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Liquidity might come at cost:
The role of heterogeneous preferences*

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ABSTRACT

Asset-pricing models with volume are challenged by the high turnover-rates in real stock markets. We develop an asset-pricing framework with heterogeneous risk preferences and show that liquidity and turnover increase with heterogeneity to a maximum, and then decline. With U.S. parameters, turnover exceeds 55%. Liquidity is costly since it facilitates a large share redistribution across agents, causing changes in average risk aversion, which increases Sharpe ratio variability, and hence stock return volatility. Illiquidity and its risk are minimized at moderate heterogeneity levels, highlighting an "optimal" heterogeneity level, yet, there is no "optimal" combination between liquidity level and Sharpe ratio variability.

Keywords: Heterogeneity; Discount rate risk; Turnover; Liquidity; Sharpe ratio

JEL Codes: C61, D53, E44, G11, G12

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