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Liquidity, Asset Prices and Financial Policy

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Liquidity, Asset Prices and Financial Policy

Liquidity is an important factor in asset pricing. For both stocks and bonds, the lower the liquidity of an asset (that is, the higher the cost of trading it), the higher the return it is expected to yield. This does not necessarily mean that investors are better off holding assets with low liquidity, because higher transaction costs can eat up return gains. Only investors with long holding periods benefit from holding low-liquidity assets.

When designing an investment portfolio, a portfolio manager should consider not only the client's risk aversion, but also its investment horizon. A short horizon calls for investing in liquid assets, whereas a long investment horizon enables the investor to earn higher net returns by investing in illiquid assets. The analyst can quantify this liquidity–return tradeoff in light of the client's investment horizon. Financial analysts should also consider how changes in assets' liquidity will affect asset values.

Given the negative effects of illiquidity on asset prices, liquidity should affect the design of publicly traded securities. The more liquid a financial instrument, the higher the price for which it can be sold. Liquidity considerations should also affect financial policies. Companies whose claims are traded in the capital market can benefit by undertaking steps to increase the liquidity of their claims, thus reducing their cost of capital. Public authorities can help reduce the cost of capital and increase market efficiency by devising rules and procedures that increase the liquidity of traded assets. They should avoid laws and regulations that hurt the liquidity of the capital markets.

LIQUIDITY (OR MARKETABILITY) is a key attribute of capital assets, and it strongly affects their pricing. The **liquidity effect** can be likened to the widely known effect of risk on capital assets. Risk-averse investors require higher expected returns to compensate for greater risk. Similarly, investors prefer to commit capital to liquid investments, which can be traded quickly and at low cost whenever the need arises. Investments with less liquidity must offer higher expected returns to attract investors. In equilibrium, the expected returns on capital assets are increasing functions of both risk and illiquidity.

This article presents evidence on the effects of liquidity on asset prices, showing that liquidity is an important determinant of the returns on capital assets. Given the existence of a liquidity effect, we demonstrate its implications for public and private financial policies. We begin with a description of the costs of illiquidity.

Costs of Illiquidity

An asset is liquid if it can be bought or sold at the current market price quickly and at low cost. Illiquidity is thus related to the costs of executing a transaction in the capital markets. In addition to direct transaction costs, which are relatively easy to measure, the costs of illiquidity include the difference between the actual execution price and the price that would have prevailed in the absence of the transaction, which is virtually impossible to measure.[1] Illiquidity costs can be separated into a number of distinct components.

(1) *Bid-ask spread*: Dealers and market-makers

1. Footnotes appear at end of article.

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