Trading

Liquidity and Asset Prices

January 1, 2006

Liquidity is a complex concept. Stated simply, it is the ease of trading a security. This survey reviews the literature that studies the relationship between liquidity and asset prices. We review the theories about how liquidity affects a security's required return and discuss the empirical connection between the two.

Liquidity has wide ranging effects on financial markets. As our survey shows theoretically and empirically, liquidity can explain the cross-section of assets with different liquidity, after controlling for other assets' characteristics such as risk, and the time series relationship between liquidity and securities returns.

Liquidity helps explain why certain hard-to-trade securities are relatively cheap, the pricing of stocks and corporate bonds, the expected return on hedge funds, and the valuation of closed-end funds. It follows that liquidity can help explain a number of puzzles, such as why equities commanding high required returns (the equity premium puzzle), why liquid risk-free Treasuries have low required returns (the risk-free rate puzzle), and why small stocks that are typically illiquid earn high expected returns (the small-firm effect).

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