

Asian Finance Association 2009 International Conference

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**Hendrik Bessembinder
David Eccles School of Business, University of Utah**

Liquidity and Asset Pricing

Abstract

Microstructure noise in observed security prices biases the results of empirical asset pricing specifications when security-level explanatory variables are cross-sectionally correlated with the amount of noise. We focus on tests of whether measures of illiquidity, which are particularly likely to be correlated with the noise, are priced in the cross-section of stock returns, and document a significant upward bias in estimated return premia for an array of illiquidity measures in CRSP monthly return data. The upward bias is larger when illiquid securities are included in the sample, but persists even for NYSE/AMEX stocks after decimalization. We introduce a methodological correction to eliminate the biases that simply involves WLS rather than OLS estimation, and find evidence of smaller, but still significant, return premia for illiquidity after implementing the correction.