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On the Importance of Quality, Liquidity Level and Liquidity Risk: A Markov-Switching Regime Approach

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Abstract : We examine time variation in the market beta of portfolios sorted on quality, liquidity level and liquidity beta characteristics across stock market phases. Using US stock market data for the period 1970-2010, we find, first, the US stock market was driven by four regimes. Second, during the crisis regime, low (high) quality, high (low) liquidity beta and illiquid (liquid) stocks exhibit an increase (a decrease) in their market betas. This finding is consistent with the flight-to-quality and liquidity phenomena. Third, we document the same pattern across stocks when the market volatility is low. We argue that, during low volatility times, investors shift their portfolios towards low quality and illiquid stocks to seek portfolio gains. The pattern observed in the tranquil regime can be, therefore, explained by a flight-to-low-quality and to illiquidity. Finally, our results reveal that liquidity level is more important than liquidity beta during the crisis regime.

Keywords : financial crises, quality, liquidity, liquidity risk, regime-switching models
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