

Market law found?

Supply and demand follow same pattern for all firms.
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Researchers in Italy and the United States believe they have finally uncovered the universal behaviour that governs how supply and demand create stock prices in economic markets.

That there is a law of supply and demand has been the foundation stone of economics since 1776, when Adam Smith wrote *Wealth of Nations*. But what the law actually is has always been something of a mystery.

Smith said that supply and demand allow prices to find a natural level, like water in a pond. If supply or demand changes, the market price adjusts. According to this model, trading always settles into a steady equilibrium.

But the reality is very different, as evinced by wild and irregular fluctuations in stock prices. Trading itself can drive prices up or down. If someone buys a lot of stocks, that sends out the signal that they are desirable, and the price goes up.

Now Rosario Mantegna of the University of Palermo in Italy and co-workers have figured out how the size of such transactions affects prices¹. This 'price impact' can be hard to discern amid the erratic fluctuations of the stock market, so the researchers used mathematical analysis to tease out the underlying regularities.

They looked at 113 million transactions in the stocks of the 1,000 largest firms on the New York stock exchange during from 1995 to 1998. In each case, they examined how the stock price changed after each transaction.

Trading has a smaller impact on the stocks of big firms than of small. In market terminology, the market for the former is more liquid: buying and selling is less likely to drive a price change.

Rosario's team found that the price impact function - the relationship between the change in stock price and the volume of stock traded - has the same general shape for all firms. But price shifts get smaller as the total market share (roughly speaking, the size) of a firm increases.

Allowing for this dependence on firm size, the researchers found that the price impact curves all fall on top of each other. There is just one master curve that describes how prices change for firms of all sizes, trading in quite different commodities, they conclude.

In other words, there seems to be a general economic law that determines how transactions push the market from a balance between supply and demand towards the abrupt fluctuations seen in real market data.

The researchers say that its predictions fit economic models in which one supposes that buying and selling is random. This is in striking contrast to the usual assumption made in economic theory that traders make their decisions in a strictly rational manner, calculated to maximize gains. In other words, there seems to be a strong element of the irrational at play in the market place.

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[Article]

Single Curve Collapse of the Price Impact Function for the New York Stock Exchange

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We study the average price impact of a *single* trade executed in the NYSE. After appropriate averaging and rescaling, the data for the 1000 most highly capitalized stocks collapse onto a single function, giving average price shift as a function of trade size. This function increases as a power that is the order of $1/2$ for small volumes, but then increases more slowly for large volumes. We obtain similar results in each year from the period 1995 - 1998. We also find that small volume liquidity scales as a power of the stock capitalization.

Although supply and demand are perhaps the most fundamental concepts in economics, finding any general form for their behavior has proved to be elusive. Here we build on earlier studies of how trading affects prices [1, 2, 3, 4, 5, 6, 7, 8, 9, 10]. Our study adds to these previous efforts by using huge amounts of data, by looking at the short term response to a single trade, and by measuring the market activity in units of transactions rather than seconds, so that we can more naturally aggregate data for many different stocks. This allows us to find regularities in the response of prices to new orders that have previously been hidden by the extremely high noise levels that dominate financial prices. We study the 1000 largest stocks of the New York Stock Exchange, from (1995-1998), and find that, by appropriate averaging and rescaling, it is possible to collapse the price shift caused by a transaction onto a single curve. The price shift grows slowly with transaction size, growing very roughly as the $1/2$ power in the small volume limit, and much more slowly in the large volume limit. The fact that such consistent results are seen across many stocks and for four different years suggests regularities in supply and demand. Orders can be viewed as expressions of changes in supply and demand, and the existence of a master price impact curve reflects the fact that fluctuations from the supply and demand equilibrium for a large number of financial assets, differing in economic sectors of activity and market capitalization, are governed by the same statistical rule.

