Local Business Cycles and Local Liquidity

Gennaro BERNILE
*Singapore Management University, gbernile@smu.edu.sg*

George Korniotis
*University of Miami*

Alok Kumar
*University of Miami*

Qin Wang
*University of Michigan - Dearborn*

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Gennaro Bernile
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University of Miami

Qin Wang

University of Michigan at Dearborn

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Abstract

This paper shows that the geographical location of a firm affects its liquidity. Specifically, firm liquidity is higher (lower) when the local economy performs well (poorly) and this effect is more pronounced among larger firms. Further, the impact of local economic conditions on local firm liquidity is stronger when local financing constraints are more binding, the local information environment is more opaque, and local institutional ownership levels are higher. This geographical variation in local liquidity generates predictable patterns in local stock returns. Local stock prices decline and future returns are higher when local liquidity is lower. A trading strategy based on the geographical variation in firm-level liquidity generates an annual risk-adjusted performance of over six percent.

Keywords: Market segmentation, liquidity, local bias, local business cycles, capital constraints, institutional investors, return predictability.

* Please address all correspondence to Alok Kumar, Department of Finance, University of Miami, School of Business Administration, Coral Gables, FL 33124, USA; Phone: 305-284-1882, Email: akumar@miami.edu. Gennaro Bernile can be reached at gbernile@bus.miami.edu or 305-284-6690. George Korniotis can be reached at gkorniotis@miami.edu or 305-284-5728. Qin Wang can be reached at qinw@umd.umich.edu or 313-583-6487. We thank Ralitsa Petkova for helpful comments and suggestions. We are responsible for all remaining errors and omissions.