

Economic Forces Shape Beliefs: A Model of Investment under Fundamental Uncertainty

Market economies regularly produce innovations in the form of novel technologies and business models that put interested financial investors in a situation of fundamental uncertainty. Absent a factual basis for assigning probabilities to possible outcomes, investors often turn to subjective prior beliefs about an innovations' chances of success or failure. In this paper, we present an application of a model on endogenous belief formation under fundamental uncertainty in the setting of a capital allocation decision. The model's core element is a "belief contest", a competition in which profit-seeking financial intermediaries wish to influence investors' priors about the chance that a recent innovation will indeed deliver a high rate of return. Using this framework, we identify factors that make investors more likely to adopt "exuberant" priors, i.e., priors that lead them to ignore objective warning signs for too long. We also demonstrate how our model can guide an impartial financial regulator that, realistically, does not have better information than the investors.