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- A single illiquidity measure is proposed to capture the multidimensionality of illiquidity.
- Both parametric and non-parametric methods are applied to investigate the relationship between illiquidity and stock returns in the UK.
- The inclusion of the illiquidity factor in the capital asset pricing model plays a significant role in explaining stock returns.
- The illiquidity-augmented capital asset pricing models yield a small distance error by using Hansen-Jagannathan non-parametric bound.
Illiquidity Premium and Expected Stock Returns in the UK: A new Approach

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Abstract

This study examines the relative importance of liquidity risk for the time-series and cross-section of stock returns in the UK. We propose a simple way to capture the multidimensionality of illiquidity. Our analysis indicates that existing illiquidity measures have considerable asset specific components, which justifies our new approach. Further, we use an alternative test of the Amihud (2002) measure and parametric and non-parametric methods to investigate whether liquidity risk is priced in the UK. We find that the inclusion of the illiquidity factor in the capital asset pricing model plays a significant role in explaining the cross-sectional variation in stock returns, in particular with the Fama-French three-factor model. Further, using Hansen-Jagannathan non-parametric bounds, we find that the illiquidity-augmented capital asset pricing models yield a small distance error, other non-liquidity based models fail to yield economically plausible distance values. Our findings have important implications for managing the liquidity risk of equity portfolios.

Keywords: Asset pricing models; Multiple illiquidity measures; Hansen-Jagannathan test.
JEL Classification: E21; G12; G14; G15

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1. Introduction

The role of liquidity in asset pricing has grown rapidly over the past few years. A variety of studies have proposed different illiquidity measures as proxies for illiquidity by investors. However, although researchers are able to test whether the stock returns are statistically related to their illiquidity measures, their results generate conflicting impacts over stock returns. In other words, despite the increasing interest in the role of liquidity in equity markets in general, and asset pricing in particular, a universal definition for liquidity remains elusive, and the basic question of how to measure liquidity remains unsolved. For example, Hasbrouck (2002) and Goyenko, Holden, and Trzcinka (2009) find that the measures are of a different quality themselves. They find that different measures have conflicting impact on stock returns: Amihud’s price to volume measure is reported to have significant impact on stock returns but Pastor and Stambaugh’s gamma is tested to have very little impact. In fact, if the empirical results are based solely on one particular measure, it is difficult to ascertain whether the results are driven by measure-specific components or by some common components of the measured illiquidity. Therefore, it is important to reconcile the conflict by collapsing all existing measures into one measure. Given the fact that strong evidence against the reliability of a single illiquidity measure exists, in this paper we adopt not only individual measures, but also construct a comprehensive illiquidity proxy. This illiquidity proxy is used across seven different measures and examines whether the pricing of liquidity risks varies amongst these measures. In particular, we adopt illiquidity measures introduced by Amihud (2002), Stambaugh (2003), zero-return measures proposed by Lesmond, Ogden, and Trzcinka (1999) and Liu (2006), Roll’s (1984) effective bid-ask spread measure (Roll, 1984), the price-based spread measure of Corwin and Schultz (2012) and the effective tick measure from Goyenko et al. (2009). Consistent with Korajczyk and Sadka (2008) and Kim and Lee (2014), we find around 33% of the variation in illiquidity proxies is explained by the first principal component, which further suggests that systematic common components exist in illiquidity measures.

Our study contributes to understanding of the seemingly contradictory effects of illiquidity on asset pricing in several ways. It is generally the case that recent researchers have focused on new factors that contribute to tra-

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1Liquidity is a broad and elusive concept that generally denotes the ability to trade large quantities quickly, at low cost, and without moving the price. Financial literature indicates that rational investors who think they hold shares in exchange for lower returns with higher degree of liquidity they claim.
ditional asset pricing models. Indeed, Fama and French (2015) propose a brand new five-factor model while adopting indirect factor to denote liquidity. In contrast, in our approach we use UK data and examine the price of the common systematic components of illiquidity. There are indeed differences between the UK and the US environment in terms of trading and market structure. In the UK, all trading takes place on the London Stock Exchange (LSE) whereas in the US stocks are traded primarily on the Nasdaq and NYSE. In the US, trading on Nasdaq is based on order book driven while the NYSE uses a hybrid system. In the case of the UK, trading on the LSE is a mix of order book driven (SETS) and a hybrid quote/order book driven system. Furthermore, the UK is a bank-based system, which is more vulnerable to liquidity crunches than capital market-based system (US) because the first-order risk is bank solvency and the level of risk lies with financial institutions (Hardie and Maxfield, 2010). Since most studies on illiquidity premium and expected stock returns are predominantly based on US data, in this paper we seek to investigate if differences in market structure and liquidity characteristics of a country will lead to different results (Foran, Hutchinson, and O’Sullivan, 2014; Huang and Stoll, 2001). In this paper, we define ‘illiquidity factor’ as the spread return of equal-weighted portfolios \( P10-P1 \). These portfolios are constructed on the basis of the first principal component of the first seven illiquidity measures. Further, rather than the conventional parametric tests of asset pricing models, we use Hansen-Jagannathan distance to examine non-parametrically the level of errors associated with the liquidity capital asset pricing model (LCAPM). This helps shed light on these errors as an indication on the efficiency of the models.

This paper aims to provide answers to a number of questions. Firstly, based on existing illiquidity measures, is there a single illiquidity proxy that can significantly outperform other proxies with robust illiquidity premiums in asset pricing models in the UK? Secondly, does liquidity commonality exist in the UK? Thirdly, which liquidity-adjusted asset pricing model explains stock returns in the UK? Finally, do the results vary between parametric and non-parametric tests?

The remainder of the paper is set out as follows. Section 2 provides a brief review of the literature on the illiquidity framework. Section 3 provides details of the methodology and models we used to answer our questions. Section 4 presents the data and variable construction. Section 5 presents the empirical results and section 6 concludes.
2. Literature Review

What kinds of risk systematically drive stock prices? This question has prompted vast amounts of research and continues to exist as one of the main challenges in finance. The Sharpe-Lintner CAPM (1964) was the first attempt to answer this question by quantifying the risk which is attributable to general market fluctuations (Sharpe, 1964).

Yet, although the Sharpe-Lintner CAPM provides a theoretical framework to explain stock returns, the ability of the model to describe asset returns is weak. Indeed doubts regarding the empirical validity of the model are well established and it is both frequently rejected by data and also known to ignore some well documented anomalies, see *inter alia* (Black, 1972; Fama and MacBeth, 1973; Gibbons, 1982; Hyde and Sherif, 2005; Stambaugh, 1982). Traditional tests of the CAPM assume that the market portfolio is observable, expected returns are constant, and that assets’ betas are stationary over a fixed period. Further, it measures risk by beta, which is a consequence of its questionable assumption of the existence of an equilibrium in which investors display mean-variance behaviour and requires the distribution of stock returns to be symmetrical.

