LIQUIDITY

Financial liquidity describes the ability to buy or sell something quickly at a fair price. An illiquid asset cannot be so easily sold. For example, real estate is typically an illiquid asset. You may have to wait months to get the price you want.

There are three components to the liquidity of securities in general, and stocks specifically:

The first is the bid-ask spread. The bid price (always lower than the asked price) is the price you get for selling the stock. The asked price is what you pay for the stock. Very liquid stocks may have bid-asked spreads of only a penny or two. Less liquid stocks have wider spreads, sometimes several dollars.

The second is the number of shares you can trade at the bid and asked quotes. You can buy or sell many shares (perhaps thousands) at the quoted bid and asked prices of a liquid stock. But you may only be able to trade 100 shares at the quotes of an illiquid stock.

The third is price pressure. Suppose only 100 shares are being offered at the asked price. How much more will you have to pay if you want to buy more shares? A penny or two more per share might define a liquid stock. It might cost you a dollar or two more per share to buy more shares of an illiquid stock. This aspect of liquidity is called “market depth.” When a market is deep, you can trade large volumes of stock with little impact on its price. The market for illiquid stocks is said to be “thin.”

Many experts believe that illiquid stocks sell at discounted prices to compensate for their illiquidity.

THE LESSON

Invest some of your portfolio in safe, liquid investments such as savings accounts, bank CD’s and money market mutual funds. You may wish to have three to six months of living expenses in these types of investments. If you own a company, keep enough current assets (cash and safe short-term securities) to improve your liquidity. When money is scarce, the Federal Reserve injects liquidity into the financial system so financial assets can be sold at fair prices.