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Why trading volumes are full of noise

By John Christofilos

Average daily volume – noise = liquidity.

This isn't an equation you'll read in a stock buyer's manual or finance textbook, but it's one that traders are being forced to solve for regularly in today's market environment.

A good deal of volume now trades from one high frequency trader (HFT) to another and moves too fast for other market participants to engage in. This "noise" has very little to do with a stock's true liquidity which is best defined as those shares trading hands between investors prepared to buy stock for the purposes of holding it, not selling it right away.

For example, a stock's average daily volume could be 200,000 shares a day, but the accurate representation of its liquidity may be closer to 100,000 shares a day once HFT activity is accounted for. This is an important differential for all investors to understand because overestimating the true liquidity of a stock may lead to a more difficult transaction and potentially higher costs. Larger trades, in particular, may need to be filled with multiple orders at escalating prices instead of being filled in one go at the price originally anticipated.

Separating the noise from the total trade volume of a stock isn't a perfect science, however. Generally speaking, HFT activity will have more of an impact on the trade volumes of small cap stocks that are less liquid, than it will on larger, more liquid stocks. Average daily volume also tends to be a truer reflection of liquidity in periods of heightened volatility because high frequency traders tend to back away from markets in more turbulent times.

An experienced trader, meanwhile, may be able to identify some of the noise by learning which broker/dealers have HFTs on their platform and then tracking trades originating from them. This is made easier in Canada, where each broker/dealer has its own unique registration number, but often comes down to a trader's ability to read the particular signs of high frequency trading (i.e. moving bid/ask spreads) that he/she has learned to recognize over time.

While quantifying the exact amount of noise in a stock's trading volume can be difficult, knowing that it exists can better shape your liquidity assumptions and make future trades go more smoothly.

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