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MARKETS

Buying or Selling Stocks? It Isn't Always Easy

Federal Reserve sounds warning as data suggests liquidity is becoming a growing problem

By Gunjan Banerji

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Stocks are flying high. Buying and selling them can be tougher than it seems.

Liquidity—how readily sellers can find buyers and buyers can find sellers—has been on the decline. That can mean higher costs and more volatile prices. The problem can touch traders big and small, from pension funds looking to hedge positions to retail traders jumping in and out of individual stocks.

Liquidity is difficult to measure, but it is likely to be a theme for investors in 2020.

"The number one client question in 2019 has been on liquidity," Goldman Sachs Group Inc. GS **0.06%** ▲ analysts wrote in a December note to clients. The firm said earlier in the year that measures of liquidity have shown "high predictive power" when estimating volatility. The Federal Reserve also weighed in last year, listing falling liquidity in its compendium of risks to the U.S. financial system.

Liquidity in S&P 500 stock-index futures—a crucial market for hedging and making directional wagers—remains weak after dropping substantially during the late-2018 market swoon, according to Goldman. Among single stocks, it hovered near some of its lowest points of the decade in August, one of the latest periods of market turmoil. And an unexpected spell of turbulence also hit money markets in 2019, leading the Fed to flood the system with temporary funding.

It can even be onerous to trade shares of individual companies around the time of their earnings reports, according to a Goldman analysis of stocks in the Russell 3000, a broad U.S. stock-market gauge. Liquidity has dissipated on those days over the past four quarters, falling below levels seen since 2008, according to the bank, which measured how many shares are available to trade without having a significant impact on prices.

"You've got to have a stronger stomach than you used to have," said Bill Smead, chief executive of Smead Capital Management, an investment firm. "When there's no liquidity—how low it can go before it hits bottom—it can shake you up. It's been a vicious circle for years."

A corporate announcement these days can lead to a bigger stock swing than it would have in the past, he said. Mr. Smead says that means he can sometimes buy stocks for lower prices than he expected. That was the case when he picked up shares of Occidental Petroleum Corp. , which were punished in 2019 during a fight with activist investor Carl Icahn.

> It is tough to identify a single cause for the slump in liquidity, though a mammoth shift in investing has underpinned the move.

Big banks are responsible for roughly half the activity they were before the financial crisis, according to Bank of America Corp. , as high-speed traders and ETFs have picked up the slack. Some analysts say the rise of passive investing, in which investors try to mimic the market through index funds, exacerbates the problem.

Meanwhile, trading firms providing continuous buy and sell price quotes have fled some corners of the market, and firms serving as middlemen between traders and central clearinghouses have backed away from the business.

Traders say they navigate the issue in different ways, like breaking up big trades into smaller, more manageable pieces to get them done or simply charging more to take the other side of a position.

Michael Beth, vice president of equity and derivative trading at brokerage firm WallachBeth Capital, said he's had to get creative when placing big orders. He was recently trying to trade shares of casino operator Full House Resorts Inc., a stock he says has grown increasingly difficult to move—and had to seek out alternative venues to traditional stock exchanges.

Other times, stock prices have fluctuated rapidly as he's tried to complete a big trade for a client, he says, and he canceled the rest of the order.

"It's gotten a little bit tougher," Mr. Beth said. "There's a lot of demand the same way, so it ends up increasing your trading costs."

Although liquidity has been a nagging concern among investors for years, it recently came to the forefront. The Federal Reserve warned in November of its risks in its Financial Stability Report, an annual assessment on the resilience of the U.S. financial system, saying liquidity had slipped in key markets like stock futures and U.S. Treasurys at times in 2019.

The past year was also marked by unexpected market strains, worrying some investors about other potential cracks in financial-market plumbing. The Fed injected cash into money markets in September for the first time in a decade after a sudden shortfall of cash. The crunch led to spikes in the cost of overnight loans using repurchase agreements, or repos, fanning concerns about bond liquidity, too.

Widely traded products including one of the biggest exchange-traded funds tracking the S&P 500, the SPDR S&P 500 ETF Trust, also appear to be affected, according to academic research from Boyan Jovanovic of New York University and Albert Menkveld of VU Amsterdam. The number of shares available to sell near the best prices available has fallen over the past decade, hitting a low in 2018, the research shows.

Some analysts have said the risks will grow more apparent in a downturn, or if many investors attempt to sell similar positions at once.

As stocks have risen over the past decade, many money managers have piled into the same top performing stocks. The overlap in the top 50 holdings between mutual funds and hedge funds recently hovered at near-record levels.

"The liquidity crises seem to happen when everybody's trying to sell the same security. It's like a rush for the doors," said Savita Subramanian, head of U.S. equity and quantitative strategy at Bank of America. "They're going to get a lot more volatility than they're expecting."

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