Is There Illiquidity in Equity Returns?

February 22, 2021
by Larry Swedroe

Liquidity is valuable to investors. Therefore, they should demand higher expected return (a risk premium) for less liquid stocks. But new research shows they have not earned that extra return in public equity markets.

The liquidity of an asset market refers to the ability of investors to buy and sell significant quantities of the asset quickly, at low cost, and without a major price concession. Thus, liquidity risk can be thought of as the risk that an investment cannot be bought or sold quickly enough to prevent or minimize a loss. The size of bid-offer spreads and the amount of daily volume are often used as measures or indicators of liquidity risk.

An important question is whether investors demand higher returns from less liquid securities. Nusret Cakici and Adam Zaremba contribute to the literature on illiquidity with their January 2020 paper, "Illiquidity and the Cross-Section of International Stock Returns." They investigated the performance of stocks from 23 markets in four global regions – North America, Europe, Japan and Asia-Pacific – for the period 1991-2019.

Following is a summary of their findings:

- They constructed long-short, equal-weighted factor portfolios that consisted of the most and least liquid stocks. Those portfolios produced sizeable and significant mean returns across all the investigated regions. However, for larger stocks, no positive illiquidity premia were observable.
- The illiquidity premium is primarily driven by elevated returns on the subset of the most volatile and least liquid stocks – firms that are very small and have negligible economic importance (accounting for only 0.04% of global market capitalization in total and an average market cap of just $13 million.
- The evidence for the premium is also fragile, limited to certain global regions, and dependent on measurement approaches and methodological choices (such as when to rebalance).

The authors concluded: "The entire abnormal payoffs on illiquid stocks may be driven by some small group of tiny – and potentially hardly tradeable – securities." They added: "If illiquidity is not rewarded anywhere except for an irrelevant segment of hardly tradeable stocks, then it should not be considered as a separate factor in qualitative portfolio management." They also suggested that "it would be interesting to extend the investigations to emerging markets, which may potentially differ in terms of pricing of illiquidity."

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