

An Equilibrium Model of Institutional Demand and Asset Prices

Abstract:
We propose an empirical asset pricing framework in which we model the demand curves of institutional investors and households as functions of characteristics. We allow for rich heterogeneity in investors’ preferences for characteristics. By imposing market clearing, we solve for asset prices. We estimate the demand functions using instrumental variables using an identification assumption that is weaker than the assumptions used in endowment economies. We show how the model can be used to measure demand and supply liquidity, to forecast future returns, and to provide a better understanding of what causes asset pricing fluctuations. We connect our framework to modern portfolio choice theory, the stochastic discount factor framework, and characteristic-based industrial organization models.