Review of Socio-Economic Perspectives **Al-Haji, A. pp. 25-49**
Vol. 5 Issue: 4/ December 2020

ARE SMALL STOCKS ILLIQUID? AN EXAMINATION OF LIQUIDITY-IMPROVING EVENTS

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Abstract

I study the introduction of decimalization in U.S. stock markets and the implementation of the Hybrid system on NYSE, and I examine the impact of these two events on liquidity, conditionally on firm size. I argue that such liquidity-improving events offer more pronounced benefits to the typically-illiquid small stocks. The basis of this conjecture lies in the notion of diminishing marginal utility. That is, the benefit from improvement in liquidity is more pronounced at stages where illiquidity is higher. Consistent with my conjecture, I find that the improvement in liquidity post decimalization and Hybrid is an inverse function of firm size. I also find that the documented positive association between size and liquidity is rendered weaker after these two events. It seems that such liquidity-improving events reduce the overlap between size and liquidity, and help make them two distinct features. The framework of this paper can be utilized in the pursuit to explain the variation of the size effect over time, by examining whether recent market changes has "cleaned" the small-size premium from the illiquidity component.

Keywords: Decimalization, Trade Automation, Liquidity, Size Effect.
JEL Codes: G12, G14.

Citation : Al-Haji, A. (2020). Are Small Stocks Illiquid? An Examination of Liquidity-Improving Events, *Review of Socio-Economic Perspectives, Vol 5(4),* 25-49.

Article Type: Research / Original Article
Application Date: 05.09.2020 **& Admission Date:** 25.11.2020
DOI: 10.19275/RSEP094

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