

Investor Professor

An educational review of basic investment concepts and techniques—in easy-to-understand terms.

How Liquidity Impacts the Attractiveness of an Asset

Liquidity refers to how easy or hard it is to exchange an asset at an identifiable market price. Greater levels of liquidity improve pricing and reduce transaction costs by attracting a large number of potential buyers and sellers. Lower levels of liquidity worsen pricing and increase transaction prices, deterring potential investors.

Liquidity Components

There are four key components to measuring an asset's liquidity: the size of the market, the number of transactions, the transparency of pricing and whether or not there are restrictions to buying and selling.

Market Size

Market size is measured by the cumulative monetary value of all transactions. The greater the monetary sum, the more liquid a market is.

Large-cap stocks, particularly those that make up the Dow Jones industrial average, are considered to be very liquid in part because the cumulative value of the daily transactions for these stocks often exceeds \$100 million. The sheer dollar size of the total transactions makes it easy to buy or sell both small and large quantities of shares. This in turn attracts a wide variety of buyers and sellers, including both individual and institutional investors.

In contrast, the market for a micro-cap stock can be very small. Cumulative daily transactions can be \$100,000 or less. These comparatively low amounts make it difficult to buy or sell large quantities of shares. As a result, larger investors often choose to pass on these companies because the size of the market is too small to fulfill their investment needs.

Transaction Volume

Whereas market size looks at the cumulative monetary value, the transaction volume measures how often an asset exchanges hands. Greater numbers of active buyers and sellers increase liquidity by making it easier to buy and sell an asset. Higher transaction volume also improves pricing by providing more competitive orders.

The bid-ask spread can be a good measure of liquidity. A very actively traded asset will have a narrow gap between what buyers are willing to pay (the “bid”) and what sell-

ers are willing to accept (the “ask”). In contrast, an asset that is not actively traded will have a wide bid-ask spread. Potential buyers and sellers can be further apart with their demands because there are fewer competitors willing to transact in the middle of the spread.

Lower transaction volumes can deter would-be investors from participating. This is because it can be comparatively harder to quickly buy or dispose of a sizeable position in an asset and because transaction costs are higher.

Price Transparency

Price transparency refers to the availability of data on previous transactions. This data allows investors to determine the current market value of their assets. A publicly traded security, such as an exchange-traded fund (ETF), has share prices that are updated throughout the day, making it easy for investors to precisely determine the market value. In contrast, non-publicly traded securities, such as the crowd-funding investments that will be allowed under the Jobs Act, lack this information, making the market value more difficult to assess. The pool of would-be investors shrinks when prices are not transparent.

Restrictions on Transactions

Depending on the type of investment, various restrictions can be imposed on both buyers and sellers. These can range from wealth and income requirements for non-public investments, such as private equity and hedge funds, to steep redemption fees for products like annuities. Each restriction limits the number of potential buyers and sellers and thereby reduces liquidity.

Liquidity and Valuations

Over the long term, valuations tend to be higher for assets with more liquidity because of the ease of buying and selling them. Conversely, investors comfortable with wider bid-ask spreads and lower transaction sizes can find assets that are mispriced because they have been overlooked by others seeking more liquid investments. Thus, while assets with less liquidity can have more volatile prices, they can also offer more potential upside if purchased astutely (see the Stock Strategies article for more on this).

—By Charles Rotblut, CFA, Editor, AAIJ Journal