AQR 25 Years

MARKET RISK AND EFFICIENCY

Market Liquidity: Asset Pricing, Risk and Crises

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Investors require compensation for the trading costs they pay when they buy or sell securities. If two assets generate the same cash flows over time but one of them is less liquid (has higher trading costs), rational investors will pay less for the less liquid asset, which costs more to trade.

Consequently, the less-liquid asset will have a lower value and a higher required (expected) return. Overall, we should observe that the returns on financial assets are increasing in asset illiquidity or transaction costs. Just as risk-averse investors require a higher return to compensate for a higher asset risk, we propose that investors require a higher return to compensate for greater asset illiquidity or transaction costs.

Illiquidity means incurring high transaction cost, which includes a large price impact when trading and facing a long time to unload a large position. Liquidity risk is higher if a security becomes more illiquid when it needs to be traded in the future, which will raise its trading cost.

The analysis in this book shows that higher illiquidity and greater liquidity risk reduce securities prices and raise the expected return that investors require as compensation. Aggregate market liquidity is linked to funding liquidity, which affects the provision of liquidity services. When these become constrained, there is a liquidity crisis, which leads to downward price and liquidity spiral. Overall, this book demonstrates the important role of liquidity in asset pricing.

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