Stock market liquidity and firm value

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\begin{abstract}
This paper investigates the relation between stock liquidity and firm performance. The study shows that firms with liquid stocks have better performance as measured by the firm market-to-book ratio. This result is robust to the inclusion of industry or firm fixed effects, a control for idiosyncratic risk, a control for endogenous liquidity using two-stage least squares, and the use of alternative measures of liquidity. To identify the causal effect of liquidity on firm performance, we study an exogenous shock to liquidity—the decimalization of stock trading—and show that the increase in liquidity around decimalization improves firm performance. The causes of liquidity’s beneficial effect are investigated: Liquidity increases the information content of market prices and of performance-sensitive managerial compensation. Finally, momentum trading, analyst coverage, investor overreaction, and the effect of liquidity on discount rates or expected returns do not appear to drive the results.
\end{abstract}

\section{Introduction}

There are strong theoretical reasons to suspect that market liquidity will positively affect firm performance. Because stock shares are the currency which commands both cash flow and control rights, the tradability of this currency plays a central role in the governance, valuation, and performance of firms. In theoretical analyses, liquid markets have been shown to permit non-blockholders to intervene and become blockholders (Maug, 1998), facilitate the formation of a toehold stake (Kyle and Vila, 1991), promote more efficient management compensation (Holmstrom and Tirole, 1993), reduce managerial opportunism (Edmans, 2009; Admati and Pfleiderer, 2009; Palmiter, 2002), and stimulate trade by informed investors thereby improving investment decisions through more informative share prices (Subrahmanyam and Titman, 2001; Khanna and Sonti, 2004). Thus, a priori, a positive relation between liquidity and performance is quite plausible. However, despite the large number of theoretical papers with predictions related to liquidity’s effect on performance, empirical researchers have not made this relation the center of systematic empirical investigation.

Our paper aims to fill this gap in the literature by examining whether and why liquidity affects firm performance. First, this study shows that stocks with high liquidity have better performance as measured by the firm market-to-book ratio. This result is robust to the use of different measures of liquidity. The market-to-book ratio is then

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The firm market-to-book ratio is defined as 
\[ \frac{V_d + V_e}{I} = \frac{V_d + V_e}{\text{Assets}} = \frac{V_d}{\text{Op. Income}} + \frac{V_e}{\text{Op. Income}} = \frac{\text{Mark. Value of Equity to Op. Income}}{\text{Op. Income}} \times (\text{Mark. Value of Equity to Book Value of Assets}). \] 

1 The firm market-to-book ratio is defined as \( \frac{V_d + V_e}{\text{Assets}} \). The components of the market-to-book ratio are defined as follows: \( \frac{V_d + V_e}{\text{Assets}} = \frac{V_d}{\text{Op. Income}} \times \left( \frac{V_d}{\text{Op. Income}} \right) + \frac{V_e}{\text{Op. Income}} \times \left( \frac{V_e}{\text{Op. Income}} \right) \times (\text{Mark. Value of Equity to Op. Income}) \times (\text{Op. Income to Book Value of Assets}). \n
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