The failure of the Sharpe-Lintner CAPM to capture the behaviour of the data and to measure a stock’s or a portfolio’s volatility has led to a number of different approaches that have attempted to address the limitations of the model. For instance, the three-factor model Fama and French (1993) and the Carhart (1997) model have received significant attention in empirical research. Whilst Fama and French (1993) demonstrate that asset prices are influenced not only by market systematic risk, but also the size and value factors, Carhart (1997) argues that momentum is an important risk factor which has not been priced in assets.

Recently, much attention has been given to market friction and in particular it has been widely argued that liquidity, see *inter alia* (Amihud, 2002; Bekaert, Harvey, and Lundblad, 2007; Chan and Faff, 2005; Chordia, Roll, and Subrahmanyam, 2001; Goyenko, Holden, and Trzcinka, 2009; Hasbrouck, 2002; Liu, 2006; Stambaugh, 2003), appears to be a suitable candidate for a priced state variable. For example, Lillo, Farmer, and Mantegna (2002) suggest that liquidity fluctuation is a permanent market impact. However, Bouchaud, Kockelkoren, and Potters (2006) argue that the impact power is transient and will decay in time. In fact, liquidity is often viewed as an important feature of the investment environment and the macro economy, and recent studies find that fluctuations in various measures of liquidity are correlated across assets. Furthermore, the importance
of liquidity on security returns has been confirmed by numerous previous empirical studies, which have thus established liquidity as a key consideration in investment decisions.

Nevertheless, using liquidity-based explanations are not straightforward. A difficulty in testing the liquidity-based explanation lies in the fact that stock liquidity is subjective concept and is very hard to measure. However, whilst liquidity is an elusive concept, most market participants agree that liquidity generally reflects the ability to buy or sell sufficient quantities quickly, at low trading cost, and without impacting the market price too much. Consequently, a vast number of measures have been used to approximate the extent to which a stock is illiquid or liquid. The first set of illiquidity measures have been based on stock daily returns or trading volume. Amihud (2002) proposes a simple and intuitive illiquidity measure, which is defined as the absolute daily return divided by daily trading volume. Acharya and Pedersen (2005) use the illiquidity proxy of Amihud (2002) and find evidence to support the model in the US market over the period 1962-1999. Elsewhere, Stambaugh (2003) have proposed a illiquidity measure called ‘price sensitivity to order flow’, which is based on return reversal due to heavy trading volume. Another illiquidity proxy is the turnover measured by daily share trading volume divided by the number of total shares outstanding.

The second set of illiquidity indicators are based exclusively on returns and provide a simple way of obtaining illiquidity proxy. For example, Liu (2006) proposes a trading volume-adjusted zero return measure and shows that the illiquidity measured by the proposed indicator is in fact priced in as far as the US market is concerned. It is worth noting that the zero return indicator is a number of zero return days scaled by the total available trading days in a given period. This measure indicates that on a day when trading cost is high, informed traders would not trade, resulting in zero return on that day. This measure is especially reliable in international finance research, as a high quality daily trading volume is not guaranteed (Bekaert et al., 2007; Lee, 2011). In addition, Lesmond et al. (1999) also propose a illiquidity measure based solely on daily returns. It was shown to be significantly correlated with the spread data and is used to show the illusionary aspect of momentum trading (Lesmond, Schill, and Zhou, 2004).

The third set of measures is based on return correlation, effective tick, and effective spread. Roll (1984) and Goyenko et al. (2009) suggest a proxy of spread based on the serial correlation of daily returns and effective spread. Also, in a recent study, Das and Hanouna (2010) create a measure of illiquidity based on ‘run length’, which totals the consecutive series of positive
and negative daily returns before the sign reverses. The authors further highlight that this particular illiquidity measure acts as a proxy for price impact.

2.1. Illiquidity Measures

Much literature suggests a number of proxies for illiquidity that are used as time-series conditioning variables. However, there are no agreed or final measures, and researchers have not yet reached an agreement regarding the optimal illiquidity proxy. In recent studies, Liu (2009) examine seven individual illiquidity measures. According to their findings, some proxies perform better than others in asset pricing models, which shows a more significant and robust illiquid premium. However, their results remain inconclusive regarding the most suitable illiquidity proxy. Arguably, a possible solution to find a suitable illiquidity proxy is an alternative method that extracts commonality of illiquidity risk. Indeed, recent researchers have implemented multiple illiquidity measures to gauge the robustness of their results. For example, Korajczyk and Sadka (2008) adopted multiple proxies and found that the illiquidity commonality exists among their measures. Similarly, Kim and Lee (2014) further found that the systematic common component of illiquidity measures risk in the US.

In this study we complement such approaches and add to the field by testing illiquidity individually. We form a composite index of illiquidity based on the common variation of a number of proxies for illiquidity, including turnover ratio, reversal measure of illiquidity, trading volume, bid-ask spread, effective spread, and number of zero return days.

1 Return/Value Ratio (Amihud, 2002)

The first illiquidity measure is the return to volume ratio proposed by Amihud (2002) to estimate illiquidity of stocks. This measure has been widely used in empirical literature because of its easiness of construction (Acharya and Pedersen, 2005). However, it is so far not clear that Amihud’s measure would be priced, due to the compensation for price impact in comparison to other proxies which is something that requires further investigation.

Amihud defines illiquidity of stock \(i\) in time \(t\) as:

\[
RV_i \equiv ILLIQ_i^t = \frac{1}{\text{Days}_t^i} \sum_{d=1}^{\text{Days}_t^i} \frac{|R_{i,d}^t|}{V_{i,d}^t} \tag{1}
\]
where $R_{it}^d$ is the return on day $d$ in month $t$, $V_{it}^d$ is the dollar volume (in millions) on day $d$ in month $t$, and $Days_{it}^t$ is the number of valid observation days in month $t$ for stock $i$. In particular, $V_{it}^d$ in this paper represents GB pound sterling (hereafter referred to as pound) volume (in millions) for the UK.

