Why You Should Avoid Low-Volume Stocks

Description

There are a number of different ratios and factors you can look at when deciding whether to invest in a stock, but there's one that makes any stock riskier than it needs to be: low volume. It can be easily overlooked by investors, especially when you're focusing on charts, price, and a variety of other metrics. But investing in stocks that trade at low volumes can put your portfolio at unnecessary risk.

The reason I say it adds risk is because the lack of liquidity can make it difficult to sell the stock at your desired price, and it may take some time to do so. Lots of buying and selling mean lots of people to trade the stock with, and the result is a more gradual price movement. When there aren't many buyers and sellers, then the bid and the ask generally are wider apart, and it plays more of a factor of when your stock will actually be sold. It's not uncommon for a stock to not even trade in a single day because the bid and the ask prices are so far apart without enough liquidity to bridge the gap.

Stop losses could prove useless with low-volume stocks

Another big reason to avoid stocks that don't see a lot of trading is that your stop loss could easily be triggered. If you trade in a stock like **Toronto-Dominion Bank** (TSX:TD)(NYSE:TD), which sees a lot of movement over the course of the day, you won't see its share price spike by big amounts from one trade to the next. But that isn't the case with stocks that trade infrequently, and a lot of volatility could make it easier for your stop loss to be breached, especially if you want it to be triggered at a small or modest decline.

TD and other high-volume stocks don't expose you to this risk, although there will always be the danger that there is a big sell-off right at the open following a bad news day. However, low-volume stocks add to that risk, which is why they should be avoided when possible.

How can investors avoid this?

A good benchmark for liquidity is to find shares with an average volume of at least 100,000. This will ensure you don't have trouble finding a buyer or seller on the market and can get your cash out as quickly as possible. Price plays an important factor here, and if you were to buy penny stocks, then 100,000 shares will still not amount to a whole lot. That said, penny stocks are an even greater risk than simply low-volume stocks.

What it comes down to is not being dependent on a handful of buyers and sellers in order to complete your sale, and for the stocks that trade over $1 and that have over 100,000 shares traded a day, you can minimize this risk. Low-volume stocks are also low volume for a reason, and you should also consider why that is and if the stock is a worthwhile investment. These types of investments warrant further analysis to ensure that you are certain you're getting good value, in case you have to hold the stock for longer than planned.

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