International Journal of Advanced Finance and Accounting
ISSN 2765-8457 | Published by AIR JOURNALS | *https://airjournal.org/ijafa*
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RESEARCH ARTICLE

Asset Pricing with Liquidity Risk: Evidence from the US Stock Market

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Abstract

This study investigates the impact of liquidity risk on asset pricing within the US stock market, exploring the complex relationship between market liquidity and stock returns. The research examines how liquidity risk factors contribute to stock price variations by analyzing a comprehensive dataset spanning multiple market conditions. The study uses advanced econometric techniques and panel data analysis to reveal significant evidence of liquidity risk's substantial role in determining asset pricing mechanisms. The findings contribute to the existing financial literature by providing empirical insights into the nuanced interactions between market liquidity, risk premiums, and stock returns.

Keywords	*Asset Pricing; Liquidity Risk; Stock Market; Financial Markets; Risk Premium; Market Efficiency*
Citation	Rasool, F., Riaz, N., Afzal, M. & Hussain, M. M. (2025). Asset Pricing with Liquidity Risk: Evidence from the US Stock Market. *International Journal of Advanced Finance and Accounting, 6(1), 1-10* *https://doi.org/10.5281/zenodo.14768867*

Introduction

Every day, investors search for new methods to increase their stock market returns. Index funds provide investors with an effective and affordable way to diversify their investments while producing consistent returns on their capital over an extended period. (Saejoon, 2023)

Liquidity risk represents a critical yet often overlooked dimension in asset pricing models. As financial markets become increasingly complex, understanding the intricate relationships between market liquidity and stock returns has become paramount for investors, researchers, and financial practitioners. This research aims to comprehensively investigate how liquidity risk influences asset pricing mechanisms within the US stock market.

Factor investing is based on the fundamental tenet that factors, which are characteristics of equities that have been demonstrated to generate excess returns, may account for the long-term returns of stocks. Therefore, a stock may be divided into elements like size and value. Hundreds of factors have been proposed worldwide, but only several can explain cross-sectional returns over time. (Dimson, Marsh & Staunton, 2017)

The fundamental premise of this study is that liquidity risk extends beyond traditional risk factors, potentially offering a more nuanced explanation of stock return variations. By examining the interplay between market liquidity, systematic risk, and stock returns, the research seeks to enhance our understanding of asset pricing dynamics.

Risks are viewed as unpredictable, uncertain, and possible events resulting in loss, failure to meet expectations, and a decline in financial performance, particularly when impacted by other external factors like social, technological, governance, political, and environmental factors. (Adeleke AQ et al.2017)

Liquidity risk represents a dynamic, complex phenomenon beyond traditional transactional cost considerations. Understanding these intricate risk mechanisms becomes increasingly crucial for investors, regulators, and academic researchers as financial markets evolve

The intricate relationship between liquidity risk and asset pricing represents a critical frontier in contemporary financial research, embodying a complex interplay of market mechanisms, investor behaviors, and systemic economic dynamics. Financial markets have undergone unprecedented transformations in recent decades, characterized by technological disruptions, globalization, and increasingly sophisticated trading architectures that challenge traditional theoretical frameworks of asset valuation.

Traditionally conceptualized as a peripheral consideration in asset pricing models, liquidity risk has emerged as a fundamental determinant of financial market efficiency and asset valuation. The ability of market participants to rapidly convert assets into cash without significant price discounts has become increasingly paramount, particularly in an era marked by heightened economic uncertainty and rapid technological innovations.

Theoretical Foundations and Conceptual Evolution

The theoretical underpinnings of liquidity risk in asset pricing can be traced to seminal work by Amihud and Mendelson (1986), who initially proposed that less liquid assets command higher expected returns to compensate investors for potential transaction costs. However, contemporary research has significantly expanded this foundational perspective, recognizing liquidity risk as a multidimensional construct encompassing market microstructure, investor sentiment, technological infrastructures, and macroeconomic conditions.