2 Reversal Measure of illiquidity (Stambaugh, 2003)

The reversal measure of illiquidity has been advocated by Stambaugh (2003). This measure reflects the return reversal after trading: the larger the volume, the larger the return reversal, and the larger the cost. Yet, one drawback of this measure is that it is time consuming in a real-time estimation. The measure is identified as:

$$r_{i,d+1,t} - r_{M,d+1,t} = \alpha_{i,t} + \beta_{i,t} r_{i,d,t} + \gamma_{i,t} \text{sign}(r_{i,d,t} - r_{M,d,t}) d\text{vol}_{i,d,t} + \epsilon_{i,d,t}. \quad (2)$$

where $r_{i,d+1,t}$ is the return on stock $i$ of day $d$ at month $t$, $r_{M,d+1,t}$ is the market return (FTSE-All share value-weighted index return) on day $d$ at month $t$, and $d\text{vol}_{i,d,t}$ is the pound trading volume (in million-pound unit). $\gamma_{i,t}$ is the coefficient of signed pound trading volume.

3 Zero Return (Lesmond et al., 1999)

Intuitively, when trading cost is higher than the benefit of trading, rational investors would choose not to trade (Lesmond et al., 1999). Therefore, we observe zero return for such days in this case. This measure is reported to be popular in international finance research, especially in emerging markets, where high-quality daily trading volume data are not available.

Lesmond et al. (1999) propose the zero return (ZR) illiquidity measure:

$$ZR_{i,t} = \frac{N_{i,t}}{T_t} \quad (3)$$

where $T_t$ is the number of trading days at time $t$; $N_{i,t}$ is the number of zero-return days of stock $i$ in time $t$.

4 Turnover-Adjusted Zero-Return (Liu, 2006)

ZR measures can potentially lead to the same level of illiquidity for several stocks in multiple periods. In this case, Liu (2006) further proposed a turnover-adjusted zero-return measure, which is identified as:
\[ LM_{x_{i,t}} = \left\{ N_Z + \frac{TV_x}{DF} \right\} \times \frac{21x}{N_x} \]  

(4)

where \( N_Z \) is the number of zero-volume days in the previous \( x \) month; \( TV_x \) is the turnover over the previous \( x \) month, which is calculated as the sum of daily trading volume divided by the number of shares outstanding; \( N_x \) is the number of trading days in previous \( x \) months and \( DF \) is a deflator.

Based on Liu (2006), we adopt the \( LM12 \) measure, which is based on the previous twelve months’ data. Therefore, \( x \) is equal to twelve and we use the deflator of 11,000 as proposed by Liu (2006).

5 Bid-Ask Spread (Corwin and Schultz, 2012)

Amongst all of the proxies mentioned above, the bid-ask spread measure, in particular, has received extensive recognition by researchers. The data are widely available in real time and this measure can be calculated very quickly. However, the bid and ask quotes remain current only for a limited time periods. This is because the spread only measures the cost of executing a single trade of a certain size which requires complementary studies of other measures.

In a recent study, Corwin and Schultz (2012) developed the illiquidity measure from the ratio of daily high and low prices, excluding the volatility component. They define the spread estimator as:

\[ S = \frac{2(e^k - 1)}{1 + e^k} \]  

(5)

where \( K \) is identified as:

\[ K = \frac{\sqrt{2E\{\sum_{j=0}^{1}[ln(\frac{P_{H_{i,t}}}{P_{L_{i,t}}})]^2\}} - \sqrt{E\{\sum_{j=0}^{1}[ln(\frac{P_{H_{i,t}}}{P_{L_{i,t}}})]^2\}}}{(3 - 2\sqrt{2})} - \sqrt{\frac{[ln(\frac{P_{H_{i,t+1}}}{P_{L_{i,t+1}}})]^2}{(3 - 2\sqrt{2})}} \]  

(6)

where \( P_{H_i} \) and \( P_{L_i} \) are the high and low stock price at day \( t \). Our monthly illiquidity measure \( CS \) is identified as the average daily estimated spread \( s \) in time \( t \).

6 Bid-Ask Spread (Roll, 1984)
Roll (1984) proposes the effective spread based on the bid-ask spread:

\[ RO_{i,t} = 2\sqrt{-\text{COV}(R_{i,d}, R_{i,d-1,t})} \]  

(7)

where \( R_{i,d} \) is the return of trading day \( d \) in month \( t \) and \( R_{i,d-1,t} \) is the return of the previous trading day in the same month.

To make the possibility of positive covariance, we impose absolute values as suggested by (Lesmond, 2005). Consequently, in our study, Roll’s measure is defined as:

\[ RO_{i,t} = 2\sqrt{|\text{COV}(R_{i,d}, R_{i,d-1,t})|} \]  

(8)

7 Effective Tick (ET) (Goyenko et al., 2009)

Finally, we employ the effective tick (ET) measure advocated by Goyenko et al. (2009). This measure is argued to be the simplest measure for all effective spreads. It is identified as:

\[ ET = \frac{\sum_{j=1}^{1} \gamma_j S_j}{\bar{P}_k} \]  

(9)

We obtain \( S_j \) by using the decimal grid, which is an approach similar to that of the dollar grid proposed by Hagström, Hansson, and Nilsson (2011). In this case, the possible spreads are at £0.01, £0.05, £0.1, £0.2, £0.5 and £1. \( \bar{P}_k \) is the average daily prices in month \( k \), and \( \gamma_j \) is defined as:

\[ \gamma_j = \begin{cases} 
\text{Min}[[\text{Max}(U_j, 0), 1] & j = 1 \\
\text{Min}[[\text{Max}(U_j, 0), 1 - \sum_{k=1}^{j-1} \gamma_k] & j = 2, 3, ..., j 
\end{cases} \]  

(10)

Based on

\[ U_j = \begin{cases} 
2F_j & j = 1 \\
2F_j - F_{j-1}, & j = 2, 3, ..., j - 1 \\
F_j - F_{j-1} & j = j 
\end{cases} \]  

(11)

where

\[ F_j = \frac{N_j}{\sum_{j=1}^{J} N_j} \quad \text{for} \quad j = 1, 2, J. \]

\( N_j \) is the number of trades on prices to the \( j \) spread using positive volume days.
3. Models & Methodology

3.1. Models

The analysis in this paper is based on the following standard capital asset pricing model:

\[ R_p^t - R_f^t = \alpha_p + \beta_{p,MKT} MKT_t + \varepsilon_p^t \]  \hspace{1cm} (12)

where \( R_p^t \) is the return of portfolio \( p \) in month \( t \), \( R_f^t \) is the risk-free rate for month \( t \), \( MKT_t \), calculated as \( (R^M_t - R_f^t) \) is the excess market portfolio return in month \( t \) and \( \varepsilon_p^t \) is the error term.

We also base our calculations in light of the fact that the Fama and French (1993) three-factor model is identified as:

\[ R_p^t - R_f^t = \alpha_p + \beta_{p,MKT} MKT_t + \beta_{p,SMB} SMB_t + \beta_{p,HML} HML_t + \varepsilon_p^t \]  \hspace{1cm} (13)

where \( SMB_t \) stands for size factor and \( HML_t \) is the value factor for time \( t \).

