SPECTRUM

LIQUIDITY MATTERS

By Thibault Gobert, Head of Liquidity Pool, Spectrum Markets

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

According to many surveys conducted in recent years, their biggest common concern is liquidity. Spectrum Markets' Head of Liquidity Pool, Thibault Gobert, explores the implications.

What is Liquidity?

An asset's liquidity reflects the effort required 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 balances out with the numerous selling orders.

Unsurprisingly, price consistency is the most important criteria for the majority of investors when selecting a liquidity source.

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 confusing liquidity in trading environments with the prevailing surplus of funds over investible assets).

The Role of Liquidity

Liquidity, as an important element of the efficiency of capital markets, plays as much of a vital role in the global economy as 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 empirical 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. In introducing new types of trading venues, MiFID I (the Market in Financial Instruments Directive I) has been blamed for fragmenting markets. MiFID II aimed to, among other things, curtail trading in dark pools, and has been blamed 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 can disguise the fact that the rules on bank capital have been, for the most part, responsible for making 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 by providing the ability to buy and sell securities within a stated bid and ask price sequence that reflects a representative bandwidth of buying and selling interest in that market – and to deliver the aforementioned 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 the market maker's own funds. While proprietary trading businesses strive to enter 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 offset by the bid/ask spreads between buying and selling positions in the market maker function, the overall risk management and potential central risk mitigation internally 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 far the pendulum may swing in either direction, a pre-Basel-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 hardly understandable why large orders, still mainly 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 us 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 liquidity in recent years.

today to discuss how the seamless market access that our venue provides, can help to grow your retail client business.

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

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