The More Illiquid, The More Expensive: A Search-Based Explanation of the Illiquidity Premium

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Liquidity premium **Liquid** assets are more valuable because they are easier to be sold

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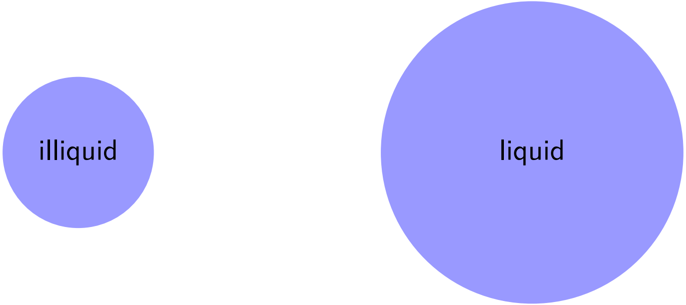
Empirically Illiquidity premium during market distress

liquidity premium in normal periods

Mechanism



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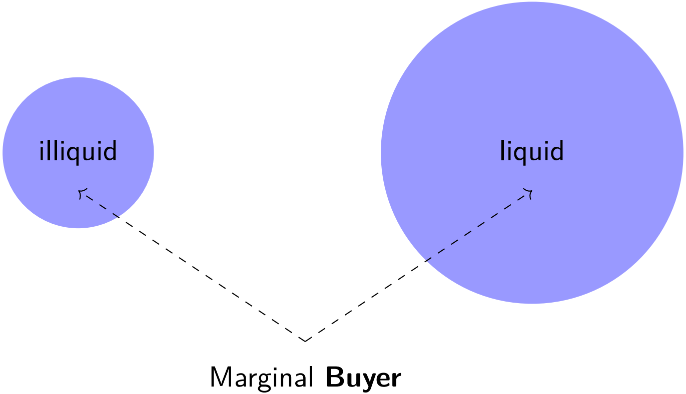

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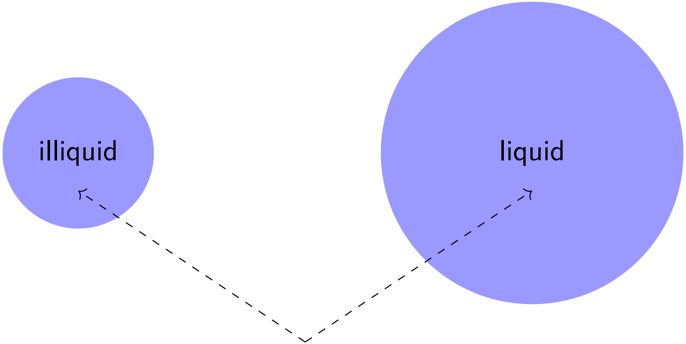

Marginal **Buyer**

$P_{\text{illiquid}} < P_{\text{liquid}}$: **Liquidity** Premium

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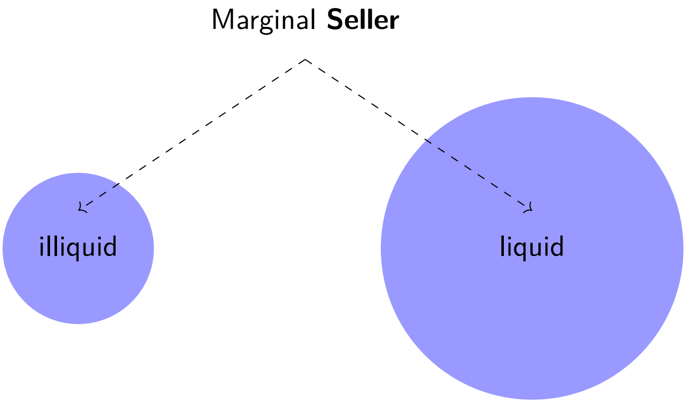

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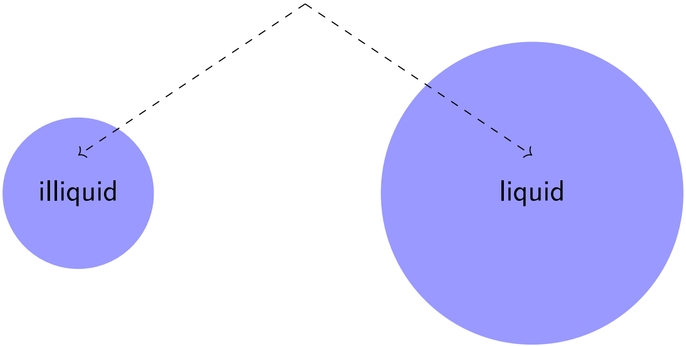
Marginal **Seller**



Connection to labor search models

- In labor search models, workers face a trade-off between a higher wage and a lower probability of getting a job

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- Firms post wages
- Each worker chooses which firm to apply
- A higher wage attracts more applications, and thus each application has a lower probability of success
- In equilibrium, a worker is indifferent between applying to a high-wage and a low-wage job

Commitment to mutually exclusive choice

- Requires investors to commit to a mutually exclusive choice of which asset to trade
- Like choosing which country to live
- If investors can choose which asset to trade upon meeting $\implies$ always liquidity premium
  - Marginal investor is indifferent between trading either of the two asset
  - $P_{\text{liquid}} > P_{\text{illiquid}}$ (standard explanation for liquidity premium)

Solution: directed search?

- Each investor has a fixed "search capicity"
- Each investor chooses how to allocate her search capacity across other investors—toward "whom" to prioritize search
- "Global" investors can trade either asset, "local" investors can trade only one asset
- Conjecture: a global investor i direct her searches only to toward a "local" investor
  - A local investor has a worse outside option
  - Investor i obtains a better price when trading with a local investor
- In equilibrium, a global seller is indifferent between search for a local buyer of asset A and a local buyer of asset B

Illiquidity premium $\rightarrow$ liquidity discount

- "What is the illiquidity premium? A primer on the rewards and hazards of investing in hard-to-trade assets" (The Economist)

- "The terms *illiquidity premium* and *liquidity premium* are used interchangeably. Both mean that an investor is getting an incentive for a longer-term investment." (Investopedia)

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- Liquidity discount?

Summary

- Illiquidity premium a striking pattern
- Elegant model that generates
  - liquidity premium during normal period
  - illiquidity premium during market distress
- Main suggestions:
  - Relax commitment to mutually exclusive choice?
  - Use directed search?