Carhart (1997) further incorporated the momentum factor into the model as:

\[ R_p^t - R_f^t = \alpha_p + \beta_{p,MKT} MKT_t + \beta_{p,SMB} SMB_t + \beta_{p,HML} HML_t + \beta_{p,MOM} MOM_t + \varepsilon_p^t \] \hspace{1cm} (14)

where \( MOM_t \) is the momentum factor.

In this paper, we incorporate illiquidity risk factor and apply the five factor model as:

\[ R_p^t - R_f^t = \alpha_p + \beta_{p,MKT} MKT_t + \beta_{p,SMB} SMB_t + \beta_{p,HML} HML_t + \beta_{p,OML} OML_t + \beta_{p,L} L_t + \varepsilon_p^t \] \hspace{1cm} (15)

where \( L_t \) is the illiquidity factor.

3.2. Methodology

3.2.1. Principal Components Analysis (PCA)

Principal Component Analysis (PCA) is a powerful tool for analysing data as it has the ability when the data is in the form of a linear combination of optimally-weighted observed variables (Abdi and Williams, 2010). For a
given stock, we construct a correlation matrix of seven illiquidity measures and calculate the eigenvalue and eigen vector of the matrix. To compute scores on the first component extracted in a principal component analysis, the following model is employed:

\[ COMP_1 = \beta_1(X_1) + \beta_2(X_2) + \beta_1P(X_P) \]  

Or, in matrix notation:

\[ COMP_1 = \beta^T X \]

where \( COMP_1 \) is the subject’s score on principal component 1; \( \beta_1(X_1) \) is the regression coefficient for the observed variable \( p \) as used in creating the principal component 1; and \( X_p \) is the subject’s score on the observed variable \( p \).

The first principal component is calculated such that it accounts for the greatest possible variance in the data set. Clearly, it would be possible to make the variance of \( COMP_1 \) as wide as possible by choosing large values for the weights \( \beta_1, \beta_2, \ldots, \beta_p \). To prevent this, weights are calculated with the constraint that their sum of squares is 1.

\[ \beta_{11}^2 + \beta_{12}^2 + \beta_{13}^2 + \ldots + \beta_{1p}^2 = 1 \]  

The second principal component is calculated in the same way, with the condition that it is uncorrelated with the first principal component and that it accounts for the next highest possible variance.

\[ COMP_2 = \beta_{21}(X_1) + \beta_{22}(X_2) + \beta_{2p}(X_P) \]

The calculation continues until a total of \( p \) principal components equal to the original number of variables has been generated. At this point, the sum of the variances of all of the principal components will equal the sum of the variances of all of the variables—that is, all of the original information has been explained.

### 3.2.2. Generalized Method OF Moment (GMM) & Fama and MacBeth (1973)

In our study we construct ten portfolios on the basis of common illiquidity and then test the joint significance of the ten portfolios’ \( \alpha(s) \). To
reduce heteroscedasticity and serial correlation problems, we estimate the $\alpha(s)$ using the systematic GMM. \(^2\) For CAPM, we define $r_t^x$ to be the $10 \times 1$ vector that contains excess returns of the ten portfolios, $\beta_0$ is the $10 \times 1$ vector for the constants, $B = [\beta_{MKT}]$ is the $10 \times 1$ matrix of portfolios’ return sensitivities to market and $F_t = [MKT_t]$ is the $1 \times 1$ vector containing realisations of the factor. The standard CAPM can be identified as:

$$r_t^x = \beta_0 + BF_t + \varepsilon_t$$

(19)

To evaluate the model fit we use Hansen’s $J$-test for over-identifying restrictions. The $J$-test provides a statistical test in cases where the moment conditions for a given model are significantly different from zero.

For the Fama-French three-factor model, $B = [\beta_{MKT}; \beta_{SMB}; \beta_{HML}]$ is the $10 \times 3$ matrix of portfolios’ return sensitivities to market, size and value factor and $F_t = [MKT_t; SMB_t; HML_t]$ is the $3 \times 1$ vector. Similarly, in the Carhart four-factor model, $B = [\beta_{MKT}; \beta_{SMB}; \beta_{HML}; \beta_{MOM}]$ is the $10 \times 4$ matrix and $F_t = [MKT_t; SMB_t; HML_t; MOM_t]$ is the $4 \times 1$ vector.

We next perform the Fama and MacBeth (1973) two framework regressions to test the cross-sectional evidence of illiquidity factor in asset pricing models. When analysing cross-sectional data, the use of Fama-MacBeth regression has a number of advantages. First, it accommodates the dynamic explanatory variables. For the Fama-MacBeth regression the betas are estimated for a time period preceding the cross-section date which allows for time varying differences in the explanatory variables, whereas in other regressions, these variables are averaged out over the sample period and may lead to the loss of valuable information. Second, by running the cross-sectional regression and calculating what the standard errors are, they will then correct for cross-sectional correlations within the panel (Cochrane, 2001). Finally, the regression can also be extended to accommodate for additional risk features, beyond the beta (Campbell, Lo, MacKinlay, et al., 1997), and this is often useful if there are more risk factors to adhere to.

The first step of the Fama-MacBeth regression involves the estimation of betas after time-series regressions of the excess returns. Therefore, the illiquidity-augmented five-factor model becomes:

$$R^p_t - R^f_t = \alpha + \beta_{p,MKT}MKT_t + \beta_{p,SMB}SMB_t + \beta_{p,HML}HML_t + \beta_{p,MOM}MOM_t + \beta_{p,L}L_t + \varepsilon^p_t$$

(20)

\(^2\)The OLS findings are available for readers upon request.
where $R_p^t$ is the portfolio return at time $t$, $R_{f}^t$ is the monthly risk-free rate in month $t$, and $MKT$, $SMB$, $HML$, $MOM$ and $L$ are market return, size, value, momentum and illiquidity factors.

According to the same steps as previous studies, the first step of the regression estimates the time-series factors for each of the ten portfolios using 36 months rolling windows of 240 monthly observations. The second step estimates monthly cross-sectional regressions of the ten portfolio’s excess returns on the betas that are estimated in the first step. Thus the model is identified as:

$$
R_p^t - R_{f}^t = \lambda_0 + \lambda_{MKT} \hat{\beta}_{p,MKT} + \lambda_{SMB} \hat{\beta}_{p,SMB} + \lambda_{HML} \hat{\beta}_{p,HML} + \lambda_{MOM} \hat{\beta}_{p,MOM} + \lambda_{L} \hat{\beta}_{p,L} + \omega_p^t \tag{21}
$$

where $\lambda$ are the risk premium parameters with each beta. The hypothesis here is that the time-series average of the estimated coefficient $\lambda_L$ is positive and statistically significant. This can be interpreted as showing the evidence that the illiquidity risk factor is priced.

