M A R K E T R I S K A N D E F F I C I E N C Y

Future Liquidity, Present Value: Measuring and Pricing Liquidity Risk

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In a seminal 1991 paper, John Y. Campbell showed how an asset's return is related to new information about its future cash flows and discount rates. This paper extends Campbell's return decomposition to show how an asset's return is also related (inversely) to new information about its future liquidity. Because liquidity costs are not incurred once, but many times over the lifetime of an asset, changes in forecasts of future liquidity levels influence contemporaneous prices.

A number of papers have estimated the price of contemporaneous liquidity risk and found it to be, perhaps surprisingly, large. This paper estimates the price of liquidity risk, now including both contemporaneous liquidity risk as well as the risk arising from new information about future liquidity.

The paper concludes that the price of liquidity risk is significantly lower when considering future liquidity than it is estimated to be when ignoring the role of news about future liquidity.