The relevance of liquidity for the stock market

MOREMI MARWA
moremi@dse.co.tz

The importance of market liquidity and its relationship to financial market development can be understood by examining the impact on various market actors.

For investors, more liquid markets are associated with lower costs of trading, an ability to move more easily in and out of assets, lower price volatility, and improved price formation.

Issuers are attracted to more liquid markets, as they reduce the cost of raising capital and produce more accurate share price valuations.

Stock exchanges value the increased attractiveness to issuers and investors, as this translates into greater use of the market, greater confidence, greater ability to attract new stakeholders, and greater ability to do business, which drives revenues both directly (through trading fees) and indirectly (through extending their product offering, for example).

Economies as a whole benefit, with companies able to access capital at a reasonable cost, subsequently increasing investment in their business and driving increased employment and their overall contribution to the economy.

Liquidity: What is it?

Stock market liquidity can be broadly understood as the ability to facilitate large volumes of trade without causing excessive price movements, while still reflecting a steady and fair market price. This concept of liquidity encompasses multiple dimensions, namely:

• Breadth: the cost of reversing a position over a short period. Breadth is usually identified (and measured) by the bid/ask spread (the tighter the spread, the better).

• Depth: a deep market has large numbers of pending orders on both sides of the bid/ask spread. This limits the influence of orders on prices.

• Resilience: the speed at which prices return to stability after a shock.

• Immediacy: the speed at which trades can be conducted at a given cost.

Market operators, investors, regulators, and others use a range of metrics to assess liquidity. These include bid-ask spreads, turnover, and turnover velocity (value traded relative to the overall market capitalization). For the remainder of this chapter, we use turnover measures (volume and value traded, and turnover velocity) as proxies for liquidity.

Promoting Development of a Diverse Investor Base

Promoting a diversified domestic investor base, including both retail investors and a range of institutional investors with different investment horizons and perspectives, is central to the development of domestic equity markets. In addition, the right investor mix ultimately depends on the goals being pursued by trading participants. In early-stage financial markets, policymakers, regulators, and exchange operators focus both on increasing long-term domestic savings and enabling the investment of a portion of those savings into equity markets. Whether a jurisdiction begins by focusing on retail or institutional investors will depend on market-specific considerations.

Some markets may have a large retail investor base from the outset, while others will have to grow that investor segment over time. As the market matures, regulators and market operators continue to promote the development and diversification of the domestic investor base, while also opening the market to (greater) international investment.

Increasing participation of institutional investors

In many early-stage emerging and frontier markets, the size of the institutional investor base is small and often highly concentrated, with relatively low levels of assets under management and limited participation in equity markets. The reasons for this vary between markets, but examples include:

• The presence of pay-as-you-go pension schemes that restrict the development of a competitive private pension fund sector.

• 'No annual loss' requirements for pension funds that compel them to invest in low-risk financial instruments, thereby limiting participation in equity markets.

• Regulatory restrictions on who may manage pension fund assets, thereby limiting the emergence of a competitive asset management industry.

• Regulatory restrictions, including outright prohibitions on pension fund and other institutional investment in equity markets.

Emerging and frontier market jurisdictions are seeking ways to address these challenges by transforming pensions schemes by eliminating or reducing the size of defined benefit or pay-as-you-go pension

schemes, the removal or relaxation of legislative and regulatory barriers to investment in equity markets, and the use of tax incentives, including the abolition of stamp duty, to encourage both the allocation of funds to institutional investors and the funneling of investments into equity markets.

Providing an enabling environment for retail investors

Growing the retail investor base requires investor education, the presence of a suitable investor protection scheme, and the existence of mechanisms to facilitate access to markets. Tax incentives may also encourage increased retail savings and investment. Providing investor education and improving financial literacy are essential to increase retail participation. They are particularly important where levels of financial literacy are low. A number of markets have introduced highly successful education programs. For example, the DSE has the DSE Scholar Investment Challenges which is an edutainment program to impart and enhance students' (both at secondary schools and higher learning institutions) knowledge base and skills on matters of money management, savings and investments. Other significant examples of exchanges that have significant success in this aspect is the Stock Exchange of Thailand that has a dedicated education arm.

In addition to providing retail investors with the tools to understand the risks of investment, regulators and market operators also ensure the existence of relevant investor protection schemes. These include providing investors with accessible dispute resolution mechanisms, creating a fund to compensate investors who suffer financial loss due to misconduct by intermediaries (available as a last resort where the bank/broker is not able to 'make good' the client i.e., the Fidelity Fund at the DSE), and ensuring that investments targeting retail investors are presented in an understandable manner. For example, in Singapore, the Money Authority (MAS) introduced facilitated prospectuses to attract retail investors, conveying the main risks and product information in everyday language.

For many retail investors, the costs of accessing the market may discourage market participation. Mechanisms that simplify market access help to reduce these costs. In India, the market regulator recently announced that it would permit the direct distribution of mutual funds via e-commerce platforms, coupled with the introduction of greater disclosure of commissions and agent fees by mutual funds. Finally, the use of tax incentives can act as a simple and effective method to attract retail flows. In Tanzania, for example, retail [and institutional] investors have been exempted on paying some forms of taxes i.e., no capital gain taxes for DSE transactions whose value is less that 25 percent of the total market capitalisation, withholding tax on dividends is half of those for non-listed companies, zero withholding taxes for investments in government bonds, etc.

Mr Marwa is chief executive officer of the Dar es Salaam Stock Exchange
Email: moremi@dse.co.tz