Financial Markets Microstructure

Lecture 2

Prices and Liquidity
Chapter 2 of FPR

Egor Starkov

Københavns Unversitet
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What did we do last week?

1. Introduced financial markets broadly speaking and motivate why we wanted to talk about it
2. Characterized market formats: order-driven markets (auctions) and dealer markets
3. Introduced some of the key concepts and language: dealer sets bid/ask price, traders submit market/limit orders

Fundamental Value

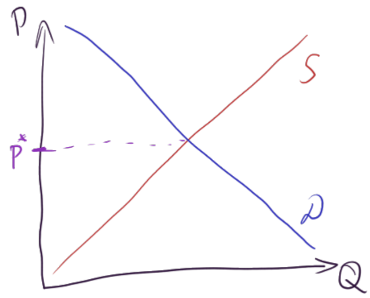
- We'd like to believe there is some "objective" / "fundamental" value of a stock – at least to some representative agent.
- The question of whether to buy of sell then often amounts to:
  "Is the current asset price above or below its fundamental value?"
- To answer, need to understand what fundamental value is.
- **Short answer**:

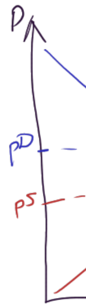
Fundamental Value 2

- Long answer: study asset pricing.
  - Field of finance devoted to calculating asset price relative to other assets, assuming perfect markets.
- Question of **market microstructure**: take the 'fundamental value' as given and analyze how it translates into prices in realistic markets.
  - In GameStop case, divergence was due to bubble(?)
  - Another broad reason for divergence: limited liquidity
- Dual question: price discovery
  "How much information about the fundamental value can be extracted from market prices?"

What is liquidity?

- In perfect markets:
  - There is one price = valuation cutoff
  - Agents who value asset above the cutoff end up with it (keep or buy)
  - Agents who value asset less end up without it (sell or do not buy)
  - This is the efficient allocation that we want
- In (financial and many other) real markets:
  - Bid/ask prices different from that ideal cutoff/fundamental value
  - (due to limited liquidity)
  - Allocation inefficient





Still, what exactly is liquidity?

- Market liquidity =

- Do not confuse with (related notions of):

1. Funding liquidity =

2. Monetary liquidity =

Why do we care about liquidity?

- Traders: liquidity provides a measure of trading costs, affects how costly it is to implement a given theoretical trading strategy
- Regulators:
  1. Efficiency is tricky to measure in financial markets: liquidity provides a proxy
  2. Illiquid markets also seem to be more prone to medium-run price deviations from fundamentals
  3. Illiquidity *may* be a sign of structural problems in the market
- Relation to depth: depth measures how much must be traded to move price by certain amount
  - $\approx$ sensitivity of liquidity to trade size

Liquidity measures

Liquidity is not a very well-defined concept, so it's not immediate how to measure it either. We will consider several measures:

1. **Spread measures**: quoted spread, effective spread, realized spread
2. **Implementation measures**: volume-weighted average price, price impact, implementation shortfall
3. **Non-trading measures**: trading volumes
4. *Missing data estimators*: Lee-Ready algorithm for trade direction, Roll's measure for quotes

Quoted spread

- Let a_t (b_t) be the best ask (bid) price at time t
- Quoted spread:

$$S_t = a_t - b_t$$

- Contemporaneous: spread facing trader at time t
- Normalize to get normalized quoted spread

$$s_t = \frac{S_t}{m_t},$$

where m_t is the midprice:

$$m_t = \frac{a_t + b_t}{2}.$$

- We can generalize it to consider average spread for trade size q:

$$S_t(q) = \bar{a}_t(q) - \bar{b}_t(q)$$

where $\bar{a}_t(q)$ and $\bar{b}_t(q)$ are average execution prices

Effective spread

- Suppose one market order is executed per period, and
  - d_t: trade direction (1: buyer-initiated, -1: seller initiated)
  - p_t: price
- Effective (half-)spread:

$$S_t^e = d_t(p_t - m_t),$$
$$s_t^e = \frac{S_t^e}{m_t}$$

- Backward looking: spread faced by previous trader
- Compare actual price with midquote the instant before: measures price impact and captures 'price improvements'

