The Role of Risk Aversion in the Determination of Equilibrium Stock Prices and their Variability

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In this paper, it is shown that risk aversion plays a critical role in the determination of the equilibrium stock prices and their variability in a one-asset pure exchange economy. Specifically, it is argued that the variance of equilibrium stock prices is a strictly increasing convex function of the Arrow-Pratt measure of relative risk aversion, γ, if γ is greater than one. Furthermore, it is shown that the inequality underlying variance bounds tests can be reversed in our model with risk aversion. Therefore, it is comcluded that the high volatility of stock prices relative to dividends may imply a rejection of risk neutrality rather than a failure of stock market efficiency.