Discussion of "Liqudity, Fundamentals and Delievery Failure?"

Pengjie Gao
University of Notre Dame

Midwest Finance Association Meeting, 2009

Main Findings: Summary

- What are the factors contributing to the delivery failure
  - Liquidity Level
  - Temporary Volume and Return Changes
    - Equity Market
    - Option Market
  - Accounting Fundamentals
    - B/M
    - Earning Yields

Main Findings: Summary

- Less liquidity stocks are more likely to be on the threshold security list (TSL)
- Equity Market: stocks with large stock turnover are likely to be on the TSL
- Option Market: stocks with large option trading volume and / or put volume are more likely to be on the TSL.
- There is not much evidence that “fundamentally weaker” stocks are more likely to be on TSL.
- The duration a stock staying on the TSL seem to be driven by similar set of factors.

Comments #1: Liquidity Level and Liquidity Shock

- This paper mainly considers the liquidity level but liquidity shock may play a role
- Delivery failure may occur because the stock suddenly becomes less liquid
  - Perhaps especially true in a interdealer market
- Conditional on liquidity level, the less liquid the stock, the more likely a small change in liquidity may trigger listing on TSL
- It is not entirely clear the implication of liquidity level and shock impact the duration of listing on TSL

Comments #1: Liquidity Level and Liquidity Shock

- In the logistic regression, and the OLS regression, instead of using the spreads at date (t-7), use some version of the change in liquidity

- In those regressions, consider the interaction of liquidity level and liquidity change

- The liquidity measure shall be more refined
  - For instance, Amihud measure estimated from one day is probably too noisy
  - Using intraday estimation seems to be necessary

Comments #2:
Regression Model Specifications

- The ordinary least square regression (OLS) is used to estimate what determines the duration of a stock being listed on TSL
  - The LHS variable is a nonnegative random variable (potentially right censored as well?)
  - At minimum, we shall take into account the feature of the data using the Tobit model or some variation of it.
  - If there is right censoring of the data, we shall take into account of the feature of the data using a duration model
  - What is nice about the duration model is that, you can specify a time-varying covariate to model what say more what get the stock out from the TSL.

Comments #3: What kind of fundamentals we shall consider?

- High B/M or Low earnings yield may not be a direct indicator of large short positions
  - After all, it depends on whether the price is right or not

- One may want to consider a set of quantitative measures to capture the idea of being a good candidate for short-selling.
  - Earnings Momentum, Accruals, among other quantitative signals

Final Remarks

- It is a very interesting paper.
- I strongly recommend you to read it.
- There are a few loose ends can be easily fixed.