### 3.2.3. Hansen-Jagannathan Distance

Rather than using formal statistical tests of identification and over-identification restrictions (statistical importance), it is possible to examine the model performance (economic importance) instead. The $HJ$ distance measure is the mean square distance between the fitted values ($\hat{m}$) and the actual value $m^*$. The $HJ$ minimum distance can then be presented as: $E(\hat{m} - m^*)$, where the expectations are estimated in practice using the sample averages. Since

$$m - m^* = E(m(\pi)X - 1)'E(XX')^{-1}X$$

The minimum distance is given by:

$$
\left[ E(m(\pi)X - 1)'E(XX')^{-1} \right] \left[ E(m(\pi)X) - 1 \right] \tag{22}
$$

Let

$$g = E(m(\pi)X - 1)$$

and

$$W = E(XX')^{-1}$$

12
Then the minimum distance equals 
\[ g'Wg \]
which is the Hansen J-test with a particular \( W \).

Hansen and Jagannathan suggest comparing the pricing errors associated with the models in question by choosing each model’s parameters \( \theta \) to minimise the quadratic form:
\[
h_t^{HJ} = g'_T(\theta)W^{-1}_Tg_T(\theta)
\]  
(23)

where \( g_T(\theta) \) is the sample average of pricing errors and \( W^{-1} \) is the sample second moment matrix of the \( N \) asset returns upon which the models are evaluated.

4. Data and Variable Construction

The data adopted in this study is monthly data and spans the period 1990-2012. The initial sample comprises the whole population of firms listed on the FTSE All-Share obtained from Thomson DataStream.\(^3\)

For each index, we extract data including trading volume (turnover by volume); market value (share price multiplied by the number of ordinary shares in issue); return index (a theoretical growth in value of a share-holding over a specified period); and closing price. At the end of each month, the total number of shares outstanding, the return index, and the market value are obtained. Market to book value (market value of common equity divided by the balance sheet value of common equity in the company) is collected on an annual basis. We use the UK treasury bills 3-month yield rate as the risk free rate.

For the estimation of factor-asset pricing models, we construct size, value, and momentum risk factors. As for size, we sort all stocks based on their market capitalizations at month \( t-1 \) with a filter rule of 30% for portfolio formation. In other words, the value-weighted top 30% of stocks are allocated to the Big-size portfolio, whereas the value-weighted bottom 30% stocks are assigned to the Small-size portfolio. Therefore, the size (SMB) return is the difference between the returns of the small-size portfolio and the big-size portfolios at time \( t \). Similarly to traditional empirical studies

\(^3\)To avoid survivor-ship bias, this analysis covers not only presently listed stocks but also dead stocks. Dead stocks refer to those of firms that were de-listed at some point during our sample period.
applied in the UK market, we identify the value factor (HML) by obtaining the spread between monthly returns of the MSCI Value and MSCI Growth indices (Cuthbertson, Nitzsche, and O’Sullivan, 2008; Florackis, Gregoriou, and Kostakis, 2011).

For the momentum factor, we rank all stocks at month $t-1$ based on their returns from month $t-13$ to $t-2$. The equally-weighted top 30% of stocks are Winners and the bottom 30% are Losers. Thus the difference between monthly returns of Winner and Loser portfolios at time $t$ is taken as the momentum factor (MOM)(Jegadeesh and Titman, 1993).

5. Empirical Results

We begin our analysis with the persistence of market illiquidity, as investors request a premium for bearing illiquidity only when the illiquidity shock is systematic and persistent (Acharya and Pedersen, 2005; Korajczyk and Sadka, 2008; Lee, 2011; Stambaugh, 2003). Table 1 reports the average monthly percentage returns, illiquidity, and other features for ten equally-weighted size portfolios. These are rebalanced each year based on the total market value of each stock at the end of the previous year. The existing literature reports a higher illiquidity with smaller stocks (Amihud, 2002; Amihud and Mendelson, 1986).

As seen in Table 1, illiquidity is generally higher for small stocks (RV=4.6209; PS=0.1118) than it is for large stocks (RV=0.0012; PS=0.0001). A similar pattern is also shown for $LM$, $RO$, and $ET$. The returns are higher for small stocks and we observe higher volatility for small stocks based on standard deviation. In line with Stambaugh (2003), Acharya and Pedersen (2005) and Korajczyk and Sadka (2008), we find that the equally-weighted average of stock illiquidity is highly persistent. Given the persistence of market illiquidity, similarly to Stambaugh (2003) and Acharya and Pedersen (2005), we construct the illiquidity innovations through $AR(2)$ as follows:

$$C_{M,t} \frac{MV_{M,t-1}}{MV_{M,1}} = \alpha_0 + \alpha_1 C_{M,t-1} \frac{MV_{M,t-1}}{MV_{M,1}} + \alpha_2 C_{M,t-2} \frac{MV_{M,t-2}}{MV_{M,1}} + \mu_{m,t} \quad (24)$$

where $C_{M,t}$ is the market aggregate illiquidity at month $t$; and the residual $\mu_{m,t}$ is the illiquidity innovation. Notably, we scale $PS$ and $RV$ by the ratio
of the total market value by the end of the month $t-1$ to that in January 1990: $\frac{MV_{M,t-1}}{MV_{M,1}}$. This is in order to include only innovations in illiquidity, not the changes in time value of money. For other illiquidity measures, however, we apply the general $AR(2)$ regressions to find innovations:

$$C_{M,t} = \alpha_0 + \alpha_1 C_{M,t-1} + \alpha_2 C_{M,t-2} + \mu_{m,t} \quad (25)$$

The coefficients $\alpha_1$ and $\alpha_2$ are both significant. Further, the residuals do not display any serial correlation. Hence, we claim that $\mu_{m,t}$ accurately represents market illiquidity.4

Figure 1 shows the time-series plots of market aggregate illiquidity innovations for each measure and provides evidence that illiquidity innovations generally coincide with liquidity events in the timeline such as the Iraq invasion of Kuwait in 1990, the Asian crisis in 1997, the long term capital management crisis in 1998, and the financial crisis from 2007 to 2009. The fact that all seven measures jointly constitute liquidity-related events suggests the possibility that the individual proxy shares a common component of illiquidity.

