

Reply to anonymous referee report

Thank you for the detailed comments! I would like to answer point by point.

Reply to main comments:

1. This point consists of several distinct and non-related comments. a) I don't know what "baroque style" means in this context. b) I agree with Sargent's quote but I deny that one "falls prey to a fallacy" if one raise methodological doubts about rational expectations and advocating other representations of expectations. What fallacy? Perhaps Sargent falls prey to the fallacy that the consistency and elegance of RE hypothesis guarantees the adequacy of its epistemological preconditions? c) Of course my overview is not complete. But as I argued on page 5 the discussed approaches have in common that they impose very structured assumptions about non-observable entities which constitute the core of the explanans. I feel uncomfortable with such an explanatory strategy for methodological reasons. Taking this argument there is no need for reviewing further approaches which face the same shortcoming. d) I regret that I have deceived your hopes for a generalized approach to fundamental uncertainty. But title and abstract of the paper indicate that the topic is portfolio choice and liquidity preference.
2. I argue that self-conscious agents who do not fully trust their beliefs and therefore adapt their decisions in a heuristic way will be more successful. If you wish to call such agents "smart" then feel free to do so. I call them "rule rational". I don't care whether the paper is a contribution to bounded rationality or to portfolio theory. It seems more important to me whether there is an interesting new argument.
3. Yes, this is perfectly right. But it is quite clear that if all agents learn how to adapt their β , this will affect assets prices and hence the (expected) returns. So I have to be careful to make any propositions about the optimal range of β . But the basic logic of the approach will not be suspended by this. Also in case of aggregation there will be responses to increased fundamental uncertainty, favoring liquidity.

Reply to minor comments:

1. I don't understand your point. Of course in RE models there are distributions of variables due to shocks, and these distributions are not driven by (heterogenous)

beliefs. I neither said that heterogenous beliefs *create* distributions of variables nor that heterogenous beliefs necessarily lead to a higher volatility. My argument is that RE crucially depends on the idea of the “true model” which is known to all agents. In fact, agents are observing data which are created by a fundamentally unknown underlying process. The data are consistent with a multiplicity of different models. As this point is shown already in the RE literature cited in my paper, I do not understand why this reflects my “outdated understanding” of RE.

2. As I argued in the previous point, observed distributions of returns give more or less evidence for numerous cognitive models of the underlying data creating process for which we have limited knowledge. This supports that agents a) may hold different beliefs (belief dispersion), b) are aware of this fact. This is the link.
3. What do I gain if I try to model explicitly all these things the agents may feel uncertain about? At the end of the day those agents who feel uncertain for whatever reasons will not completely trust their beliefs and adapt their portfolio decisions in favor of liquidity, and those agents *will benefit from doing so*, thus providing a rationale for heuristic behavior. This is what the paper is about. Opening the black box of their individual knowledge and belief formation processes is an extremely expensive exercise, and I am not sure what we can learn from that.