The Beauty Contest and Short-Term Trading

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Abstract

Short-termism need not breed informational price inefficiency even when generating Beauty Contests. We demonstrate this claim in a two-period market with persistent liquidity trading and risk-averse, privately informed, short-term investors and find that prices reflect average expectations about fundamentals and liquidity trading. Informed investors engage in “retrospective” learning to reassess inferences (about fundamentals) made during the trading game’s early stages. This behavior introduces strategic complementarities in the use of information and can yield two stable equilibria that can be ranked in terms of liquidity, volatility, and informational efficiency. We derive implications that explain market anomalies as well as empirical regularities.

Keywords: price speculation, multiple equilibria, average expectations, public information, momentum and reversal, disagreement, volume, volatility

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