Market Selection: Hungry Misers and Happy Bankrupts*

Katsumasa Nishide† and L.C.G. Rogers‡

(November 29, 2010)

Abstract. The Market Selection Hypothesis is a principle which (informally) proposes that 'less knowledgeable' agents are eventually eliminated from the market. This elimination may take the form of starvation (the proportion of output consumed drops to zero), or may take the form of going broke (the proportion of asset held drops to zero), and these are not the same thing. Starvation may result from several causes, diverse beliefs being only one. We firstly identify and exclude these other possible causes, and then prove that starvation is equivalent to inferior belief, under suitable technical conditions. On the other hand, going broke cannot be characterized solely in terms of beliefs, as we show. We next present a remarkable example with two agents with different beliefs, in which one agent starves yet amasses all the capital, and the other goes broke yet consumes all the output – the hungry miser and the happy bankrupt. This example also serves to show that although an agent may starve, he may have long-term impact on the prices. This relates to the notion of price impact introduced by Kogan et al. (2009), which we correct in the final section, and then use to characterize situations where asymptotically equivalent pricing holds.

Keywords: Market selection, asset pricing, heterogeneous beliefs.

JEL classification: D51, D01, G12,