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Empirical evidence on the evolution of liquidity: Choice of market versus limit orders by informed and uninformed traders ☆

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Abstract

We empirically investigate the evolution of liquidity, as well as the changing strategies of informed traders, over the course of the trading day. In particular, we empirically examine the relative use of market versus limit orders by informed and liquidity traders early versus later in the trading day using detailed order and audit trail data from the NYSE. Our study complements experimental research that shows that informed traders tend to take liquidity earlier in the trading day while acting as liquidity suppliers later in the day. We find that informed (i.e., institutional) traders actually use market orders more often in the first half of the day than the second. We also find support for informed traders' use of limit orders. Limit orders placed by informed traders perform better than those placed by uninformed

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(i.e., individual) traders. Our findings serve to underscore the importance of developing new theoretical models to more accurately reflect the changing and complex trading milieu.
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1. Introduction

How do informed traders behave with regard to the choice of their strategies over the course of the trading day? How do the uninformed liquidity demanding traders respond with their own strategy choices over the same period? The answers to such questions hark back to the fundamental questions related to the source and availability of liquidity, which is a crucial determinant of the success of any modern exchange. In recent years, both the regional stock exchanges and electronic markets such as ECNs have emerged as viable trading alternatives for investors. These alternative trading systems have transformed the use of limit orders, and made the role of public limit orders as suppliers of liquidity particularly significant. Given this increased prominence of limit orders in today's environment, it behooves us to understand the evolution of informed trading, especially through traders' choice of market and limit orders, over the course of the trading day.

Unfortunately, this is easier said than done. Informed traders are not observable since they take pains to disguise themselves and their trading motives, and it is left to the creative resources of empirical researchers to come up with reasonable proxies of what comprises informed (and uninformed) trades. Our research builds on the important assumption that institutions are informed traders while individuals are uninformed.[1] Additionally, most publicly available intraday transactional databases do not provide details pertaining to orders behind each transaction, let alone on the counterparties to the trade, or a view of when limit orders are submitted, and the market conditions prevailing at the time of order submission. There is, however, one publicly available database which allows us to investigate the above questions. This is a well used (and well documented) audit trail of all orders and their execution details, over a well represented sample of NYSE stocks over a three month period, known as TORQ.

Using this data, we find that informed initiating trades (through market orders and marketable limit orders)[2] account for a higher cumulative price change in the first half of the day than the second. Thus, informed traders use market orders early on in the trading session. We also study the performance of institutional and

[1] Szewczyk et al. (1992), Alangar et al. (1999), and Dennis and Weston (2001) find corroborating evidence of institutions being better informed. Chakravarty (2001) finds that institutional medium-size orders have a significantly greater cumulative stock price impact than individual orders.

[2] A marketable limit order is one that is placed at or better than the opposite quote and hence is immediately executable.

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