

Author's Accepted Manuscript

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PII: S0014-2921(14)00052-X
DOI: <http://dx.doi.org/10.1016/j.euroecorev.2014.03.009>
Reference: EER2584

To appear in: *European Economic Review*

Received date: 14 May 2013
Accepted date: 17 March 2014

Cite this article as: Kevin J. Lansing, Stephen F. LeRoy, Risk Aversion, Investor Information and Stock Market Volatility, *European Economic Review*, <http://dx.doi.org/10.1016/j.euroecorev.2014.03.009>

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Risk Aversion, Investor Information and Stock Market Volatility*

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March 24, 2014

Abstract

This paper employs a standard asset pricing model to derive theoretical volatility measures in a setting that allows for varying degrees of investor information about the dividend process. We show that the volatility of the price-dividend ratio increases monotonically with investor information but the relationship between investor information and equity return volatility (or equity premium volatility) can be non-monotonic, depending on risk aversion and other parameter values. Under some plausible calibrations and information assumptions, we show that the model can match the standard deviations of equity market variables in long-run U.S. data. In the absence of concrete knowledge about investors' information, it becomes more difficult to conclude that observed volatility in the data is excessive.

*Forthcoming, *European Economic Review*. An earlier version of this paper was titled "Risk Aversion and Stock Price Volatility." We thank an anonymous referee for helpful comments and suggestions that significantly improved the paper. Part of this research was conducted while Lansing was a visiting economist at the Norges Bank, whose hospitality is gratefully acknowledged.

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