Stock Liquidity and Investment Efficiency – Evidence from Listed Companies

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Introduction

All investors in the financial markets endeavour to achieve the highest level of returns with the lowest level of risks. Also, the main goal of managers is to maximise the wealth of the shareholders. Therefore, investors require managers to invest efficiently in order to achieve their main goal.

For a firm to invest efficiently, it should accept only the projects that have positive net present values in frictionless markets where the agency costs and the adverse selections are absent (Bidlle, Hilary and Verdi, 2009). On the other hands, when a company passes up a positive net present value project (underinvestment) or engages in a negative net present value project (overinvestment), these projects are referred to as inefficient investments (Durnev, Morck and Yeung, 2001).

Being in an underinvestment state or in an overinvestment state prevents managers to achieve their main goal; hence they fail to maximise the stock price of the company.

Literature Review

In fact, the role of stock liquidity in empirical finance has grown rapidly over the past ten years. The liquidity risk appears when investors decide to transfer the ownership of their securities. Many studies document an important role of liquidity risk factor in asset pricing through various financial markets all over the world, where the authors find out a significant negative relationship between stock liquidity and stock returns Moreover, other researches prove a significant impact of the stock liquidity on the capital structure of the firms where it was stated that an increase in stock liquidity leads to a decrease in the leverage level of a company. On the other hand, a few studies search the role of stock liquidity on managerial compensation and find that as stock liquidity goes up, the proportion of equity-based compensation in total compensation increases while the proportion of cash-based compensation declines.

Indeed, little research has been done to investigate the relationship between stock liquidity and firm investment. Using a sample of US firms, Becker-Blease and Paul (2006) figure out a positive relationship between changes in capital expenditures and changes in stock liquidity. Surprisingly and contrary to them, Gregoriou and Nguyen (2010) find out that there is no statistical association between stock liquidity and investment opportunities when using a U.K sample of firms that experience a negative exogenous liquidity shock. In terms of the emerging markets, Munoz (2012), using a panel of Latin American firms, finds evidence that a higher stock trading volume is associated with higher a level of investment in the firm. In addition, Xiong (2016) proves that firm investment is positively related to stock liquidity in China.

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Current Research

The main aim of this research is to examine whether stock liquidity decreases the levels of investments in the overinvestment firms and to find out whether stock liquidity motivates managers to increase the level of investments in the underinvestment firms. Indeed, ample research finds out that managerial agency problems and adverse selection problems are important factors which affect the level of investments in firms. Therefore, it is vital to study any firm characteristic that mitigates these problems.
One of the firm characteristics that is proved to mitigate these two problems is stock liquidity. There is a growing part of the literature proving that stock liquidity decreases information asymmetry. Thus, this research argues that high stock liquidity can motive the managers to invest efficiently by reducing agency costs and information asymmetry.

In short, using secondary data of common law countries represented in US, UK, Canada and Australia as well as civil law countries represented in France, Belgium, Italy, Germany, Netherland, Japan, Denmark, Norway and Sweden; this research aims to explore whether stock liquidity is a significant factor that leads to firm's optimal investment; specifically by applying different econometric tools including OLS and GMM methods to a panel of 13 countries from 1987 to 2018.

How might stock liquidity affect investment efficiency?

Stock Market Approach

As stock liquidity increase, the cost of equity decreases which might make previous negative NPV projects to have positive NPV; hence solving the underinvestment problem.
Also, high stock liquidity leads to less information asymmetry and more transparency making the managers work under watchful eyes; hence managers will invest efficiently.
Moreover, high stock liquidity facilitates the market feedback from investors to managers via informative stock prices. The movements of the stock prices might provide the managers with constructive feedback which motivates them to adjust their investment decisions.

According to that, this research will investigate whether stock liquidity could increase investment efficiency thorough three channels; reducing cost of equity, monitoring managers and stock prices feedback.

Corporate Governance Approach

Indeed, high liquid stocks are attractive to institutional investors who can use their large monitoring power on firms' managers. These block holders have the power to intervene the poor management decisions through various forms, such as takeover, strategic voting, and public criticism through media. Therefore, managers would be motivated to invest efficiently in order to avoid such intervention.
At the same time, institutional investors might push the managers to invest efficiently through their threat of exit. The stock which is highly liquid gives the opportunity to the institutional investors to sell all their shares and walk away from the company where the managers are not investing efficiently.

According to that, this research will investigate whether stock liquidity could increase investment efficiency thorough the effective ability the institutional investors have to intervene the management decisions.

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