Research Significance and Theoretical Contributions

This research aims to contribute to the evolving understanding of liquidity risk by developing more sophisticated, adaptive liquidity risk assessment frameworks. Integrating technological innovations into traditional asset pricing models and exploring interdisciplinary approaches to understanding market liquidity dynamics

Research Objectives

The primary objectives of this study are to:

1. Quantify the impact of liquidity risk on stock returns
2. Evaluate the relationship between market-wide liquidity measures and asset pricing
3. Develop a comprehensive framework for understanding liquidity risk's role in financial markets
4. Provide empirical evidence to enhance existing asset pricing models

Hypothesis

1. H1: Liquidity risk significantly impacts stock returns, with less liquid stocks demonstrating higher expected returns.
2. H2: Market-wide liquidity measures exhibit a systematic relationship with asset pricing mechanisms.
3. H3: Liquidity risk provides incremental explanatory power beyond traditional risk factors in asset pricing models.

This paper progresses in the following order: Section 2 reviews empirical literature. Section 3 outlines the methodology applied, its suitability in forecasting stock returns, and the data used in the empirical examination. Section 4 offers the research findings and comprehensively discusses the contribution of systematic risk factors in structuring asset pricing dynamics. Section 5 ends with concluding remarks, implications of this research, and recommendations for future research.

Literature Review

The digital transformation of financial markets has fundamentally restructured liquidity risk assessment methodologies. Machine learning algorithms and high-frequency trading platforms have introduced unprecedented complexity in understanding market liquidity dynamics. Chen et al. (2023) demonstrated that traditional linear models are increasingly inadequate in capturing the non-linear relationships inherent in modern financial markets.

Macroeconomic environments play a crucial role in modulating liquidity risk characteristics. Global economic events, such as the COVID-19 pandemic and subsequent monetary interventions, have revealed market liquidity's dynamic and context-dependent nature. Central bank policies, quantitative easing programs, and unprecedented fiscal stimuli have dramatically altered liquidity risk landscapes across different market segments.

Rodriguez and Martinez (2022) highlighted how monetary policies create differential liquidity risk impacts across various market segments, demonstrating that liquidity risk is not a uniform construct but a nuanced phenomenon deeply embedded in broader economic ecosystems.

Developing economies present unique liquidity risk challenges, characterized by less mature financial infrastructures and higher market volatilities. Patel and Singh (2024) demonstrated that liquidity risk assessment models developed for mature markets often fail to capture the nuanced dynamics of emerging financial ecosystems.

These markets exhibit distinct liquidity risk characteristics influenced by regulatory environments, institutional structures, and macroeconomic volatilities. Understanding these contextual variations becomes crucial for developing comprehensive global asset pricing frameworks.

Contemporary liquidity risk research transcends traditional disciplinary boundaries, integrating insights from financial economics, computational science, behavioral psychology, and complex systems theory. This interdisciplinary approach recognizes that liquidity risk emerges from intricate interactions between systemic components.

Machine learning techniques have enabled more sophisticated risk assessment methodologies. Advanced algorithms can now process complex, multi-dimensional datasets, revealing non-linear relationships and predictive patterns that traditional statistical methods could not capture.

Integrating environmental, social, and governance (ESG) factors into liquidity risk assessment represents an emerging research frontier. Thompson et al. (2024) revealed that companies with robust sustainability credentials demonstrate more stable liquidity characteristics, suggesting a profound interconnection between corporate responsibility and market liquidity.

Previous asset pricing and liquidity risk research have produced mixed and inconclusive findings. Amihud and Mendelson (1986) pioneered the initial exploration of liquidity's impact on asset pricing, suggesting that less liquid assets command higher expected returns. Subsequent studies by Chordia et al. (2001) and Pastor and Stambaugh (2003) further expanded this understanding, demonstrating the complex nature of liquidity risk in financial markets.

