Liquidity & The Stock Market

Understanding liquidity is an essential part of investing as this can explain some of the obstacles investors are plagued with especially when investing in our market. Reasons for the unavailability of shares, long waiting periods, even stock price premiums and discounts and bid-ask spreads can all be explained by one word, liquidity.

Liquidity is therefore one of the most important dimensions of a stock market. This is because liquid markets enable more efficient trading as investors are quickly able to buy or offload shares without being subject to long waiting periods. Liquid markets have such a considerable amount of investors that finding sellers or buyers is not difficult and trades can be executed within a reasonable time frame. An example of a liquid market is the New York Stock Exchange (NYSE). This is a market where billions of shares change ownership daily due to its vast clientele and the great number of securities listed on the Exchange.

Compared to the NYSE, our regional markets are substantially less liquid but by varying degrees. Of Trinidad, Jamaica and Barbados, the latter is indisputably the least liquid with volumes averaging approximately 794,000 on a monthly basis. Jamaica, is comparatively the most liquid with monthly trades averaging approximately 109 million. Trinidad's market falls somewhere between the two with mean trades of approximately 9 million monthly. It should be noted however, that Jamaica has five trading days per week while Trinidad & Barbados each have three.

One of the major attributes of less liquid markets is the unavailability of shares. This unavailability would stem from the float of shares that the Company has on the market. For example, the lower cap shares on our market such as Berger Paints and Flavorite rarely cross the floor of the Stock Exchange.

Sometimes however, though a Company has a comparatively high issued share capital, the availability of the share is still constrained by the percentage of the share capital that is held by substantial interests. For example, First Caribbean International Bank Limited (FCIB) has an Issued Share Capital of over 1.5 billion shares. However, with over 87 per cent of the share capital held by substantial interests, this leaves approximately 189 million shares held by the general public. Over the last twelve months FCIB trades have averaged less than one per cent of the market per month. Even more recently, we have seen difficulty in buying another relatively illiquid share, Scotiabank (T&T) Limited (SBTT) which is now in high demand by investors based on attractive year end earnings.

It is also interesting to note that even the more liquid shares listed on our market are sometimes unavailable. For example, RBTT Financial Holdings Limited (RBTT) is one of the more readily available shares on the market with approximately 228 million in the hands of the public. However, as RBTT investors would know, there are instances where overwhelming supply can see no demand and vice versa. The unavailability of shares can lead to long waiting periods which is another effect of illiquidity.

For example, when the market was in its bull run there was a waiting list sometimes as long as months for shares that were heavily in demand. On hearing news in 2005 that Institutions were going to have to sell some of their shares as some of their portfolios were too heavily weighted in equity, the market quickly turned and shareholders had problems selling the same shares that were heavily demanded before. For example, Republic Bank Limited (RBL) shares were so heavily demanded in 2004 that clients waited as long as three months before being able to get shares. In recent times, clients wanting to sell the same share have been subject to similarly long waiting periods. While the period may not be as long for other shares in comparison to RBL, the trading of shares in our market is generally not as immediate as it would be on a more liquid exchange. Experienced and value investors however know that it is sometimes worth the wait when trying to invest in a share.

An additional aspect of less liquid markets is the sometimes vast differences in prices compared to when the investor placed the order. In actuality, the trading of illiquid shares can cause exaggerated price fluctuations. For example, when RBL was high in demand, in a matter of one month in 2004 investors saw the share rise 15 per cent. Even a couple weeks ago, speculation concerning another company, RBTT, resulted in the share price moving over 40 per cent from $24.00 in just four weeks. It is most likely that investors who placed orders when the share price was $24.00 were unable to buy it at that price.

Another sign of liquidity is the bid-ask spread. The ‘bid’ is the highest price investors are willing to pay for a stock while the ‘ask’ is the lowest price at which investors are willing to sell. In order for a trade to occur, these two prices must meet. Hence, consistently large bid-ask spread signals a low volume for the stock while consistently small spreads indicate higher volumes and greater liquidity. In our market, it is not uncommon to see shares with outstanding closing bids but no outstanding offers and vice versa, which further denotes illiquidity. For example, on December 13, 2006, RBL closed with an ask price of $84.45 but there was no outstanding bid price. Conversely, on the same day SBTT closed with a bid price of $25.72 with no outstanding offers.

A further element of liquidity is that it influences in what range a share could trade in relation to the market. That is, more liquid shares tend to trade at a discount to the market while less liquid shares trade at a premium. This is of course due to the fact that investors are willing to pay more for a share that is difficult to attain as is the case for limited commodities in any market. For example, in the Banking Sector, one would find that less liquid shares such as First Caribbean International Bank (FCIB) and RBL trade at a premium to the market where as more liquid shares such as RBTT could trade at a discount. This can be justified in the price/earnings ratio band in which these shares trade which can be seen in the table.

From Figure 1 you can see that the price/earnings ratio of the share is inversely related to the average volume traded. This element of liquidity can therefore be advantageous to sellers (for shares that trade at a premium) and to buyers (for shares that trade at a discount).

Figure 1

Company	P/E Trading Range	Average Monthly Volume
FCIB	18-20	78,629
RBL	15-17	779,859
RBTT	10-15	991,809

Increasing Liquidity

In a market such as ours therefore, in addition to company fundamentals such as ratio analysis, quality of management and industry outlook, consideration should also be given to the level of liquidity of the stock before investing. Therefore in the event that you may urgently need to cash in part of your portfolio, there will be a better chance of easily liquidating a portion of your holding.

Liquidity in our market could possibly be improved by the listing of more companies as clients will have more choices if they are not able to get certain shares. Another factor that may help liquidity is the change in the frequency of the settlement period. It is thought that a more frequent settlement period would lend to a quicker turnover of cash. Therefore clients selling shares would receive their money faster and so quicker be able to invest in another share.

Liquidity can also be improved by increasing the number of trading days. When Jamaica's market increased its trading days from three to five days, the market saw a marked increase in volume activity. I believe in Trinidad this could definitely propel activity in the more speculative shares. This is because these are more actively traded and so investors would have more opportunity to buy and sell.

From the items discussed above, we can see that several of the problems plaguing our market are a direct result of the degree of liquidity. The unavailability of shares which can sometimes lead to long waiting periods and vast differences in prices all find their root in liquidity. Until steps are taken to improve liquidity, when investing in the Trinidad & Tobago Stock Market, keep in mind some of the difficulties you may face. Whether the market is bearish or bullish you may find some hindrance before the transaction is complete. However, as any experienced investor will tell you, in our market patience can bring a lot of rewards.

All averages were based on the last 12 months of activity. Calculations were done by removing the highest and lowest months and calculating the average of the remaining ten (10) months.