

Discussion of "Liquidity and Liquidity Risk
in the cross-section of stock returns"
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Methodology

- ▶ investigates portfolio of stocks sorted on the basis of liquidity level and liquidity risk
 - ▶ Define $Illiq_{i,m}$ as the monthly average of Amihud's daily illiquidity measure.
 - ▶ Define the aggregate monthly illiquidity level as $Illiq_m^M = \frac{1}{N} \sum_{i=1}^N Illiq_{i,m}$.
 - ▶ **Liquidity level** is defined as $\frac{Illiq}{Illiq^M}$
 - ▶ Define aggregate liquidity factor ($MLiq$) as the residual of regression of the market cap weighted $Illiq^M$ on two of its own lags.
 - ▶ **Liquidity Risk** is defined as the coefficient on $MLiq$ in a time series regression of stock i on $MLiq$ and controls (the market return, SMB and HML).
- ▶ Investigates performance (sharpe ratios) of:
 - ▶ 5 portfolios sorted on liquidity level,
 - ▶ 5 portfolios sorted on liquidity risk,
 - ▶ 9 portfolios double sorted (3×3) on liquidity level and risk
- ▶ Then main results are:
 - ▶ High illiquidity level portfolios have highly significantly positive (four-factor FF) alphas.
 - ▶ Low illiquid stocks have insignificant (four-factor FF) alphas
 - ▶ High-minus low illiquidity portfolios have significant (four-factor FF) alphas.
 - ▶ Illiquidity risk spread portfolios have insignificant alphas.
 - ▶ Double sorted portfolios confirm that liquidity level not liquidity risk matters for the cross-section of expected returns.
- ▶ Conclude that "investors are more concerned with cost of trading than with exposure to market-wide liquidity" (p 16)

Comments

- ▶ Research question stated page 4-5: "there is clear recognition of liquidity's importance for asset pricing models, but there is no understanding about what investor should take into account while making investment decisions: the liquidity level or the liquidity risk?"
- ▶ Are the proxies proposed really picking up cost of trading versus liquidity risk?
- ▶ What are costs of trading: bid-ask spreads? price impact?
- ▶ What does the Amihud measure capture: Adverse selection? News? Risk?
 - ▶ Example of large activist share-holder who announces his position in a stock (e.g., Carl Icahn on Chesapeake last week). stock jumps 5% with little change in volume. On that day Amihud measure is high. Is this an Illiquid stock (more than prior to the announcement)?
 - ▶ Suppose that abnormal volume is correlated with systematic 'risk' factors. Suppose one stock's volatility tends to comove highly with these factors and hence with volume. It will tend to have higher Amihud measure. And probably higher liquidity '**risk**'?
- ▶ The construction of the liquidity risk-measure. Where does it come from (theory?)

Contribution

- ▶ Interesting question.
- ▶ Analysis seems very similar to Acharya Pedersen (same definition of liquidity level and risk). Important to discuss relative contribution.
- ▶ As in AP, find that liquidity risk is not (very) significant in explaining cross-section of stock returns.
- ▶ Most interesting result (to me) is fact that neither alternative measure (Pastor-Stambaugh or Lou-Sadka) of liquidity risk seems statistically significant in the cross-section: how to reconcile this with the respective authors' results? (different time period, or ...?)
- ▶ Main concern (as for AP) is whether Liquidity level proxy really captures trading costs (as it should in their theory).
- ▶ Perhaps should explore alternative measures of trading costs and liquidity risk (TAQ data...).