Study questions for Treynor

This article offers a simple formal model of the dealer function. Try to understand it on its own terms first before extending to banking. It may help to have in mind that Treynor's own business made him a value-based trader (VBT).

1) Get clear in your mind the distinction between

a. a value based trader (VBT) who analyzes the value of a security and establishes a price at which he is willing to buy and a price at which he is willing to sell, which is the outside spread

b. an information based trader (IBT) who is buying or selling on the basis of new information (or pseudo-information) which makes him think the current price is wrong

c. a liquidity based trader (LBT) who is buying or selling only because he needs the cash or has cash he needs to invest

2) How would the market work without a dealer? Treynor says the price would oscillate between the limits of the VBT outside spread. Explain, and notice the opportunity for someone to profit by offering to buy and sell at prices just inside the outside spread. That's the origin of dealers who offer their own inside spread. Competition among dealers causes a narrowing of that spread until expected economic profit is zero. That gives Treynor his theory of price and spread.

3) Treynor says that the dealer price (average of inside spread) moves up or down with the VBT outside spread. Why is this?

4) Treynor says that the dealer spread (inside) increases and decreases with the size of VBT spread. Why is this?

5) Treynor says that the dealer price varies with the dealer's "position". What does that mean? A dealer with a matched book has what kind of position? In what sense can we understand a position limit as a way of controlling risk exposure?

6) Treynor provides no explicit theory of position limits, but let's push the theory a bit by considering what happens if position limits change. Suppose dealers all decide to reduce their position limits. What happens to price, and inside spread. Suppose dealers all decide to extend their position limits. What happens to price, and inside spread.

7) Treynor says (p. 33) that dealers would like VBTs (like himself) to make mistakes in valuation. How does that make the job of the dealer (the profit of the dealer) easier? Does that incentive help explain why there is so much talk (advertising) about which securities are underpriced and which are overpriced?