The response of prices to orders is a key property of a market. If an attempt to buy or sell results in a small change in price, then the market is considered *liquid*; otherwise it is considered *illiquid*. One expects liquidity to

depend on properties of the asset, such as trading volume, or for stocks, the market capitalization (the total worth of the company, i.e. the total number of shares times their price). The data collapse that we observe here gives a clearer understanding of how liquidity depends on volume and market capitalization.

The study is based on the Trades And Quotes (TAQ) database, which contains the prices for all transactions as well as price quotations (the best offers to buy and sell at a given price at any given time) for the US equity markets. We analyze data for the period 1995-1998 for the 1000 stocks with the largest market capitalization traded in the New York Stock Exchange. The analysis is based on roughly 113 million transactions and 173 million quotes.

Our goal is to understand how much the price changes on average in response to an order to buy or sell of a given size. Of course, in each trade there is both a buyer and a seller. Nonetheless, one often loosely refers to a trade as a “buy” or a “sell” depending on whether the initiator of the trade was buying or selling. By *initiator* we mean the agent who placed the more recent order. Buy orders tend to drive the price up, and sell orders tend to drive it down. It is this *price impact* that we are interested in.

Based on only transactions and quotes it is not possible to know with certainty whether trades are initiated by buyers or sellers. However, we can infer this indirectly using an algorithm developed by Lee and Ready [11]. This algorithm identifies the correct sign of trades by comparing the prices of transactions with recent quotes. The Lee and Ready algorithm is able to classify the sign of approximately 85% of the trades of our database. An order by a single party may trigger transactions with multiple counterparts; from the TAQ database we can only see transactions. To cope with this, we lump together all transactions with the same timestamp and treat them as a single trade.

We study the shift in the midquote price caused by the

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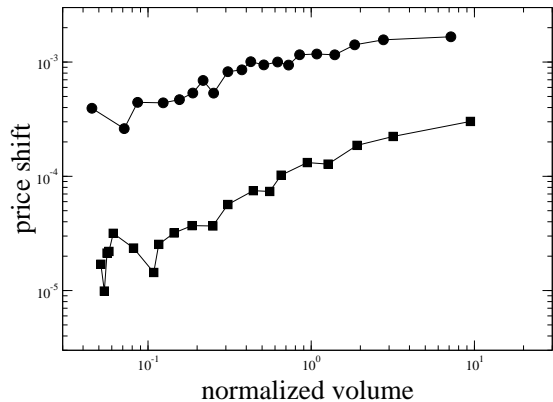


FIG. 1: Price shift vs. normalized transaction size for buyer initiated order for two representative stocks, General Electric Co. (squares) and International Rectifier Corp. (circles) in 1995.)

most recent transaction. For each transaction of volume ω occurring at time t we observe two cases: (i) When the next event is a quote revision, we compare the next quote to the previous (prevailing) quote, and compute the difference in the logarithm of the midquote price. Letting the logarithm of the midquote price be $p(t)$, we compute the price shift $\Delta p(t_{i+1}) = p(t_{i+1}) - p(t_i)$, where t_i is the time of the prevailing (previous) quote and t_{i+1} is the time of the next quote following the transaction; (ii) When the next event is a new transaction we set the price shift $\Delta p(t_i)$ to zero [12]. We then investigate the average price shift as a function of the transaction size ω measured in dollars, doing this separately for buys and sells.

To investigate the average behavior we bin the data based on transaction size and compute the average price shift for the data in each bin. To put all stocks on roughly the same footing, we normalize the transaction size by dividing by its average value for each stock in each year. The results of doing this for two representative stocks are shown in figure 1. For one of the highest cap stocks (General Electric) the average price impact increases roughly as $\omega^{0.6}$ throughout almost the entire volume range. In contrast, for a mid-cap stock such as International Rectifier Corp. (IRF), for small ω ($\omega < 1$) the price impact increases as $\omega^{0.5}$, but for larger values of ω it increases roughly as $\omega^{0.2}$. The behavior is roughly the same for both buy and sell trades.

