SPECTRUM®

LIQUIDITY MATTERS

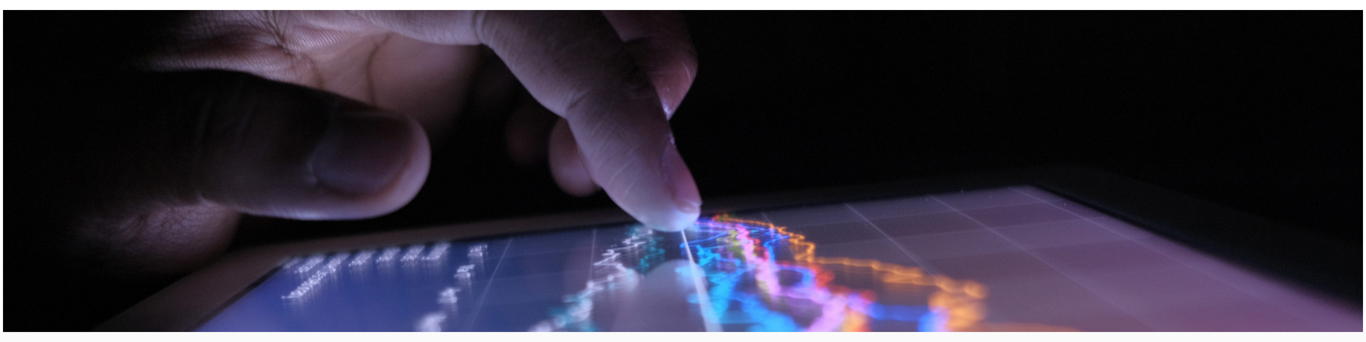
What have large institutional asset managers, FX traders, electronic traders, and most other types of investors got in common?

According to many surveys conducted over the past couple of years, their biggest common concern is liquidity.

WHAT IS LIQUIDITY?

For an asset its degree of liquidity is said to reflect the effort to convert it into cash at its present value (the more liquid the asset the easier it is to sell). In stock markets, it is no different – in liquid markets high volumes are traded and a high demand is countervailing the numerous selling orders. Consequently, liquidity is the ultimate measure for the informative value of the reference price of a given asset. Unsurprisingly, price consistency is the most important criteria for the majority of investors when selecting a liquidity source.

In literature, liquidity is often referred to as being a multidimensional concept with the dimensions being tightness (transaction costs), immediacy (or likelihood) of execution, depth (number of orders above and below the current trading price), breadth (orders in large volumes) and resiliency (speed of price and order adjustment). These dimensions are often used to measure the degree of liquidity by applying certain metrics to each dimension such as the bid-ask spread for the tightness or trading values or turnover ratios for the depth etc. (it is important to avoid the confusion of liquidity in trading environments with the prevailing surplus of funds over investible assets).



Role of liquidity

Liquidity, as an important element to the efficiency of capital markets, plays as a vital role in the global economy as do the banking functions of lending or payments. It is both a lubricant for and a catalyst between the different aggregates that economic entities represent. There is empiric evidence for a positive correlation between a high degree of liquidity and productivity as well as overall economic growth rates – as it lowers the cost of capital and risk.

Regulatory impact

Regulation has had a massive impact on liquidity in recent years. Often cited in that context, MiFID (the Market in Financial Instruments Directive) hasn't been the most influential piece of regulation when analysing the effects detrimental to the development of liquidity. MiFID I, introducing new types of trading venues, has been blamed for fragmenting markets while MiFID II, substantiating this approach for non-equity instruments and, among other things aiming at curtailing trading in dark pools for ultimately shrivelling liquidity. Extended trading obligations and an impactful pre- and post-trade transparency regime have been introduced that capture a broader, almost all-encompassing range of financial instruments.

Providers of liquidity

None of the above may however cover up the fact it had been, for the most part, the rules on bank capital that made some providers of liquidity call their business models into question. If we look at the role of banks as market makers, the liquidity dilemma becomes more obvious. The role of a market maker (in the on-venue trading of sufficiently standardised securities) is to facilitate trading through the ability to buy and sell securities within a stated bid and ask prices sequence that is reflecting a representative bandwidth of buying and selling interest in that market – and to deliver the above mentioned dimension of immediacy by doing so on a permanent basis. To this end, the market maker must maintain an inventory of securities available even during volatile market periods which inevitably exposes it to risk that, in turn, must be covered by own funds. As opposed to the proprietary trading business that is bent on entering into proprietary strategies aiming at profitability on a standalone basis, the market maker must occasionally take losses where this serves the overall purpose of providing liquidity. These losses are being offset by the bid/ ask spreads between buying and selling positions in the market maker function and the positive revenues from the inventory. For banks, it has become increasingly difficult to perform this service on profitable terms.

Perspective

There are other factors that re-shape the liquidity landscape and however strong the pendulum may swing in either direction, a pre-Basle-III-world with massive bank trading books is unlikely to be seen again. On the other hand, if we take share trading as an example, the trading volume in a share on a single-stock basis has lost some of its significance amid the emergence of Exchange Traded Funds. Also, at least from a market structure perspective, it is not really understandable why large orders, still overly executed in dark pools, should not be part of a transparent price formation process (the fact that smaller ticket sizes are increasingly traded in dark pools should give pause for thought about whether or not some are trying to escape high transaction costs rather than hiding their trades for the purpose of price stability).

At Spectrum, being a multilateral trading facility, we naturally belong to the camp in favour of on-venue trading. We believe that ongoing technological progress will help to offset some of the fragmentation of the liquidity of recent years.

Please don't hesitate to get in touch if you wish to receive further detail.

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