

Liquidity: The Silent Killer

February 22, 2024

Contents

1	Liquidity	1
2	Finding Liquid Options	1
2.1	Where do you find liquid Options?	1
2.2	What to Avoid	1
3	How to Trade This	2

1 Liquidity

- Liquidity is defined as the degree to which an asset or security (in our case an Option) can be bought or sold in the market without affecting the asset's price'.
- High liquidity is linked to high volume in the market.
- Price slippage in high liquidity markets is rare.
- For example, someone trying to sell a certain car for \$10,000 in a town with only 5 buyers will have a much tougher time selling the car for the asking price than someone who is trying to sell the same car for the same price in a town with 100,000 buyers. The more liquidity within the market the more likely you are to get your asking price for whatever the Option and transaction are.
- The Bid'Ask Spread, the difference between what people are willing to buy the Option at and what people are willing to sell the Option at, is a good indicator for liquidity.
- The narrower the spread, the better for the trader.

2 Finding Liquid Options

2.1 Where do you find liquid Options?

- Typically found on larger cap stocks, ie. large corporations
- Can be found on "popular", "momentum" stock
- ATM Options
- Options on stocks that will be reporting earnings soon
- Options on highly-traded, near-dates future contracts
- Options on popular ETF's

2.2 What to Avoid

- Conversely, from a liquidity standpoint, you want to avoid:
 - Options on small-cap stocks
 - Very deep ITM or OTM Options
 - Very long-dated Options
 - Options on non-active future contracts (usually those far away in time)

3 How to Trade This

- Select underlyings that have high market capitalizations, healthy volume levels, and are "popular".
- Before entering a trade, look at the Bid/Ask spread of the Options. Only proceed if the spread is tight enough.
- Keep an eye on liquidity while holding the Option, as you will also need it when you want to close the position.
- Always avoid getting trapped in with a non-liquid Option.