Realized spread

- Realized spread:

$$\begin{aligned} S_t^r &= d_t(p_t - m_{t+\Delta}) \\ &= d_t(p_t - m_t) - d_t(m_{t+\Delta} - m_t) \end{aligned}$$

- Spread realized by somebody who holds the asset for Δ periods
- Idea: measure the spread after prices have adjusted to new information
- As a forward-looking measure:
  - $\mathbb{E}_t S_t^r = d_t(p_t - m_t) = S_t^e$ if $\mathbb{E}_t m_{t+\Delta} = m_t$
- As a backward-looking measure:
  - Typically smaller than effective spread: why?

Comparing the spreads

- The quoted spread and the effective spread may be more useful to traders:
  - Quoted spread: what is the quoted trading cost now
  - Effective spread: what was the trading cost faced by the last trader

  These are (imperfect) measures of the cost of executing a market order now
- The realized spread is more relevant to a market maker (liquidity provider) or a researcher:
  - It measures the cost of taking a position (long or short) for an amount of time
  - Can also be interpreted as the long-run (informational) impact of trades on prices

Estimating direction of trade

- We often only observe quotes and realized prices: not the direction of trade
- Thus, we need to develop methods to classify trades
- Complication: trading may be 'within the quotes': harder to guess direction
- Lee-Ready algorithm: (Lee and Ready [1991])

$$d_t = \begin{cases} 1 \text{ if } |p_t - a_t| < |p_t - b_t| \\ \quad \text{or } p_t = m_t \text{ and } p_t > p_{t-1} \\ -1 \text{ if } |p_t - a_t| > |p_t - b_t| \\ \quad \text{or } p_t = m_t \text{ and } p_t < p_{t-1} \end{cases}$$

Lee-Ready precision

- Odders-White [2000]: large-scale (144 NYSE stocks over 3 months; $>$ 400k transactions) test of Lee-Ready algorithm with NYSE data
- 85% correct
- Most mistakes with:
  - trades at the midpoint
  - small transactions
  - transactions in large-cap / frequently traded stocks

Quote data

- We often lack information on quotes to compute the spread
  - Can we estimate the spread knowing only trade prices?
- Roll [1984]: use transaction prices to estimate it
  1. Construct a simple model of trading and calculate spread
  2. Estimate it
  3. Check robustness to simplifying assumptions

Roll's model

Suppose the following:

1. All trades have the same size. $d = 1$: buy, $d = -1$: sell
2. Arriving orders are i.i.d. with $\mathbb{P}(d_t = 1) = \frac{1}{2}$
3. Midquote is random walk: $m_t = m_{t-1} + \epsilon_t$, where ϵ_t are i.i.d. shocks
4. Market orders are not informative: $\mathbb{E}(d_t \epsilon_t) = \mathbb{E}(d_t \epsilon_{t+1}) = 0$
5. Spread $S = a_t - b_t$ is constant.

Then

$$p_t = m_t + \frac{d_t S}{2}.$$

We know p_t but not m_t. How do we estimate S?

Roll's model

- Roll's observed that although ϵ_t and d_t are i.i.d., $\Delta d_t = d_t - d_{t-1}$ is mean-reverting, yielding:

$$Cov(\Delta p_t, \Delta p_{t-1})$$

- Intuitively: if $\Delta d_t > 0$, this means that we go from a sale to a buy - then the next change must be opposite

The estimator

- We can then work out that

$$Cov(\Delta p_t, \Delta p_{t-1}) = -\frac{S^2}{4},$$

giving us the estimator

$$S_t^R = 2\sqrt{-Cov(\Delta p_t, \Delta p_{t-1})}.$$

- Recall the assumptions of the model. We (the book) can work out extensions to treat some of them
- In our example: $S_t^R = 0.01$

Price impact

- How much do trades affect prices? Price impact λ; $1/\lambda$ captures market *depth*

$$\Delta m_t = \lambda q_t + \epsilon_t.$$

Here q_t is the order imbalance in period t. In our example: $\lambda = 0.15$ (q_t in 100,000EUR)

- Hasbrouck measure (γ): sensitivity of returns to trading volume (Hasbrouck [2007])

$$|\Delta m_t| = \gamma Vol_t + \epsilon_t.$$

Meaningful for single trades, but if t aggregates many trades, γ is hard to interpret.

