Share Liquidity

By Michael Kemp

I recently read a fascinating statistic. At the end of World War II, a US stock was held, on average, for four years; in 2008, the average holding time had fallen to two months. And in 2011 it had fallen to 22 seconds.

The main reason for the dramatic drop in the period of possession has been the rapid development of High Frequency Trading, a phenomenon that has caught on around the world, including Australia.

Now statistics like that sound like good news for the average punter, right? After all, with more shares being traded each day, surely that makes it easier for you to buy and sell shares? Or to use a market term - surely the stock market has now become more “liquid”?

But before you jump to that conclusion it’s important to realise that share liquidity isn’t defined so simply. This article sets out to explain what share liquidity is, how you can measure it in a practical sense, and most importantly, how to make it your slave not your master.

What Is Share Liquidity?

In the world of finance the term “liquidity” has more than one meaning. But in this article I’ll be considering just one particular meaning, that of share liquidity.

Shares are considered to be liquid if they can be rapidly sold (implying they can also be rapidly bought) and the act of selling has little impact on the share price.

There is no doubt these properties are important to share traders. Traders often need to move quickly in or out of a position either to capture a favourable price or when a stop loss order is triggered. But these properties are less important to investors, and I’ll discuss that in a bit more depth later on.

So let’s now consider how you can judge the liquidity of a listed company’s shares before you take the plunge and make a purchase.

How is liquidity measured?

There are many different ways share liquidity can be measured. That’s because it can be looked at from many different angles – for example, on an average day, it can be described as the total number of shares traded, the total value of shares traded, the turnover (which is the proportion of a company’s total tradeable shares which are traded), how regularly trading occurred, the width of the price spread between what buyers wanted to pay and what sellers wanted to receive or even how resilient the quoted share price was to given volumes of trade.

Adding to the confusion, academics have written countless mathematical papers on the subject filled with more Greek-letters than you’d find in an Athens newspaper.

What you need is a practical way of looking at things – so you can judge there to be sufficient depth of trade to comfortably establish a position when you choose to buy and comfortably convert that position into cash when you choose to sell.

It's important to say at this stage that liquidity has a personal side. For example a small investor, wishing to buy or sell a few hundred shares, is nearly always going to find sufficient liquidity to meet their needs. However, a large institution, wishing to buy or sell a million shares at a time, needs to limit their fishing to the bigger ponds.

If your needs lie somewhere between these two extremes then here are some practical tips to avoid getting caught attempting a trade when everyone else has left the party.

How to Judge Liquidity before you Trade

A practical starting point is to check the stock's average daily trading volume. Yahoo Finance provides up-to-date averages for every stock on its web site. After bringing up the company you are investigating click on the heading "key statistics". Daily averages are shown for the previous 10 days and three months. If the two figures vary significantly, investigate the reason. One might be atypical.

Once the average is found, it is useful to compare this to the size of your own shareholding, be it actual or intended. If the typical daily trading volume is significantly higher than the volume you wish to trade, it should provide you with a degree of comfort.

It's also worth checking out your broker's web page. For example Commsec displays the daily trading volume for each listed stock on every trading day for the previous 12 months (just click on "Trade History"). You can also access the price, volume and total value of all trades executed so far for the day you make the inquiry (by clicking on "Course of Sales").

And it's a good idea to check the market depth just before placing your order. You can access this information on the quotation page of your broker's website. It displays the number of shares both bid for and offered in real time.

If insufficient shares are being bid for or offered within the price range at which you wish to trade then it's inadvisable to place an "At Market" order. To do so means you will probably end up buying or selling at some pretty unfavourable prices. It's much safer, under such conditions, to place an "At Limit" order.

Does liquidity matter if you are a long-term investor?

In theory the answer to the above question is no. But in practice the answer is – "It depends".

The world's most successful investor, Warren Buffett, has said that if you are not willing to own a stock if the exchange shuts down for five years after purchase, then you should not buy the stock in the first place. These aren't idle words from Buffett. Berkshire Hathaway, the company which he heads, has acquired around 90 unlisted companies in the time he's been at the helm, indicating that he's not scared of buying relatively illiquid businesses.

But it's important to add that buying into investment situations that are difficult to exit requires a supreme confidence in your ability to judge the future business prospects for that company. And let's face it, when things start to go pear-shaped, most "investors" (and pretty much all traders) prefer the comfort of being able to get out quickly.

Can I profit from illiquidity if it causes a stock to trade at a discount?

If you fancy yourself as a hot stock picker then illiquidity might be the very best friend you have.

That's because most investors and traders avoid less liquid stocks so there's a tendency for these overlooked equities to trade at a discount. But that doesn't mean investing in a randomly selected group of illiquid stocks will guarantee market-beating returns. Skilful selection is still required so it's a sport reserved for budding Warren Buffett-types.

What about the liquidity of Exchange Traded Funds?

Exchange Traded Funds, or ETFs as they are commonly referred to, are investment funds that are bought and sold on a stock exchange. For this reason, when they originated, they were widely viewed as a more liquid alternative to mutual funds.

But the factors underlying their liquidity require special mention. And that's due to the market making mechanism underlying their creation. Increased demand for the shares of a particular ETF can result in new shares being created. Therefore the liquidity of an ETF also depends upon the liquidity of the securities it's invested in.

Generally speaking, that means ETFs which invest in large-cap stocks, developed economies, broad market indexes and investment-grade bonds will be the most liquid.

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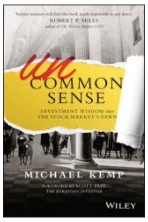

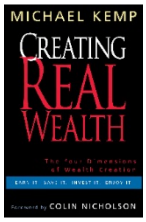

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Michael Kemp is the chief analyst for the Barefoot Blueprint and author of "Uncommon Sense". Published under the Wiley label "Uncommon Sense" delivers a deeply considered and logical approach to the otherwise complex world of investing.