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Abstract

Traditional models of portfolio choice assume that investors can continuously trade unlimited amounts of securities. In reality, investors face liquidity constraints. I analyze a model where investors are restricted to trading strategies that are of bounded variation. An investor facing this type of illiquidity behaves very differently from an unconstrained investor. A liquidity-constrained investor endogenously acts as if facing borrowing and short-selling constraints, and one may take riskier positions than in liquid markets. I solve for the shadow cost of illiquidity and show that large price discounts can be sustained in a rational model.

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