

INFORMATION AND THE EQUITY PREMIUM

Christian Gollier
Toulouse School of Economics

Edward Schlee
Arizona State University

Abstract

We determine how better information affects the average equity premium in a standard representative-agent exchange economy. Perfect information obviously eliminates the equity premium, and a particular kind of information about the *level* of future consumption always lowers the average equity premium. Surprisingly, information sometimes raises the average equity premium, no matter what the preferences of the representative agent. Information purely about the *volatility* either of consumption or the marginal utility of consumption raises the equity premium for a wide class of preferences. Moreover, information can raise the average equity premium by an arbitrarily large percentage (while still matching important magnitudes, such as average growth and the risk-free rate). We consider two different economies: a two-period economy with arbitrary preferences for the representative agent; and an infinite horizon economy, in which we restrict both preferences and the endowment distribution.