



Hedging Market Risk in Optimal Liquidation (Paperback)

By Office of Fi Department of the Treasury

Createspace Independent Publishing Platform, United States, 2015. Paperback. Condition: New. Language: English . Brand New Book ***** Print on Demand *****.Financial institutions commonly face the risk that large trades will execute at unfavorable prices due to price impact effects from insufficient market liquidity. A typical method to manage these price impact effects is to split a given order into smaller pieces and to trade these pieces sequentially over time. Such a strategy, however, is exposed to market risk. Unlike price impact, market risk can be hedged. This paper explores the market risk management of the liquidation of a large trade that is subject to price impact. Specifically, we consider an investor, such as a large financial institution or a broker-dealer, who must a priori liquidate a large position in a primary risky asset whose price is influenced by the investor's liquidation strategy. The investor hedges the market risk involved with liquidation by simultaneously taking a position in a liquid proxy asset that is imperfectly correlated with the primary asset. We show that the optimal strategies for an investor with a finite investment horizon and constant absolute risk aversion are deterministic and we find them explicitly using the calculus of...



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