Lower Liquidity Can Boost Returns

There is arguably a fifth investment style in addition to the commonly followed growth, value, momentum and size styles: liquidity. The liquidity style focuses on buying stocks that trade with less volume. Rather than buying the glamour stocks, whose names are familiar to most, liquidity-style investors look for stocks few people are talking about or trading.

There is evidence to suggest that there are monetary benefits to not following the herd. A working paper by Yale Professors Roger Ibbotson and Zhiwu Chen and Research Analysts Daniel Kim and Wendy Hu finds that among the 3,500 companies with the largest market capitalizations, those stocks with the lowest level of liquidity have delivered annualized returns of 14.5% over the last 31 years (1971-2011). This is double the 7.24% annualized return realized by stocks with the highest level of liquidity. Lower liquidity stocks also outperformed stocks with the strongest momentum (12.8%) and stocks with the smallest market capitalization (13.0%). Only seeking out stocks with the lowest valuation would have given you better performance (16.1%).

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