When Does Liquidity Become a Concern for Stock Market Investors?

Description

The stock market is undeniably one of the most liquid markets in the world. Should an investor decide, on any trading day, to sell some stocks, they are almost guaranteed to find a buyer within minutes or a few hours and the cash hitting their bank accounts within three days.

That’s the beauty of the stock market; it provides liquidity when needed and at very low transaction costs!

However, does this convertibility of stock investments to cash mean that investors should never ever consider liquidity issues during portfolio construction and stock selection?

The answer depends on how we perceive liquidity, if only considering how readily a portfolio can provide cash at short notice, either for emergency cover or a planned cash expenditure. Cash can be easily obtained within a few days, and investors shouldn’t worry about market liquidity.

The issue becomes a bit complex when the portfolio is meant to make regular cash disbursements to cover living expenses on a long-term basis. Generating the required cash will have an impact on portfolio trading efficiency and tax efficiency.

Regular cash requirements have a significant effect on which stocks should be held in a portfolio. Poor alignment of liquidity requirements with cash disbursed by the portfolio may lead to premature stock sales before meeting investment targets and could trigger early payment of capital gains taxes.

When is liquidity a concern?

When nearing retirement, when faced with a job loss, or when a regular income source has dried up, the need for regular and dependable cash disbursements from investment portfolios becomes a priority.

Should investors sell their stocks every time they need groceries or want to pay rent?

Of course not.

A lack of regular cash disbursements from a portfolio results in a frequent selling of stocks and increases the risk of over trading, which is the biggest factor leading to below-average investment returns. Frequent selling may distort a portfolio's strategy, unless the investors are experienced enough to do the complex modelling and Monte Carlo simulations to make sure that they are still on course to achieving their set investment targets.

Warren Buffett is a role model as an investment icon because of his long-term investment horizon and buy-and-hold strategy. It doesn't matter how good one is at stock picking; if they can't hold the position for the intended period, they are no better than any poor Joe.

What to do

Invest in stable dividend-paying stocks!

Even if the stock market is liquid, investors should create cash paycheques to meet regular cash needs by investing a portion of their wealth in qualified dividend stocks. That way, they delay realizing capital gains taxes on long-held investments.

There is a huge gain in capital gains tax deferral. It compounds the rate of wealth accumulation.

Dividends also increase total returns.

Do the wise thing; populate your portfolio with stable, qualified dividend stocks that offer good dividend yields. Consider an investment in **Thompson Reuters Corp**. (TSX:TRI)(NYSE:TRI) and **Toronto-Dominion Bank** (TSX:TD)(NYSE:TD), both reviewed here by Fool contributor Ryan Goldsman. They pay very reliable, growing dividends.

Investors can also consider holding **Altagas Ltd.** (TSX:ALA), reviewed here by Fool contributor Kay Ng. The high dividend yield seems quite appealing. Another possible stock is **Corus Entertainment Inc.** (TSX:CJR.B), which was reviewed here by Fool contributor Andrew Walker.

CATEGORY

1. Bank Stocks
2. Dividend Stocks
3. Investing

TICKERS GLOBAL

1. NASDAQ:TRI (Thomson Reuters)
2. NYSE:TD (The Toronto-Dominion Bank)
3. TSX:ALA (AltaGas Ltd.)
4. TSX:CJR.B (Corus Entertainment Inc.)
5. TSX:TD (The Toronto-Dominion Bank)
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Date
2025/08/21
Date Created
2017/03/10
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