment' are identical across investors. Decisions to load on sentiment depends on how much ex-ante investors will revise their expectations following private signals. Different timing will affect how much they decide to load on 'sentiment' ex-post. Should discuss this simplifying assumption further.
Comments

2. Robustness and extensions

- Key assumption: private information must be very dispersed for the mechanic to work

Realistic quantitatively ($\frac{\sigma_v}{\sigma_X} = 10$)?

With endogenous information acquisition, might appear endogenously. Should strengthen the results.

- Assets pay-offs and 'market sentiment' uncorrelated. How the results depend on that assumption?
Comments

3. Empirical implications

- Positive relationship between the amount of ’sentiment’ (excess volatility) and the dispersion of information across investors.

Way to test this empirically across asset classes (OTC versus exchange traded assets, corporate vs public bonds)? Price responses to public news?

Way to exploit time-variation in the dispersion of information? Narrative of the crisis?
Conclusion

Very nice paper. Very topical.

Need to clarify further the set-up.

Would be nice to find a way to test their story. And separate it/relate it better to existing literature (’bubble type story’ or moral hazard/career concerns in portfolio delegation).