Market Makers as Entrepreneurs in Financial Markets

Orville Brown
And
Adrian Morris*
Central Connecticut State University

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Abstract

This paper investigates the choice that market makers take when deciding what assets to trade in the face of the diversity in the risk profile of investors. Specifically, financial assets are dichotomized into relatively high risk and relatively low risk assets. Consequently, a model of vertical product differentiation in the tradition of Bresnahan (1987) is deployed in the analysis. The main finding of the paper is that Market Makers will optimally choose to specialize in different financial assets. That is, in equilibrium some market makers, although possessing a portfolio that spans the full range of assets, prefer to facilitate trades in assets which exhibit low volatility such as government paper and triple "A" rated paper. On the other hand, some market makers prefer to specialize in assets that constitute far more significant risks. These conclusions speak directly to managers of pension funds not being allowed to take on the riskiest of assets and hedge fund managers accepting far greater risks. The paper also shows that this dichotomous choice on the part of market makers allows for both sets of market makers to generate greater profits.

JEL Classifications: G10, G11, G12.
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