



Disagreement and Asset Prices

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How do differences of opinion affect asset prices? Do investors earn a risk premium when disagreement arises in the market? Despite their fundamental importance, these questions are among the most controversial issues in finance. In this paper, we use a novel data set that allows us to directly measure the level of disagreement among Wall Street mortgage dealers about prepayment speeds. We examine how disagreement evolves over time and study its effects on expected returns, return volatility, and trading volume in the mortgage-backed security market. We find that increased disagreement is associated with higher expected returns, higher return volatility, and larger trading volume. These results imply that there is a positive risk premium for disagreement in asset prices. We also show that volatility in and of itself does not lead to higher trading volume. Rather, it is only when disagreement arises in the market that higher uncertainty is associated with more trading. Finally, we are able to distinguish empirically between two competing hypotheses regarding how information in markets gets incorporated into asset prices. We find that sophisticated investors appear to update their beliefs through a rational expectations mechanism when disagreement arises.

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