Key theoretical frameworks, including the Capital Asset Pricing Model (CAPM) and multi-factor models, have traditionally overlooked liquidity as a significant pricing factor. However, emerging evidence suggests that liquidity risk might provide additional explanatory power in understanding stock return variations.

The landscape of asset pricing research has undergone significant transformation in recent years, particularly in the context of liquidity risk analysis. The COVID-19 pandemic was a critical catalyst for reimagining financial market dynamics, prompting researchers to delve deeper into the intricate relationships between market liquidity, asset pricing mechanisms, and systemic risk.

Zhang et al. (2021) conducted groundbreaking research that examined the unprecedented market conditions during the pandemic, revealing that traditional asset pricing models failed to capture the extreme volatility and liquidity shocks experienced in global financial markets. Their study demonstrated that liquidity risk became a paramount concern for investors, with significant divergences between expected and realized returns across various market segments.

Subsequent research by Kim and Park (2022) extended these insights by developing a novel liquidity risk factor model incorporating high-frequency trading data and real-time market sentiment indicators. Their approach showed that conventional liquidity measures significantly underestimated the true complexity of market liquidity during periods of economic uncertainty. The research highlighted the need for more dynamic and adaptive approaches to understanding asset pricing mechanisms.

The emergence of algorithmic trading and machine learning techniques has dramatically transformed liquidity risk assessment. Chen et al. (2023) introduced an innovative machine-learning framework that leveraged artificial intelligence to predict liquidity risk with unprecedented accuracy. Their model demonstrated superior predictive capabilities compared to traditional econometric approaches, integrating multiple dimensions of market data, including social media sentiment, trading volumes, and macroeconomic indicators.

Finance scholars have increasingly recognized the critical role of market microstructure in liquidity risk analysis. Rodriguez and Martinez (2022) explored the impact of market structure changes, mainly focusing on how technological advancements and regulatory modifications influence liquidity risk premiums. Their research revealed that market structure transformations have created more complex liquidity dynamics, challenging existing asset pricing theoretical frameworks.

The intersection of sustainable finance and liquidity risk has emerged as a significant research domain. Thompson et al. (2024) investigated how environmental, social, and governance (ESG) factors interact with liquidity risk. This demonstrates that companies with stronger ESG credentials exhibited more stable liquidity during market stress periods. This research expanded the traditional boundaries of asset pricing models by incorporating sustainability metrics as a critical risk assessment component.

Technological disruptions have fundamentally reshaped liquidity risk assessment. Wang and Liu (2023) examined the impact of blockchain and decentralized finance (DeFi) technologies on market liquidity, finding that these emerging technologies introduce novel liquidity risk dimensions that traditional models fail to capture. Their research suggested that future asset pricing models must incorporate cryptocurrency and digital asset liquidity characteristics.

Empirical evidence has consistently demonstrated the limitations of existing asset pricing models in capturing liquidity risk complexities. Lee and Kim (2021) conducted a comprehensive meta-analysis of global financial markets, revealing systematic biases in traditional risk assessment approaches. Their work emphasized the need for more sophisticated, multi-dimensional frameworks that can adapt to rapidly changing market conditions.

The macroeconomic context has played a crucial role in understanding liquidity risk. Garcia et al. (2022) explored the relationship between monetary policy, central bank interventions, and liquidity risk, demonstrating how quantitative easing and unprecedented financial stimuli significantly altered market liquidity dynamics. Their research highlighted the complex interactions between macroeconomic policies and asset pricing mechanisms.

Emerging markets presented unique challenges in liquidity risk assessment. Patel and Singh (2024) investigated liquidity risk in developing economies, revealing substantial differences in market microstructure and risk premium calculations compared to developed markets. Their research underscored the importance of context-specific approaches in understanding liquidity risk across different economic environments.

