Liquidity

A market's ***liquidity*** represents the amount of open (public) interest in the market at a given time. As a cumulative measure, liquidity is indicative of the size of a market. In a single frame, it is a measure of the consensus among *market-makers* to transact at or near the current offer price. This definition is specific to markets. In a more abstract sense, *liquidity* represents the amount of friction preventing the conversion of one asset into another. A liquid asset is one that is easily convertible. An illiquid asset may require negotiations, paperwork, or bank requests. For example, a real estate transaction is generally *illiquid*. Market transactions (in equities, bonds, derivatives, or cash), in comparison, are highly liquid, since transactions on the open market can occur instantaneously, though not always at the desired price.

Characteristically high liquidity is a desirable quality for a market because it generates trader confidence, increasing trader's willingness to engage in the market. In this way, liquidity is self-reinforcing. However, even in the most dependably liquid markets, a sudden investor panic may cause liquidity to plunge dramatically, resulting in a temporarily volatile market. While moments such as these are the exception rather than the rule, the irregularity of the event can lead to devastating (or remarkable) results for traders who choose to engage in the spooked market.

In a general sense, traders will prefer a liquid market over an illiquid one; but in such liquid, established markets, the tradeoff for price stability is profitability. For this reason, some traders prefer lucrative markets (where the lack of market efficiency is the defining feature) since significant value opportunities are more likely to be found in these smaller markets; however, flexibility to engage in small markets is not available to everyone. Large individual traders and institutional traders are, on the whole, prevented from trading in small markets in relatively meaningful amounts due to the devastating effect their transactions would have on the small market's market depth. If they were to unwind a position large enough to merit their engagement, the institutional trader would need to either accept an average execution price significantly less competitive than the advertised market price, or else sell off their position in small batches over time (an undesirable strategy as it limits price precision and access to funds.) The individual trader willing to conduct their own research and analysis has the advantage of considering smaller, illiquid markets that large fund managers are unwilling to (and cannot) touch. This viewpoint is supported by statistical fact, and is particularly of note for the readers of this book.

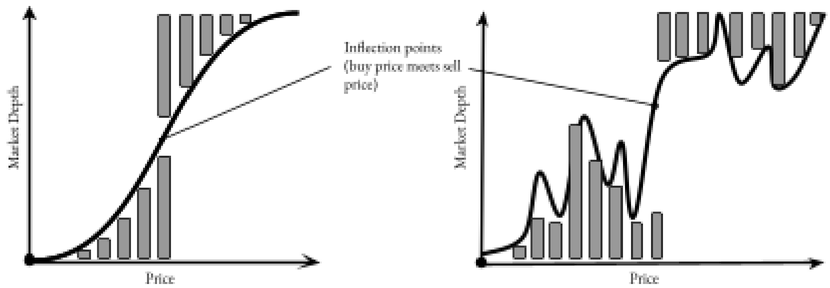

Figure X.x—Comparing the order book of a liquid market (left) with an order book for an illiquid market (right). Note the lack of consensus price among traders on the right. The distribution of market depth is relatively even across a range of prices. In order to fill a large order, a buyer would need to buy at a higher average price than indicated by the midpoint between bid and ask prices, whereas on the left there is depth to fulfill a large order at the ask price.