6.6 *The Law of One Price and Arbitrage*

Arbitrage A zero-risk, zero-net investment strategy that still generates profits.

One of the most fundamental concepts in investments is arbitrage, as you will see again and again throughout this book. Arbitrage is the act of buying an asset at one price and simultaneously selling it or its equivalent at a higher price.

If you can buy Kodak stock over the counter for $128.00 per share and sell it on the New York Stock Exchange for $128.50, you can make a risk-free arbitrage profit of 50 cents per share. Furthermore, by synchronizing the purchase and sale you might not have to tie up any of your own funds in the transaction. You can use the proceeds from the sale at $128.50 to finance the purchase at $128 and clear the 50 cents without investing any of your own money.

Pure arbitrage opportunities of this sort are understandably rare, because it takes the participation of only a few (maybe only one) arbitrageurs to eliminate the price differential. The increased demand for Kodak by arbitrageurs buying on the OTC market would tend to drive the price above $128, and the increased supply of Kodak on the NYSE would drive the price down, until the stock would reach a single price in both markets.

This is of course a simplified example of arbitrage and the activity of arbitrageurs. In practice, there are transaction costs to deal with, and often the arbitrage opportunity involves not one security but combinations of securities. We will see in later chapters that Kodak stock can be created synthetically, using Kodak options plus T-bills, and arbitrage considerations, therefore, dictate a pricing relationship that must hold among these securities.

Practitioners and academicians may often disagree about the right way to characterize equilibrium yield and price relationships, but almost everyone would agree that the *law of one price* holds almost all of the time in the securities markets. Stated simply, the law of one price is that equivalent securities or bundles of securities are priced so that risk-free arbitrage is not possible.