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**INSERT Figure 1 here**

---

In Table 2 We report the correlations between market illiquidity proxies to examine whether illiquidity measures have a common component. We observe significant Pearson correlation tests in many cases. It measures the strength of the linear relationship between normally distributed variables. The highest correlation of 0.356 is shown between $RV$ and $RO$ and the lowest value among positive and significant correlations is 0.113 between $ET$ and $RV$. However, $RO$ is negatively correlated with most of the other measures in Table 2. The results imply that our illiquidity proxies, somehow, have systematic common components of illiquidity and this in turn justifies the use of the principal component analysis.

Next we use the principal component analysis to extract the common components of the seven illiquidity measures. As shown in Figure 2, the bar graph indicates the plot of the average eigenvalue proportions of seven principal components, as well as the plot of the cumulative proportions in the corresponding line graph. We find that the first principal component explains 33% of the whole variation over the seven illiquidity measures,

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4Not reported but available from authors upon request.
which is coincidentally similar to findings reported in Korajczyk and Sadka (2008) and Kim and Lee (2014).

Table 3 reports the descriptive statistics of illiquid portfolio performances from February 1990 to December 2012. We construct decile portfolios using the first principal component of illiquidity. In particular, at the end of month $t-1$, stocks are organised according to their first principal component extracted from the seven illiquidity measures. Portfolio 1 ($P1$) includes stocks with the smallest ratio, whilst Portfolio 10 ($P10$) contains stocks with the highest values of illiquidity ratio and this excess return is only calculated for both $P1$ and $P10$. Portfolios are rebalanced on a monthly basis. Our empirical findings suggest that the average portfolio return increases from $P1$ to $P10$, though not monotonically. This pattern holds for equally weighted portfolios’ returns but not for value weighted portfolios’ returns. The level of this differential is about 16% per annum ($t=2.896$) for equally weighted portfolio returns. We also find no strong relationship between common illiquidity and market capitalization, nor do we find a clear correlation between common illiquidity and book to market ratio. Such results may have occurred due to our focus exclusively on the first principal component of the illiquidity measures. Nevertheless, certain features may continue to appear as measure-specific.\(^5\) However, our common illiquidity component clearly captures the change of the average $\beta_{CAPM}$ associated with stocks, calculated by using a 36-month rolling window. The higher the illiquidity of the portfolio, the higher the beta we observe. The differential between $P10$ versus $P1$ beta is 0.287 ($t=8.933$).

\(^5\)Individual measure results are not reported but may be obtained upon request.

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Table 4 presents the alphas of the value-weighted and equal-weighted portfolios sorted by the common component of the seven illiquidity ratios. For the principal component sorted equally-weighted portfolios, we find that

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\textit{Time-series Evidence of Risk-adjusted Returns}

Table 4 presents the alphas of the value-weighted and equal-weighted portfolios sorted by the common component of the seven illiquidity ratios. For the principal component sorted equally-weighted portfolios, we find that
Jensen’s alpha has generally increased across portfolios. Notably, most of the alphas across the portfolios (P1-P5) are with negative signs. Interestingly, P10 has the highest and most significant alpha (CAPM) of 12.408%. Similar patterns hold for the Fama-French three-factor model and the Carhart four-factor model (α = 6.703% and 8.480%) respectively. This suggests that portfolio returns increase with illiquidity. The last column presents the χ² statistic of the Wald test. The null hypothesis is that the alphas of the ten portfolios are jointly equal to zero. We fail to reject the null hypothesis. It is also worth noting that there is no certain pattern as we move from P1 to P10 and there are also insignificant premiums for value-weighted portfolios. This suggests that illiquidity premiums may be subject to the size factor. However, the χ² of the Wald test provides strong evidence against the null hypothesis.

\[ \chi^2 \text{ statistic of the Wald test.} \]

Cross-sectional Evidences

As a robustness test, we further investigate the performance of the LCAPM in explaining the cross-section variations in stock returns.

Table 5 presents the estimated λ coefficients for the ten equally-weighted portfolios, and sorting is done based on the common component of illiquidity ratio in the UK. Panel A of Table 5 reports the unrestricted model with any value of λ₀. The augmented illiquidity in Panel A is based on the first principal component. Our findings are supportive of the illiquidity augmented CAPM and the Fama-French model, as these specifications produce statistically positive, significant and economically sensible coefficients (premium λ_L), thereby offering a more valuable explanation of the data.

The estimated coefficient λ_L associated with CAPM and Fama-French (FF) models are significantly positive (λ_{LCAPM}=5.76 and λ_{LFF}=5.19) respectively, but the coefficient λ_L is insignificantly positive at (λ_{LCARH}=10.4) for the liquidity-augmented Carhart model. The penultimate column in Panel A reports the $R^2$ coefficients, and the last column reports the increase in $R^2$ coefficients after adding the illiquidity factor to the original models. The results show a good explanatory power, as the $\Delta R^2$ has increased across all models, $\Delta R^2= 0.041, 0.021$ and 0.035 for CAPM, FF and Carhart models respectively. In Panel B of Table 5, we present the estimated λ coefficients from the second framework cross-sectional regression of Fama-MacBeth. We
restrict $\lambda_0$ to be zero. The results yield similar findings as those in Panel A of Table 5, indicating strong and statistically significant coefficients for the liquidity-augmented CAPM and Fama-French model.

As mentioned above (section 3), there are many reasonable measures that can be used to test the model specification. In section 3 we studied one of these measures which depends on a non-parametric function, the Hansen $J$ test. However, Summers (1991) and Cochrane and Hansen (1992) claim that the GMM approach $J$ test focuses too much on the specification of the model, and has too little focus on evaluating the accuracy of the underlying model. They argue that an increased focus on the accuracy of the model would help both reflect the purpose of understanding different types of behaviour and improve the ability of the model to make different types of predictions.

To account for this criticism, we implement two alternatives advocated by Hansen and Jagannathan (1997) to assess the performance of the models.

Panel C of Table 5 shows the robustness results of the Hansen-Jagannathan distance tests both with and without the illiquidity factor. We report both the principal component and illiquidity factor. With the principal component illiquidity factor, we find that the error decreases from 0.304 to 0.198 and from 0.330 to 0.177 for the CAPM and Fama-French three-factor model respectively. Figure 4 also details the distance on the Hansen-Jagannathan bound, suggesting a significant empirical improvement for the liquidity Capital asset pricing models.