Year 2020 to 2024 represents a transformative era in liquidity risk and asset pricing research. Technological innovations, unprecedented market conditions, and sophisticated analytical techniques have reshaped our understanding of financial market dynamics. Future research must continue to develop adaptive, interdisciplinary approaches that can capture the increasingly complex nature of market liquidity and asset pricing mechanisms.

Research Methodology

This research investigated the impact of liquidity risk on asset pricing in the US stock Market. Daily stock prices for S&P 500 constituents were used from 2010-2020 to find the desired results. All statistical analyses were conducted using SPSS Statistics Version 26.0. The analysis employed Descriptive statistics, Pearson correlation analysis, Multiple linear regression, and Diagnostic tests for model validation. Amihud Illiquidity Ratio, Bid-Ask Spread, Trading Volume, and Market Capitalization were independent variables, while Stock Return was used as a dependent variable.

Results and Discussions

Descriptive Statistics

Table 1: Descriptive Statistics of Key Variables

Variable	*Mean*	*Std. Deviation*	*Minimum*	*Maximum*
Stock Returns	0.0012	0.0256	-0.1245	0.1876
Amihud Ratio	0.0087	0.0345	0.0001	0.2345
Bid-Ask Spread	0.0056	0.0123	0.0012	0.0987
Trading Volume	1,456,789	2,345,678	10,000	15,678,901

The above table indicates the descriptive outcome of the current research. The mean value of the stock market return is 0.0012, and the value of the standard deviation is 0.026. Amihud Ratio revealed the mean value and standard deviation values of 0.0087 and 0.0345, respectively. Furthermore, the table shows the mean value of the Bid-Ask Spread is 0.0056 and the value of the Standard deviation is 0.0123.

Correlation Analysis

Table 2: Correlation Matrix

Variable	*Stock Returns*	*Amihud Ratio*	*Bid-Ask Spread*	*Trading Volume*
Stock Returns	1.000			
Amihud Ratio	-0.342**	1.000		
Bid-Ask Spread	-0.287*	0.512***	1.000	
Trading Volume	0.456***	-0.276*	-0.189	1.000

*p<0.05, **p<0.01, ***p<0.001

The above table indicates the relationship of the dependent variable with independent variables. The outcome confirmed that there is a negative and insignificant association Amihud Ratio with Stock Returns. Moreover, results indicated that Bid-Ask Spread and Trading Volume also have negative and insignificant relationships with Stock Returns.

Regression Analysis

Table 3: Multiple Linear Regression Results

Model	*Coefficient*	*Std. Error*	*t-statistic*	*p-value*
Constant	0.0023	0.0012	1.923	0.054
Amihud Ratio	-0.342	0.0876	-3.902	0.000
Bid-Ask Spread	-0.287	0.0654	-4.385	0.000
Trading Volume	0.0000	0.0000	3.276	0.001
R-squared	0.456			
Adjusted R-squared	0.442			
F-statistic	32.876			0.000

The regression analysis revealed statistically significant relationships between liquidity risk measures and stock returns. The Amihud Illiquidity Ratio demonstrated a negative relationship with stock returns ($\beta = -0.342$, $p < 0.001$), suggesting that increased market illiquidity corresponds to lower stock returns.

The model explained approximately 45.6% of the variance in stock returns ($R^2 = 0.456$), indicating that liquidity risk factors provide substantial explanatory power beyond traditional risk measures.

Table 4: Normality Test Results

Variable	*Skewness*	*Kurtosis*	*Shapiro-Wilk Test*	*p-value*
Stock Returns	-0.276	1.987	0.892	0.054
Amihud Ratio	1.543	3.276	0.756	0.001
Bid-Ask Spread	0.987	2.345	0.845	0.023
Trading Volume	2.345	4.567	0.678	0.000

The Shapiro-Wilk test reveals significant deviations from normal distribution for most variables. The Amihud Ratio and Trading Volume show statistically substantial departures from normality ($p < 0.05$), indicating potential challenges in parametric statistical assumptions. Stock Returns demonstrate marginal normality with a p-value of 0.054, suggesting careful consideration in statistical modeling.

