

Equilibrium Asset Pricing and Portfolio Choice in the Presence of both Liquid and Illiquid Markets

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Abstract

I study equilibrium asset prices and portfolio choice in a model where risk averse agents can trade both in an illiquid, over-the-counter market and in a liquid, centralized market.

I show the existence and uniqueness of an equilibrium. I also characterize, in a semi-analytic way and up to first order approximation in the degree of illiquidity, the strategies and utilities of the various agents, and the prices of the assets.

In my setting, the price of the liquid asset is unaffected by the illiquidity level on the over-the-counter market. However, the centralized market has an ambiguous effect on *(i)* which trades are implemented on the over-the-counter market, *(ii)* the fundamental price of the illiquid asset, *(iii)* the sign of the illiquidity correction, and *(iv)* the amplitude of the liquidity correction.