To understand more systematically how this behavior varies with market capitalization, we group the 1000 stocks of our sample into 20 groups. The groups are ordered by market cap, and the number of stocks in each group is chosen to keep roughly the same number of transactions in each group. The groups are labeled with letters from A to T. The group size varies from the highest market cap group (T) with 9 stocks, to the

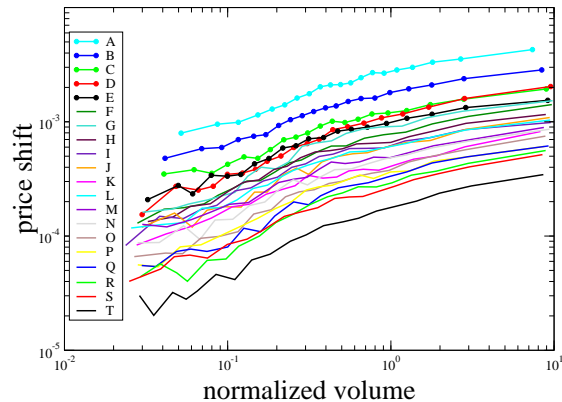


FIG. 2: Price shift vs. normalized transaction size for buyer initiated trades for 20 groups of stocks sorted by market capitalization. The investigated year is 1995. The mean market capitalization increases from group A to group T.

least capitalized group (A) with 290 stocks [13]. We then bin each transaction based on size, choosing bin widths to maintain roughly the same number of transactions in each bin (18,000 in 1995, 22,000 in 1996, 33,000 in 1997 and 46,000 in 1998), and plot the average price impact vs. transaction size for each group. The results obtained for 1995 are shown in figure (2). The price impact functions naturally stratify themselves from top to bottom in increasing order of market capitalization. The slope of each curve varies from roughly 0.5 (for small transactions in higher cap stocks) to ≈ 0.2 for larger transactions in lower cap stocks). When we repeat this for 1996, 1997 and 1998, we see similar results, except that the slopes are somewhat increasingly flatter, ranging roughly from ≈ 0.4 to ≈ 0.1 in 1998.

It is clear from these results that higher market cap stocks tend to have smaller price responses for the same normalized transaction size. Naively, one might have expected liquidity to be proportional to volume; the fact that the price impact for higher cap stocks is lower, even though we are normalizing the x -axis by average transaction size, says that larger cap stocks are even more liquid than one would expect. To gain a better understanding of this, we perform a best fit of the impact curves for small values of the normalized transaction size with the functional form $\Delta p = \text{sign}(\omega)|\omega|^\beta/\lambda$. In figure (3) we plot the parameter liquidity parameter λ as a function of the mean market capitalization of the group. Surprisingly, for all four years the liquidity of each group increases as roughly $C^{0.4}$, where C is the average market cap of each group (the individual values of the exponent are 0.40, 0.42, 0.37, and 0.37 for each year, respectively.)

We now make use of this apparent scaling to collapse the data of figure (2) onto a single curve. We rescale the x

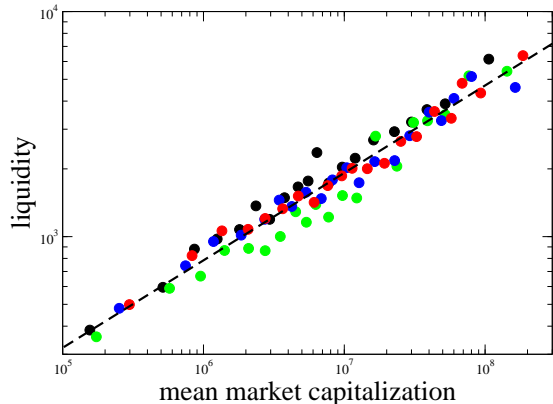


FIG. 3: Liquidity λ as a function of mean market capitalization of each group of stocks for 1995 (black), 1996 (green), 1997 (blue) and 1998 (red). The black dashed line is the power law best fit on all points. The best fitting exponent is 0.39.

