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A Search-Based Theory of the On-the-Run Phenomenon

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ABSTRACT

We propose a model in which assets with identical cash flows can trade at different prices. Infinitely lived agents can establish long positions in a search spot market, or short positions by first borrowing an asset in a search repo market. We show that short-sellers can endogenously concentrate in one asset because of search externalities and the constraint that they must deliver the asset they borrowed. That asset enjoys greater liquidity, a higher lending fee ("specialness"), and trades at a premium consistent with no-arbitrage. We derive closed-form solutions for small frictions, and provide a calibration generating realistic on-the-run premia.

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