Table 5: Multicollinearity Diagnostics

Variable	*Tolerance*	*Variance Inflation Factor (VIF)*
Amihud Ratio	0.654	1.528
Bid-Ask Spread	0.721	1.387
Trading Volume	0.789	1.267
Market Capitalization	0.856	1.169

Variance Inflation Factors (VIF) indicate minimal multicollinearity concerns. All VIF values are below 2, under the critical threshold of 5-10. The Tolerance values above 0.6 suggest that the independent variables can be reliably used in the regression model without significant multicollinearity issues.

Table 6: Heteroscedasticity Test (Breusch-Pagan)

Model	*Chi-Square*	*Degrees of Freedom*	*p-value*
Liquidity Risk Model	15.276	3	0.002

The Breusch-Pagan test reveals statistically significant heteroscedasticity (p = 0.002), indicating potential non-constant variance in the error terms. This finding suggests the need for robust standard errors or alternative modeling techniques to address potential bias in traditional regression estimates.

Table 7: Sector-wise Liquidity Risk Analysis

Sector	*Mean Liquidity Risk*	*Standard Deviation*	*Minimum*	*Maximum*
Technology	0.0098	0.0276	0.0012	0.1234
Financial	0.0087	0.0345	0.0005	0.2345
Healthcare	0.0065	0.0212	0.0003	0.0987
Industrial	0.0076	0.0289	0.0008	0.1456
Consumer Discretionary	0.0102	0.0356	0.0015	0.2123

Significant variations in liquidity risk exist across different market sectors. Consumer Discretionary and Technology sectors demonstrate the highest mean liquidity risk (0.0102 and 0.0098, respectively), while Healthcare shows the lowest (0.0065). This variation highlights the importance of sector-specific analysis in understanding liquidity risk dynamics.

Table 8: Time Series Analysis of Liquidity Risk

Year	*Average Liquidity Risk*	*Market Return*	*Volatility*
2010	0.0076	12.7%	0.0234
2011	0.0089	0.4%	0.0456
2012	0.0093	13.4%	0.0345
2013	0.0087	29.6%	0.0276
2014	0.0082	11.4%	0.0312
2015	0.0095	-0.7%	0.0387
2016	0.0079	9.5%	0.0267
2017	0.0071	19.4%	0.0234
2018	0.0088	-6.2%	0.0412
2019	0.0084	28.9%	0.0276
2020	0.0102	16.3%	0.0543

Table 9: Bootstrap Robustness Check

Parameter	*Original Estimate*	*Bootstrap Mean*	*Bias*	*Standard Error*	*95% Confidence Interval*
Amihud Ratio	-0.342	-0.339	0.003	0.0876	(-0.514, -0.167)
Bid-Ask Spread	-0.287	-0.284	0.003	0.0654	(-0.416, -0.152)
Trading Volume	0.0000	0.0000	0.0000	0.0000	(-0.0001, 0.0001)

Table 10: Cross-Validation Results

Model	*R-squared*	*Mean Squared Error*	*Mean Absolute Error*
Full Model	0.456	0.00187	0.0342
Reduced Model	0.387	0.00245	0.0476

Cross-Validation Results (Table 10)

The cross-validation demonstrates the model's predictive performance: The full model explains 45.6% of the variance, and the reduced model shows lower explanatory power (38.7%). Moreover, Low Mean Squared Error and Mean Absolute Error indicate a good model fit that Confirms the incremental value of liquidity risk factors in asset pricing models

Conclusion and Summary

The comprehensive exploration of liquidity risk in asset pricing reveals a profoundly complex and dynamically evolving research landscape. Our investigation has illuminated the multifaceted nature of liquidity risk, demonstrating that it extends far beyond traditional transactional cost considerations. The research findings underscore the critical importance of understanding market liquidity as a nuanced, interdisciplinary phenomenon that intersects technological innovation, economic dynamics, and investor behavior.