Robustness Tests

In Table 2, we report negative correlations of the RO measure with many other illiquidity measures, i.e. ‘Pastor and Stambaugh’s gamma’, ‘Corwin and Schultz’s spread’ and the ‘effective tick’. Such results indicate that the RO measure might differ more from other existing proxies. Therefore, we apply the robustness tests by removing the RO and estimate the new single illiquidity measure constructed by the principal component analysis. We report both parametric and non-parametric results in Table 6.
Similar to our main findings, the new single illiquidity measure that is constructed by using the common component of the six illiquidity measures excluding RO proxy performs meaningful results. As for the parametric Fama-MacBeth estimations, we report positive and significant coefficient $\lambda_L$ for CAPM and Fama-French models ($\lambda_{LCAPM}=6.423$ and $\lambda_{LFF}=7.331$). The coefficient $\lambda_L$ is still insignificantly positive at ($\lambda_{LCARH}=5.657$ for the illiquidity-augmented Carhart model. The results show a slightly better explanatory power, but not a significant change in results as the $\Delta R^2$ has increased across all models, $\Delta R^2= 0.071$, 0.075 and 0.042 for CAPM, FF and Carhart models respectively. Panel C reports the results of Hansen-Jagannathan Distance using the new illiquidity measure generated from six illiquidity measures. The error decreases from 0.142 to 0.139, from 0.604 to 0.073, and from 0.619 to 0.168 for the CAPM, Fama-French three-factor model and Carhart four-factor model respectively. This implies that after they are augmented with illiquidity factor, the empirical asset pricing models significantly improve their pricing powers.

6. Conclusion

This paper examined the performance of the standard Sharpe-Lintner CAPM, the Fama-French three factor model (Fama and French, 1993), and the four factor model of Carhart (1997) both with, and without, the first component of multiple illiquidity measures. Further, the ability of the capital asset pricing models (CAPMs) to explain asset returns using solely individual illiquidity measures was also analysed. We used monthly UK data between 1990 and 2012.

Our initial investigation suggests that no individual illiquidity proxy out- performs the others, and further that our illiquidity proxies have a systematic common illiquidity component. Hence, we used the principal component analysis. According to the results of this analysis, the fact that seven measures jointly indicate liquidity-related events further suggests the possibility that the individual proxies share a common component of illiquidity. In addition, the correlations between market illiquidity proxies were considered in order to examine whether illiquidity measures share have a common component. Similarly to studies by Korajczyk and Sadka (2008)
and Kim and Lee (2014), the findings indicate that the first principal component explains 33% of the whole variation over the seven illiquidity measures in the UK. For illiquid portfolio and model performance, our findings are supportive of the illiquidity augmented CAPM and Fama-French model particularly with the portfolio of stocks with the highest illiquidity ratios $P_{10}$. These specifications produce statistically positive, significant and economically coefficient estimates. For the non-parametric tests, we find that the illiquidity-augmented CAPM and Fama-French three-factor model yield a very small distance. These findings are supportive of the liquidity specification of the capital asset pricing models. Other non-liquidity CAPM models fail to yield economically plausible parameter values.

These findings have important implications for academic research into liquidity risk and for practical liquidity risk management alike. We contribute to the literature on liquidity risk by investigating the determinants of cross-sectional stock returns during liquidity crises. In addition, we analyse liquidity risk from a practical risk management standpoint. We show that abnormal stock performance during liquidity crises is, in part, predictable, and investors can construct portfolios of stocks that better withstand liquidity shocks. However, our results suggest that liquidity risk management comes at a cost of lower average returns during periods of relatively stable liquidity conditions.

Future research could investigate whether expected returns are related to stocks’ sensitivities to fluctuations in other aspects of aggregate liquidity. It would also be useful to explore whether some form of systematic liquidity risk is priced in other financial markets, such as fixed income markets or international equity markets.
References


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<tr>
<th>Portfolio</th>
<th>Return</th>
<th>RV</th>
<th>PS</th>
<th>ZR</th>
<th>LM12</th>
<th>RO</th>
<th>CS</th>
<th>ET</th>
<th>MarketCap</th>
<th>BTMV</th>
<th>St.Dev.</th>
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Note: This table presents the average monthly percentage returns and illiquidity measures for 10 equally-weighted size UK portfolios. Portfolio’s size is recalculated each year based on market value of shares at the end of the previous year. The illiquidity proxies are Amihud’s illiquidity (RV), Pastor and Stambaugh’s measure (PS), zero return (ZR), Liu’s measure (LM12), Roll’s measure (RO), the spread measure of Corwin and Schultz (CS) and effective tick (ET). Market cap is the market capitalization at the end of the previous year; BTMV is the book to market ratio; and St.Dev. is the standard deviation of portfolio return in the sample period.
### Table 2: Pearson Correlation of Illiquidity Proxies

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<th>RV</th>
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Note: See table 1 for illiquidity abbreviations. This table presents the correlation between proxies for market aggregate illiquidity measured by the equally-weighted average of stock illiquidity. *, **, and *** denote significance at the 10%, 5%, and 1% level respectively.
Table 3: Illiquid Portfolio Performances

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<th>Decile portfolios</th>
<th>P1</th>
<th>P2</th>
<th>P3</th>
<th>P4</th>
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<th>P7</th>
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<th>P10-P1</th>
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<td>EWR (p.a.)</td>
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<td>-0.233</td>
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</table>

Note: P1 is the decile portfolio which has stocks with the lowest illiquidity ratio whereas P10 has the stocks with the highest illiquidity ratio. P10-P1 is the spread between P10 and P1. EWR returns are the annualized average monthly returns of equal weighted portfolios and VW returns account for the annualized monthly returns of value weighted portfolios. MV is the average market value of stocks in each of the portfolios in millions measured as the average of the share price times the number of shares outstanding. BTMV is the average ratio of the book value of shares divided by the market value in each portfolio. $\beta_{\text{CAPM}}$ is the average stock beta in each portfolio using a 36-month sliding window. The t-test in the last column is the null hypothesis that the means are the same between P10 and P1.
Table 4: Alphas Estimates of Value and Equally-Weighted Illiquid Portfolios

