E Q U I T I E S

Adverse Selection and the Required Return

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Securities are traded by buyers and sellers with different levels of knowledge about those securities. One party may suspect the other of knowing more about the security than they do, and this could affect the buyer's bid or the seller's offering price. This paper seeks to answer two questions: What are the costs implied by present and future asymmetric information? And how are those costs reflected in securities prices?

We find that asymmetric information leads to adverse selection and imperfect risk sharing, resulting in a reduced price and a higher required return. We explicitly derive the effect of adverse selection on required returns, and show how our result differs from models that consider the bid-ask spread to be an exogenous cost, like the cost of trading.

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