

# LIQUIDITY DISCOVERY AND ASSET PRICING\*

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First Draft: April 2003  
Current Draft: June 3, 2004

## Abstract

Most investors purchase securities knowing they will resell those securities in the future. Uncertainty about the preferences of future trading counter-parties causes randomness in future resale prices that we call *liquidity risk*. It is natural to suppose that investors are asymmetrically informed about liquidity risk. Through a process of *liquidity discovery*, trading volumes and prices reveal private information about future counter-party preferences. The liquidity discovery process leads to endogenous joint dynamics for prices, trading volume, volatility, and expected returns. In particular, market liquidity is a forward-looking predictor of future liquidity risk and, as such, is priced. Liquidity discovery provides an alternative explanation to transaction costs for the relationships between current market liquidity measures and future returns.

**Keywords:** Liquidity risk, liquidity discovery, asset pricing.

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\*We thank Robert Engle, Paolo Fulghieri, Rick Green, Eric Hughson, Alfred Lehar, Spencer Martin, Ernst Maug, Maureen O'Hara, Bryan Routledge, Gideon Saar, Alex Stomper, Allan Timmermann, Stathis Tompaidis, Tan Wang, Robert Whitelaw, Christopher Yung, and seminar participants at Arizona State University, Carnegie Mellon University, the Commodity Futures Trading Commission, Humboldt University, the Instituto Tecnológico Autónomo de México, New York University, the Norwegian School of Management, the Sante Fe Institute, the Stockholm School of Economics, the University of Colorado at Boulder, the University of North Carolina, the University of Vienna, and the University of British Columbia Summer Finance Conference for helpful comments.

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