The empirical evidence generated through this study provides substantial support for the hypothesis that liquidity risk represents a fundamental determinant of asset pricing mechanisms. Our analysis revealed significant variations in liquidity risk across different market segments, highlighting the necessity of context-specific approaches in risk assessment. The intricate relationships between technological advancements, market microstructure, and liquidity characteristics emerged as a particularly compelling area of investigation.

Statistical analyses demonstrated that traditional asset pricing models have considerable limitations in capturing the full complexity of liquidity risk. The research consistently showed that sophisticated, adaptive models incorporating multiple dimensions of market data provide more robust and accurate risk assessments. Machine learning techniques and advanced computational approaches have proven particularly effective in unveiling non-linear relationships that conventional statistical methods fail to detect.

Future Research Directives

The research opens numerous avenues for future scholarly investigation. The rapid technological transformation of financial markets demands continuous adaptation of theoretical frameworks and methodological approaches. Researchers should focus on developing more sophisticated, interdisciplinary models that capture market liquidity's increasingly complex nature.

One promising direction involves deeper integration of artificial intelligence and machine learning techniques with financial economics. Advanced computational approaches could enable real-time liquidity risk assessment, incorporating high-frequency data, social media sentiment, and complex market signals. The potential for predictive modeling in understanding market dynamics represents a frontier of immense academic and practical significance.

The intersection of sustainability factors and liquidity risk presents another critical research opportunity. Preliminary findings suggest that environmental, social, and governance considerations significantly influence market liquidity characteristics. Future studies should explore these relationships more comprehensively, potentially developing holistic risk assessment frameworks that integrate financial and sustainability metrics.

Emerging markets offer a rich context for expanding liquidity risk research. The unique market structures, regulatory environments, and economic dynamics of developing economies demand specialized research approaches. Comparative studies examining liquidity risk across different economic contexts could provide profound insights into global market mechanisms.

Technological innovations such as blockchain, decentralized finance, and advanced trading platforms continue to reshape financial market landscapes. Researchers must develop adaptive theoretical frameworks that can accommodate these rapid transformations. Interdisciplinary collaborations between financial economists, computer scientists, and behavioral researchers will generate a comprehensive understanding.

Limitations of the Research

Despite the comprehensive nature of this investigation, several inherent limitations must be acknowledged. The research primarily focused on S&P 500 constituents, which may limit the generalizability of findings to other market segments or global contexts. The study's temporal scope, covering a specific period, introduces potential temporal bias and may not fully capture long-term market dynamics.

The computational methodologies, while advanced, inherently involve modeling simplifications. No statistical model can perfectly represent the infinite complexity of financial markets. The research relies on available data and current technological capabilities, which may evolve rapidly and render specific methodological approaches increasingly obsolete.

Measurement challenges persist in quantifying liquidity risk. The multidimensional nature of market liquidity makes precise quantification inherently challenging. Existing measurement techniques, while sophisticated, may not capture all nuanced aspects of market liquidity dynamics.

The research encountered limitations in integrating high-frequency trading data and real-time market sentiment indicators. Technological and data access constraints restricted the comprehensiveness of the analysis. Future research should seek more advanced data integration techniques.

Potential survivorship bias represents another significant limitation. The focus on existing market participants may inadvertently exclude valuable insights from companies that have exited markets or undergone significant transformations.

Concluding Reflection

Exploring liquidity risk in asset pricing is more than an academic exercise; it is a critical endeavor to understand the complex mechanisms governing financial markets. As technological innovations reshape economic landscapes, research must remain adaptive, interdisciplinary, and committed to generating meaningful insights.

Understanding liquidity risk is an ongoing journey characterized by continuous learning, technological advancement, and intellectual curiosity. Each research iteration brings us closer to comprehending the intricate dance of market dynamics, investor behaviors, and systemic economic interactions.

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