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Margin-based Asset Pricing and Deviations from the Law of One Price Get access >

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Abstract

In a model with heterogeneous-risk-aversion agents facing margin constraints, we show how securities' required returns increase in both their betas and their margin requirements. Negative shocks to fundamentals make margin constraints bind, lowering risk-free rates and raising Sharpe ratios of risky securities, especially for high-margin securities. Such a funding-liquidity crisis gives rise to "bases," that is, price gaps between securities with identical cash-flows but different margins. In the time series, bases depend on the shadow cost of capital, which can be captured through the interest-rate spread between collateralized and uncollateralized loans and, in the cross-section, they depend on relative margins. We test the model empirically using the credit default swap-bond bases and other deviations from the Law of One Price, and use it to evaluate central banks' lending facilities.

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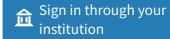
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