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The Time Cost of Information in Financial Markets

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The Time Cost of Information in Financial Markets

Chad Kendall*

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Abstract

I model a financial market in which traders acquire private information through time-consuming research. A time cost of information arises due to competition - through the expected adverse price movements due to others' trades - causing traders to rush to trade on weak information. This cost monotonically increases with asset value uncertainty, so that, exactly opposite to the result under the standard modeling assumption of a monetary cost of information, traders acquire the least information when this uncertainty is largest. The model makes several novel testable predictions regarding volume and order imbalances, some of which have existing empirical support.

1 Introduction

Incentives to acquire information about financial assets are crucial to the informational efficiency of market prices, which is in turn important for the efficient allocation of resources, specifically capital.[1] As such, a large literature studies information acquisition in financial

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[1]The idea that prices serve an important role in allocating resources goes back to at least Hayek (1945). In particular, firm prices are socially valuable because they allow capital to be allocated efficiently across firms and serve as a signal to managers that internal resources are being used appropriately. See Bond, Edmans, and Goldstein (2012) for a recent review of the literature on the real effects of secondary financial markets.

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