In our example: $\gamma = 0.01$ (Vol_t in 100,000EUR)

- Amihud measure (I_t): take ratio btw return Δm_t and volume to get *illiquidity ratio*: (Amihud [2002])

$$I_t = \frac{|\Delta m_t|}{Vol_t}.$$

On Hasbrouck and Amihud measures

- Neither Hasbrouck, nor Amihud measures make immediate sense when applied to aggregate data – yet this is the most common application.
- Afaik, at least the Hasbrouck measure was born to deal with pre-1983 historical stock data, which only contained aggregated daily prices and volumes, and no intraday data.
- Hasbrouck [2007] shows that γ is mildly correlated with λ under some distributional assumptions
- Bottom line: do not use γ or I if you have data that lets you estimate λ directly.

Implementation Measures

We can also look at measures of how costly it is for traders to implement a given trade in reality, as opposed to "paper trading" (looking at trades-you-could-have-done).

Example

[Perold (1988) observed that] from 1965 to 1986, a paper portfolio based on the Value Line ranking system outperformed the market by 20% per year, and the real Value Line fund, which implemented the trades recommended in the newsletter, outperformed the market by only 2.5% per year, emphasizing that the quality of implementation is at least as important as the investment idea itself. [Anand et al., 2012]

Volume based measure

- Volume-Weighted Average Price (VWAP):

$$VWAP = \sum w_i p_i,$$

  where $w_t = |q_i| / \sum_i |q_i|$ is the order weight, q_i is the size of order i
- This equals the amount of dollars traded over the number of shares traded: average price
- Trader can compare the price he got with VWAP to evaluate how good was his deal relative to market.
- This measure may depend excessively on few orders (if they are large) and therefore be subject to manipulation
- For our example, $VWAP = 3.02$

Implementation shortfall

- Aim at time 0: to (net) purchase q shares at current (mid)price m_0
  - Suppose by time t, fraction κ_t has been executed, at an average execution price $\bar{p}_t$
  - The realized trading gain is $\kappa_t q(m_t - \bar{p}_t)$
  - An ideal gain from immediate execution without price impact would have been $q(m_t - m_0)$
  - The difference is the implementation shortfall:

$$
\begin{aligned}
IS_t &= q(m_t - m_0) - \kappa_t q(m_t - \bar{p}_t) \\
&= \kappa_t q(\bar{p}_t - m_0) + (1 - \kappa_t) q(m_t - m_0).
\end{aligned}
$$

  - Interpretation: Execution cost plus opportunity cost

Implementation shortfall

- Anand et al. [2012] show evidence that top market performers have a consistently negative implementation shortfall.
- "there is more to a trading strategy than just selecting a broker"
  - (e.g., when to trade, how much, how to react to market movements...)

Other measures

- Measures such as trading volume and trade frequency are also used
- Time-to-trade for limit orders is another measure, but difficult to use (depends on order size, depends on past traders' intent – some post LOs to provide liq-ty, trading is not the final goal)
- Some measures may contradict each other, e.g.:
  - trading volume and spreads are both positively correlated with information releases (why?)
  - price volatility is low in very liquid – but also very illiquid markets
- Frequency of trading or related measures may be more relevant in 'thin' markets, for instance in emerging economies

Conclusion

- We have looked at different manners in which to estimate liquidity
- No method is perfect: depends on trade size, time horizon, trade motivation
- Data shows that liquidity varies both continuously throughout a trading day, and more abruptly around big events
- Next time we will start analyzing *what* drives the spread

Exercises for next week

- Recreate the graphs and figures and numbers I presented today using the KrispyKreme dataset. Better: calculate the (average) values of all measures for the whole dataset.
- Solve exercise 8 regarding implementation shortfall, on page 75 in the textbook. Discuss the meaning of m_t in this analysis.

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