

# Information tranching and Liquidity

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## Abstract

The paper revisits and qualifies existing insights on security design. A rich literature argues that tranching creates debt-like instruments that are robust to adverse selection or discourage wasteful information acquisition. Yet, for a given information structure, while tranching confines and liquefies the safe part of a cash flow (the insulation effect), bundling makes the risky part more liquid (the trading adjuvant effect). Moreover, tranching always has adverse welfare effects on information acquisition: It encourages (discourages) information acquisition when it should be deterred (encouraged). The paper provides conditions under which tranching reduces welfare even when the insulation effect dominates the trading adjuvant effect. The paper's second contribution is to analyze the velocity of assets that are repeatedly traded. The dynamic model can be nested into the static one and insights are shown to be closely related to those on tranching. The central insight is that liquidity is self-fulfilling: A perception of future illiquidity creates current illiquidity.