Everything you need to know about market liquidity you can learn from the engine of your car. Liquidity is often viewed as market lubrication, but lubrication isn’t everything, and, even more importantly, horsepower is different from torque. This fact leads us to appreciate the importance of contrarian investing and enables us to think more clearly about the impact of potential regulatory changes, such as the Volcker Rule (which would force investment banks to cut back sharply on their proprietary trading) and the Tobin Tax (a tax on financial transactions).

The difference between horsepower and torque may not be commonly understood. Torque is a component of horsepower, which has two dimensions: torque (force times distance, as when a force is applied at the end of a lever) times revolutions per minute. Automobile racing engines are high-revving engines that often have relatively little torque at low RPMs; tractor trailers and tugboats have slow-turning engines that deliver enormous amounts of torque with each turn of the engine.

Today’s stock market is a high-revving engine that requires a highly sophisticated lubrication system – it’s very temperamental. The lubrication system is prone to failure, so the engine sometimes seizes up dramatically, as in the “flash crash” of May 2010. And sometimes the engine just runs out of gas, as when all the buyers disappear at once. Even when it’s running normally, the engine doesn’t have as much torque as we’d like.

Torque relates to size, not speed. On a “normal” day, bid/offer spreads are tight and you can do small trades at a price pretty close to the last trade. To improve liquidity, you can try to get the smaller trades done faster, or you can try to get larger trades done without incurring a painful price penalty. In automotive terms, if you want to boost horsepower, you can either make the engine turn faster or increase the torque. When market engineers focus exclusively on executing small orders at faster and faster speeds, the result is a high-revving engine with not nearly enough torque.

We think of liquidity as a short-term phenomenon: “short-term liquidity” is redundant, and “long-term liquidity” is a contradiction in terms. But short-term traders are an unreliable source of liquidity. The
most important form of liquidity comes from long-term investors who have strong nerves, that is, they can withstand some price volatility. The high-frequency trader with a microsecond investment horizon isn’t really willing to “take the other side of the trade.” He’s willing to hold the hot potato for a fraction of a second, but true liquidity comes from investors who are willing to grasp the potato for a longer period. Short-term investors can deliver high RPMs, but not torque.