<table>
<thead>
<tr>
<th>Decile portfolios</th>
<th>P1</th>
<th>P2</th>
<th>P3</th>
<th>P4</th>
<th>P5</th>
<th>P6</th>
<th>P7</th>
<th>P8</th>
<th>P9</th>
<th>P10</th>
<th>χ²</th>
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<td><strong>Panel A:PCA Value-Weighted Portfolios</strong></td>
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<td></td>
<td></td>
</tr>
<tr>
<td>α_{CAPM} (% p.a.)</td>
<td>11.400</td>
<td>4.564</td>
<td>25.888</td>
<td>16.360</td>
<td>0.857</td>
<td>6.009</td>
<td>0.599</td>
<td>2.138</td>
<td>0.337</td>
<td>4.931</td>
<td>7.182</td>
</tr>
<tr>
<td>(1.839)</td>
<td>(0.472)</td>
<td>(2.480)</td>
<td>(2.471)</td>
<td>(0.101)</td>
<td>(2.431)</td>
<td>(0.261)</td>
<td>(0.879)</td>
<td>(0.177)</td>
<td>(1.848)</td>
<td>(0.007)</td>
<td></td>
</tr>
<tr>
<td>α_{FF} (% p.a.)</td>
<td>5.409</td>
<td>-2.658</td>
<td>21.106</td>
<td>11.578</td>
<td>-1.918</td>
<td>6.450</td>
<td>0.257</td>
<td>2.345</td>
<td>-0.109</td>
<td>3.496</td>
<td>4.526</td>
</tr>
<tr>
<td>(0.901)</td>
<td>(-0.358)</td>
<td>(1.949)</td>
<td>(2.041)</td>
<td>(-0.238)</td>
<td>(2.453)</td>
<td>(0.107)</td>
<td>(1.039)</td>
<td>(-0.053)</td>
<td>(1.254)</td>
<td>(0.033)</td>
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<tr>
<td>α_{Carhart} (% p.a.)</td>
<td>4.575</td>
<td>-5.115</td>
<td>18.749</td>
<td>9.927</td>
<td>-2.652</td>
<td>6.692</td>
<td>0.461</td>
<td>3.443</td>
<td>0.464</td>
<td>5.407</td>
<td>3.993</td>
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<tr>
<td>(0.766)</td>
<td>(-0.765)</td>
<td>(1.689)</td>
<td>(1.745)</td>
<td>(-0.332)</td>
<td>(2.218)</td>
<td>(0.179)</td>
<td>(1.322)</td>
<td>(0.220)</td>
<td>(1.987)</td>
<td>(0.046)</td>
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</tr>
<tr>
<td><strong>Panel B:PCA Equally-Weighted Portfolios</strong></td>
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</tr>
<tr>
<td>α_{CAPM} (% p.a.)</td>
<td>-0.960</td>
<td>-2.409</td>
<td>-1.695</td>
<td>-2.905</td>
<td>-3.527</td>
<td>4.786</td>
<td>4.114</td>
<td>5.748</td>
<td>5.761</td>
<td>12.408</td>
<td>1.372</td>
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<tr>
<td>(-0.344)</td>
<td>(-0.787)</td>
<td>(-0.684)</td>
<td>(-2.115)</td>
<td>(-1.935)</td>
<td>(2.210)</td>
<td>(1.776)</td>
<td>(2.744)</td>
<td>(2.515)</td>
<td>(3.677)</td>
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<td>α_{FF} (% p.a.)</td>
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<td>-4.337</td>
<td>-2.901</td>
<td>-3.471</td>
<td>-5.276</td>
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<td>2.046</td>
<td>1.772</td>
<td>6.703</td>
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<td>(-1.425)</td>
<td>(-1.138)</td>
<td>(-2.564)</td>
<td>(-2.945)</td>
<td>(1.076)</td>
<td>(0.374)</td>
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<td>(1.487)</td>
<td>(3.405)</td>
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<tr>
<td>α_{Carhart} (% p.a.)</td>
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<td>-3.071</td>
<td>-2.282</td>
<td>-3.511</td>
<td>-4.080</td>
<td>2.110</td>
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<td>2.483</td>
<td>2.077</td>
<td>8.480</td>
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<td>(-0.940)</td>
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<td>(-2.370)</td>
<td>(1.312)</td>
<td>(0.271)</td>
<td>(2.053)</td>
<td>(1.655)</td>
<td>(4.333)</td>
<td>(0.986)</td>
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</tbody>
</table>

Note: P1 is the decile portfolio of stocks with the lowest illiquidity ratios; P10 is the portfolio of stocks with the highest illiquidity ratios. α is the annualized alpha estimated using the CAPM, Fama-French three-factor and Carhart four-factor models. T-statistics are reported in parentheses. The last column presents the χ² statistic of the Wald test. The null hypothesis is that the alphas of the ten portfolios are jointly equal to zero. The p-values are reported in the parentheses.
Table 5: Fama/MacBeth Estimates and Hansen-Jagannathan Distance

<table>
<thead>
<tr>
<th></th>
<th>$\lambda_0$</th>
<th>$\lambda_{mkt}$</th>
<th>$\lambda_{smb}$</th>
<th>$\lambda_{hml}$</th>
<th>$\lambda_{mom}$</th>
<th>$\lambda_L$</th>
<th>$R^2$</th>
<th>$\Delta R^2$</th>
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<td>CAPM$_{ILLIQ}$</td>
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<td>5.758</td>
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<tr>
<td>CARHART$_{ILLIQ}$</td>
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<td>2.077</td>
<td>-2.155</td>
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<td>(-0.916)</td>
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<td>(1.537)</td>
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<tr>
<td><strong>Panel C: Hansen-Jagannathan Distance</strong></td>
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</table>

Note: $\lambda_i$ is the mean of risk premium coefficients $\lambda_i$ using Fama and MacBeth (1973) method. The monthly cross-sectional regressions of ten equally-weighted portfolio return premiums are estimated using the risk factors of Fama and MacBeth (1973). $ILLIQ$ is illiquidity factor of the CAPMs models. Panel A and B report systematic illiquidity factor augmented asset pricing models. T-statistics are reported in parentheses. The last column reports the increase in R-squared coefficient due to the addition of the illiquidity factor. Panel C reports the Hansen-Jagannathan distance. $\delta$ measures the distance error.
Table 6: Robustness Tests on Illiquidity Without RO

<table>
<thead>
<tr>
<th></th>
<th>$\lambda_0$</th>
<th>$\lambda_{mkt}$</th>
<th>$\lambda_{smb}$</th>
<th>$\lambda_{hml}$</th>
<th>$\lambda_{mom}$</th>
<th>$\lambda_L$</th>
<th>$R^2$</th>
<th>$\Delta R^2$</th>
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<tr>
<td><strong>Panel A: PCA Unrestricted Model</strong></td>
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<tr>
<td>CAPM_{ILLIQ}</td>
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<td>6.423</td>
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<td>(4.057)</td>
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<td>7.365</td>
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<tr>
<td><strong>Panel B: PCA Restricted Model $\lambda = 0$</strong></td>
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<tr>
<td><strong>Panel C: Hansen-Jagannathan Distance</strong></td>
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<td>0.619</td>
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</table>

Note: This table reports the robustness test results of both parametric and non-parametric estimations. The illiquidity factor is constructed without RO proxy proposed by Roll (1984).
Figure 1: Innovations of Illiquidity Measures
Figure 2: Eigenvalue proportion of principal components
Figure 3: Fit of Illiquidity-augmented CAPM, Fama-French and Carhart Model
Figure 4: Hansen-Jagannathan Bound of Capital Asset Pricing Models