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When There Are No Buyers

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Whether selling an IBM bond, 100 shares of Apple stock, a suburban NJ home or a 2010 Honda Accord, a seller seeks the highest possible sales price. What one condition has the greatest impact on the final sales price? The number of interested buyers of course. This is most commonly understood when buying or selling real estate. Times are generally described as either a “Sellers’ Market” or a “Buyers’ Market.” Healthy and efficient markets depend on the breadth and depth of buyers and sellers. Without one or the other, no deal gets done.

Overnight on Sunday, August 23, 2015, there was a relatively large drop in stock prices in Asia. The following Monday morning, buyers were scarce. The Dow Jones Industrial Average dropped 1,100 points, or about 6.7%, in the first five minutes of trading. The market recovered about half of this loss before the day was out, but August 23, 2015 was not a good day for investors.

During that month, about 85 billion shares of stock were traded on the New York Stock Exchange.[1] Despite the incredible depth of this market, there are times that sellers significantly outnumber buyers. Monday, August 24th was one of those days. When this happens, highly motivated sellers will continue to lower their price, until a buyer finally comes along. In times of distress, it may take a significant drop in price before a buyer eventually arrives…sometimes to an irrationally low price.

Trading volume in the U.S. stock market is immense, providing a high level of “liquidity.” That said, many specific market investments have markedly less liquidity. The iShares U.S. Technology ETF (IYW) is one such investment. ETFs (exchange traded funds) are traded like stocks and generally represent a “basket” of individual holdings. The value of this ETF at any one time approximately equals the sum total of the underlying investments – its intrinsic value. This was not true for a short time on the morning of August 24, 2015. This ETF closed at $98.25/share on the prior Friday. But on Monday morning, the ETF plummeted to a low of $73.71, a drop of 25% within minutes of the open! This occurred despite a much smaller drop in its intrinsic value. Within minutes, astute traders (arbitragers) started buying the ETF under the assumption that the price should increase to intrinsic value, but the damage had been done. Many investors sold the ETF at a huge loss. The ETF subsequently closed that day at $94.84, with a relatively modest decline of 3.5% from the prior trading day.

Why would the value of a basket of stocks (the ETF) drop four to five times more than the sum total of the stocks in that basket? Because for a short time, nobody would buy the ETF. There were plenty of buyers for the underlying stocks, but too few buyers of the ETF. The price continued to drop, to an irrational price, until finally buyers realized and stepped in. This phenomenon can be summarized by the investment axiom - “markets are made on the margin.” No matter how many shares of an investment exist, the price for all of those shares is set by the active buyers and sellers of those shares "at the margin," even if those active buyers and sellers represent a very small fraction of existing shareholders.

Another example of a significant, but relatively small imbalance "at the margin" occurred in 2014 and 2015. In June of 2014, the price of crude oil hit its most recent high of $111.93/barrel. By December 31, 2015, the price had dropped to $38.01…an extraordinary decline of about 66%! For the year 2015, the U.S. Energy Information Administration (EIA) estimated that on average, the world was consuming 93.8 million barrels of oil per day, and producing 95.5 million barrels per day.[2] This resulted in an oversupply condition of 1.8%. This seemingly modest 1.8% oversupply, combined with motivated sellers at the margin, resulted in a 66% drop in price for all 93.8 million barrels sold per day.

As investment advisors, we generally seek investments that offer a good deal of liquidity. We also try to avoid selling into a market in turmoil, recognizing that a dearth of buyers can lead to an irrationally low price. While stocks tend to have great liquidity, there sometimes are large swings in the number of buyers and sellers. Corporate bonds, on the other hand, have significantly less liquidity than stocks. In times of turmoil, this relatively conservative investment can experience a significant and sometimes irrational drop in market value, simply because there are too few buyers. In such an event, unless we see a significantly increased risk of default, we would certainly look to hold these investments. Our ability to hold, knowing we are assured a guaranteed return over term, is precisely the reason we generally prefer individual bonds to bond funds.

Markets are made on the margin. The small minority of active buyers and sellers of an investment set the price for all investors. The effect that a very small minority of buyers and sellers can have on the overall value of an investment can be great, especially in tumultuous markets. Successful investing requires an understanding of this condition, and an appropriate response to it.

[1] "NYSE Market Data," 1960 through 2001 NYSE Fact Book
http://www.nyxdata.com/nysedata/asp/factbook/viewer_edition.asp
[2] *Guide to the Markets® U.S. 1Q 2016*, JP Morgan Asset Management, as of December 31, 2015