PHYS ORG

Greater market liquidity actually increases risk: study

25 July 2018

Contrary to most common theories that greater liquidity is necessarily better for financial markets overall, Ben-Gurion University of the Negev (BGU) researchers contend in a new paper that liquidity comes at cost: it increases market risk.

Prof. Haim Kedar-Levy of the BGU Department of Management and Prof. Shmuel Hauser of the Department of Business Administration in the Guilford Glazer Faculty of Business and Management presented their theory in "Liquidity might come at cost: The role of heterogeneous preferences" at the 25th Annual Conference of the Multinational Finance Society held in Budapest, Hungary.

Financial literature contends that liquidity of specific assets, such as a stock, is an important and positive attribute that can reduce risk and add value to the stock. Kedar-Levy and Hauser agree, however their findings on the impact of liquidity on the whole market is different.

"The model we developed is richer than the classic theory because, among other reasons, it takes into account a more realistic treatment of financial markets in which various investors have different investment strategies," the researchers say. "Investors differ in the amount of risk they are willing to assume, and therefore choose different proportions of investments in risky assets, such as equities."

In this more realistic scenario, the study shows that the more liquid the market is, the more volatile becomes the average appetite for risk in the whole market. At reasonable risk appetite parameters, trading volume and liquidity of the stock market as a whole peak. When that occurs, there is a massive exchange of shares between investors with different risk appetites. This attribute causes the market price of risk (a.k.a. Sharpe ratio) to be highly volatile, and makes all stocks more risky.

The Sharpe ratio measures how much excess return an investor is receiving for the extra volatility that he endures for holding a riskier asset. Investors need to be compensated for the additional risk vs. holding a risk-free asset, like cash.

However, if the investors in the market are either very similar or very different in their appetite for risk, then trading volume and liquidity drop, and market risk declines, as well.

"This is not to say that we favor less liquid markets over highly liquid ones, but we find that liquidity comes at cost," the researchers say. "It is not a free attribute of stock markets."

The study was published in the *Journal of Financial Markets*.

More information: Shmuel Hauser et al, Liquidity might come at cost: The role of heterogeneous preferences, *Journal of Financial Markets* (2018). DOI: 10.1016/j.finmar.2018.03.001

Provided by American Associates, Ben-Gurion University of the Negev

PHYS.ORG

APA citation: Greater market liquidity actually increases risk: study (2018, July 25) retrieved 20 May 2019 from https://phys.org/news/2018-07-greater-liquidity.html

This document is subject to copyright. Apart from any fair dealing for the purpose of private study or research, no part may be reproduced without the written permission. The content is provided for information purposes only.