LIQUIDITY EFFECTS OF FIRM SIZE AND MARKET DISTRESS ON INDEX TRACKING ETFs

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ABSTRACT

This paper explores the effects of firm size and financial distress on the liquidity of the most popular ETF that tracks the Standard and Poor's 500 market index: the SPY. We use the financial crisis of 2008 as a natural episode to assess the liquidity shock in this index-tracking ETF. This period is compared to the least volatile quarter within a two-year window of the 4th quarter of 2008, which happens to be the 2nd quarter of 2007 ---a proxy for normal times. Our metric for liquidity is the Amihud illiquidity measure. Within these two extreme market conditions we ask whether firm size may trigger group-specific liquidity strains that spread to the ETF as a whole. Our findings point to a clear increase of the effect of firm level illiquidity on the SPY's overall illiquidity during market turmoil for all firm sizes, and also highlight the higher liquidity impact of smaller firms on the SPY regardless of market conditions.

Keywords: *Index Tracking ETFs, Liquidity, Financial Crisis, Firm Size Effect.*