and y axes of each group according to the transformations

$$x \rightarrow x/C^\delta \quad y \rightarrow y C^\gamma \quad (1)$$

We then search for the values of δ and γ that do the best job of placing all the points on a single curve. To do this we divide the x axis into bins, and find values that minimize the mean of the two dimensional variance $\epsilon = (\sigma_y/\mu_y)^2 + (\sigma_x/\mu_x)^2$, where σ denotes the standard deviation and μ denotes the mean, and y is the renormalized return and x is the renormalized transaction size. In all investigated years there is a clear minimum for $\delta \approx \gamma \approx 0.3$ (to be precise $\gamma = 0.3 \pm 0.05$ for all years and $\delta = 0.3 \pm 0.05$ for 1995, 1997 and 1998 whereas $\delta = 0.4 \pm 0.05$ for 1996). The resulting rescaled price impact curves for buys in the investigated years are shown in Figure (4).

In all cases the collapse is quite good. The resulting master function spans three decades. It increases slower than a power law, and decreases more slowly in 1998 than in 1995. The data from 1996 and 1997 show similar behavior, with the slopes decreasing steadily from year to year.

This slow rate of increase of the price impact function shown here is surprising. Naive arguments predict that it should increase at least exponentially for positive ω . In contrast, many previous empirical studies of price impact suggest concave behavior [2, 5, 6, 7, 9, 10]. However, this result has not been observed universally [14], and none of these studies have given a clear indication as to functional form. We have solved the problems by focusing on the most elementary response, which is the price impact following a *single* trade, by analyzing a huge amount of data, aggregating across different stocks and by scaling the data based on market capitalization.

The traditional approach in economics to deriving demand curves is to assume that agents maximize their

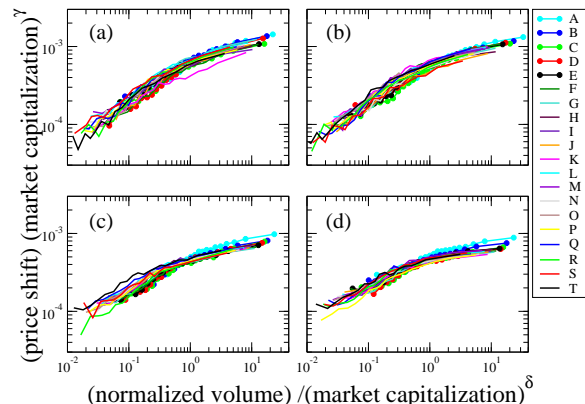


FIG. 4: The price shift vs. transaction size, for buy orders in 1995 (a), 1996 (b), 1997 (c) and 1998 (d), renormalized as described in the text in order to make the data collapse roughly onto a single curve. The parameter $\gamma = 0.3$ for all years and the parameter $\delta = 0.3$ for 1995, 1997, and 1998 and $\delta = 0.4$ for 1996. Results for sell orders are very similar.

utility under assumptions about cognitive ability and access to information. The standard interpretation of our results would be that the size dependence of price impact is due to differences in the information content of trades. In other words, some trades are based on more information than others, and this is known by market participants and factored into the price setting process. This hypothesis suffers from the problem that the information content of trades is difficult to assess *a priori*, making the hypothesis unfalsifiable. In contrast, an alternative approach is to study the mechanism for making transactions in detail, under the hypothesis that order placement and cancellation are largely random. This results in predictions of price impact that are qualitatively consistent with those seen here [15, 16]. If these predictions are born out quantitatively it will be significant in demonstrating that it is important to model financial institutions in detail, and that for some purposes it is may be more useful to model human behavior as random rather than rational.

In summary, we have demonstrated a remarkable regularity in the immediate response of stock prices to fluctuations in supply or demand. In each year we are able to get a good data collapse with similar parameters. This scaling holds for stocks with trading volumes and market capitalizations that differ by 6 and 4 orders of magnitude respectively. The resulting data collapse is useful because it tells us how the liquidity of stocks varies with their market cap, increasing as powers of market cap, in a way that is not obvious *a priori*.

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