

Endogenous Noise Trading in Financial Markets

We study a financial market where agents with heterogeneous preferences-i.e., heterogeneous gains to trading an asset-trade sequentially. Gains from trade are modeled as a continuous parameter that enters the agents' utility functions. We show that there will always be a positive measure of informed traders who disregard their private information and decide only on the basis of their preferences. These informed traders act as noise traders. The proportion of these traders changes over time: it increases in expected value, as the expectations of the traders and the market maker converge and the importance of private information diminishes. The asset price converges to the fundamental value, but slowly. For example, if the fundamental value is high and there is a crisis, the price will stay low and far from the fundamental for a long period, given that, after the price has dropped, only few traders will trade according to their private information.