Stock Market Liquidity

By Michael Kemp

In July 1914 the world was bracing for war. Investors were selling their foreign assets and bringing capital back behind domestic borders. In response to an impending international stock market collapse global exchanges were pulling down their shutters and suspending trade.

The New York Stock Exchange was the last major exchange to act. Aware of how grave the situation had become its governors called an emergency meeting on the morning of 31 July, 1914. Their decision, effective immediately, was to close the trading floor of the NYSE for an indefinite period. As it turned out its doors remained closed for the next four months.

But what happened then was something the exchange's governors hadn't counted on. Behind the New York Exchange building is a narrow thoroughfare called New Street. There a fringe group of outside brokers had long gathered on the street to buy and sell small parcels of shares. And now, free from the ruling which had closed the principal exchange, business for the New Street brokers started to boom.

Investors had turned to the pavement brokers to perform their trades. It was clear many feared the prospect of holding their shares for an indefinite period. That attitude prevails today.

Even for those investors who love to regurgitate the following well-worn Warren Buffett quote: *I buy on the assumption that they could close the market the next day and not open it for five years*, the reality is the closure of the stock market would see the palms of many become very sweaty.

That the stock market provides a deep and reliable secondary market for the purchase and sale of shares is one of its great attractions. The term describing this feature is market liquidity. This article explores what market liquidity is, how it's measured and how important it is to the average investor.

What is Market Liquidity?

Stock market liquidity refers to the ease by which shares can be traded. There are two essential features in defining the word "ease".

Firstly speed. A liquid stock is one that can be sold quickly. For this to happen there must always be willing buyers when sellers choose to sell.

Secondly price. Liquidity also implies that a stock can be sold without materially affecting the market price. In other words there must be sufficient demand to support the price during the course of the transaction. Clearly most things can be sold quickly if sellers are willing to accept a low price. But if a significant price adjustment is required to facilitate the sale then the market isn't liquid.

Let's bring these two factors together in one sentence and define liquidity as the ability to trade a substantial amount of a financial asset at close to current market prices.

That sounds fine but how do we measure it?

Measuring Market Liquidity

The most useful measure of liquidity for any stock is its average daily trading volume. Trading volume varies from day to day so it's best to use an average. You can calculate it yourself however Yahoo Finance provides up to date averages on their web page. Look under "key statistics" for the company in question. Daily averages are shown for the previous 10 days and 3 months. If the two figures vary significantly then investigate the reason why. One might be atypical.

Once the average is obtained it's useful to compare this to the size of your own shareholding, be it actual or intended. If the trading volume is consistently much higher than your required trade volume then it should provide a degree of comfort.

Another liquidity metric that's commonly used is the share turnover ratio. Let's start by defining its two inputs:

1. Average daily trading volume as just discussed.

2. The Float - the second input to the share turnover ratio represents the company's total number of outstanding shares minus those owned by insiders (like the founding owner(s), the CEO, Directors, etc.) and what the company is holding back (treasury stock). In other words the float represents the shares available for public trade. Yahoo Finance provides this information also.

Now to the calculation: to demonstrate let's calculate the share turnover ratio for two listed stocks, namely BHP Billiton and building materials company Embleton Limited. For this example the daily trading figure used is the average for the previous 30 days. Embleton hadn't traded over the previous 10 days!

Share Turnover Ratio (BHP) = 7.166 million / 5.310 billion

= 0.135%

And for Embleton:

Share Turnover ratio (EMB) = 68 / 276.34 k

= 0.0246 %

The share turnover ratio for BHP is higher than for Embleton, which isn't a surprise. But given that BHP is the largest mining company in the world and Embleton is a $14 million minnow an assessment of relative liquidity can't be made by reference to the ratio alone.

That's because company size is such an important factor in defining liquidity. And the share turnover ratio masks this metric. Large companies typically deliver high liquidity even when their turnover ratios are low.

Liquidity also carries a personal face. For example the liquidity of listed company Hansen Technologies (with a recent average daily trading volume of 78,000 shares) might be fine for Mum and Dad investors but I'm sure James Packer would consider it highly illiquid.

Illustrating these points, and again comparing Embleton and BHP, the average daily trade value for Embleton (based on the previous 30 days) was an incredibly low $440. The value of BHP's average daily trade was $275 million. That's a massive 625,000 times the value in daily trade for BHP despite its share turnover ratio being just five times that of Embleton.

What the Share Turnover Ratio is Actually Telling Us

Having established that the share turnover ratio is of limited value to investors it should be said that it's more useful to traders. Traders view it as a relative measure of the supply and demand relationship for a stock. The lower the turnover ratio, the more potential there is for price volatility (both up and down).

Does Market Liquidity Really Matter?

The answer to this question really depends on who you are and whether your game is investing or trading.

A commonly stated benefit of liquidity is that it allows the rapid exit from a stock when the share price falls. For traders who utilize a stop loss this advantage is clearly very relevant. But for investors it's less so. If the investment story remains appealing then true investors should be prepared to hold a stock even after the price drops. Even if the investment story has changed for the worse my experience has been that the market price adjusts rapidly to reflect the news. That means a so-called "quick" exit by most small investors is usually well behind the play. Which means the rapid exit benefit that liquidity is said to provide is not that useful and grossly overstated.

Liquidity Discount

Given that most traders and investors place a value on liquidity the question needs to be asked - do illiquid stocks typically trade at lower prices? This is because they could present bargains for long-term investors if they do. Whilst it appears that such discounts do exist quantifying them is difficult, but it's a very interesting concept to explore. And maybe it's why gun stock investor, Warren Buffett, turned his main focus away from the share market years ago and became more interested in purchasing relatively illiquid non-listed companies instead.

The Final Word

If you're a trader liquidity is important – both in formulating strategy and executing stop loss orders.

If you're a Warren Buffett type who looks to buy for keeps then liquidity would appear to be less important. After all investors are supposed to take the view that they're buying a part share in a business. And the reality is most businesses aren't even listed on stock exchanges. But few "investors" fit this mould. Most perceive liquidity to be important. And for them I'd recommend limiting their shareholding to a comfortable fraction of the daily trading volume of the respective company. That's easy to do for stocks like BHP and Woolworths. But keep an eye out when investing in the smaller cap stocks.

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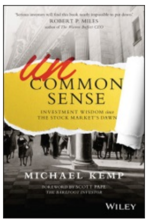

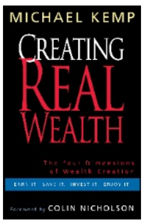

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Michael Kemp is the chief analyst for the Barefoot Blueprint and author of "Uncommon Sense". Published under the Wiley label "Uncommon Sense" delivers a deeply considered and logical approach to the otherwise complex world of investing.