Liquidity and Asset Pricing (B40.4306)

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Professor

Lasse H. Pedersen
Email: lpederse@stern.nyu.edu
Homepage: http://www.stern.nyu.edu/∼lpederse/

Course Website

http://www.stern.nyu.edu/∼lpederse/courses/LAP/LAP.html

Organization of the Class

While standard finance models are based on the assumption of perfect markets, real-world markets are plagued by several important frictions and imperfections, often referred to as illiquidity. In this Ph.D. seminar class, we discuss how liquidity affects the optimal behavior of traders and the pricing of assets.

In the first part of the class, we derive the asset prices in the context the main sources of illiquidity that are enumerated on page 2. In the second part of the class, we discuss research papers chosen by the students. An important part of the class is the research discussion and, hence, all students are expected to be well prepared and participate actively in the discussion.

Outline

1. Basic Models of Liquidity and Asset Prices
    (a) Overview
    (b) Transactions Cost
        i. Fixed Transactions Costs and Trading Periods
        ii. Endogenous Trading Horizons
        iii. Time-Varying Transactions Costs and Liquidity Risk
    (c) Inventory Risk and Demand Pressure
        i. Single Period and One Security
        ii. Dynamics and Multiple Securities
        iii. Funding Liquidity and Market Liquidity
    (d) Private Information and Strategic Trading
        i. Private Information about Fundamentals
        ii. Private Information about Order Flow
        iii. Required Returns
    (e) Search Frictions
        i. Valuation
        ii. Marketmaking
        iii. Multiple Securities
    (f) Short-Sale Constraints and Differences of Opinions
        i. Static Effects
        ii. Dynamic Effects
        iii. Securities Lending
    (g) Derivative Pricing in Illiquid Markets
        i. Bounds on Derivative Prices with Illiquid Markets
        ii. Demand-Pressure Model
2. Topics (to be Decided)