Twitter Thread by swapnilkabra



swapnilkabra
@caswapnilkabra

Have you ever wondered why price of large cap cos like Reliance ind. Ltd. or Apple inc. fluctuates less in magnitude but share price of a small cap co witnesses huge volatility?
A simple thread to explain the economics behind stock fluctuations!■■
#investing #financialliteracy

1. Penny stocks show huge volatility but on the other hand stock of large cap companies show little fluctuations.
Did you ever observe how ‘Foreign Exchange’ rates show little fluctuation and are range bound?
Let us understand the economics behind it.

2. In this thread we will learn two things,
■Why large companies show quick change in their prices though the magnitude of change is less?
■What causes huge jump in prices of penny stocks? Or why on a bad day they can easily fall with huge magnitude?

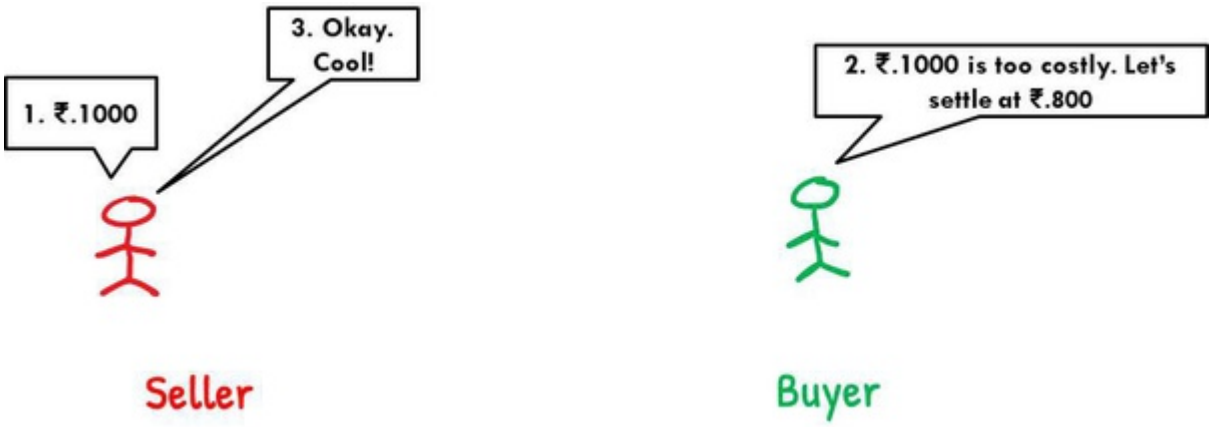
3. First things first. Let us understand who decides the price of goods? Is it the ‘Buyer(s)’ or the ‘Seller(s)’?
The answer to this basic question is that price is decided by both of them.

This is because,
■ A ‘Buyer’ would always be willing to buy any commodity at lesser price.
■ A ‘Seller’, on the other hand would try to sell his product at a greater price.

For a trade to take place, both ‘Buyer(s)’ and ‘Seller(s)’ must arrive at a consensus. In economics, we call this as ‘Equilibrium Price’.



4. Case 1: Only one buyer and one seller



Consider a case where there is only one seller and only one buyer. Initially, the seller fixes the price of his commodity at ■.1000.

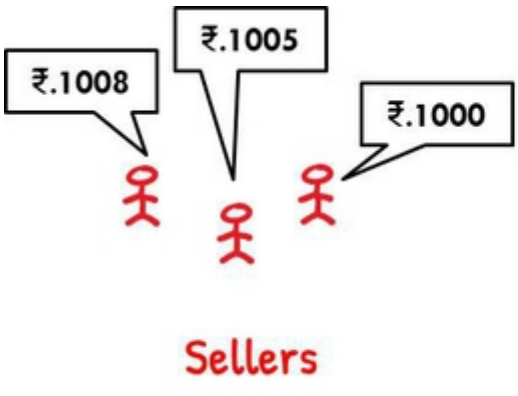
However, buyer feels that the price is inflated. He therefore negotiates and they mutually settle at ■.800.
If you observe closely, you would realize that the price changed from ■.1000 to ■.800 and that is a huge price fluctuation.

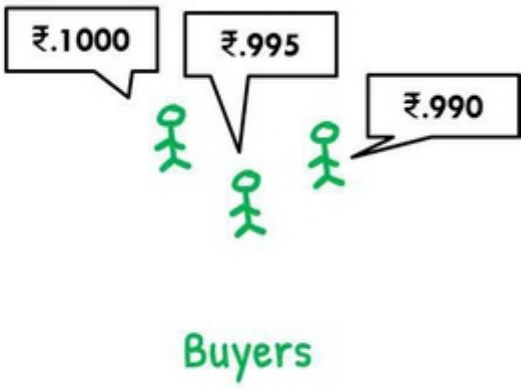
If you do a little math, you would learn that it is a good 20% change in the price.
The price easily managed to change from ■.1000 to ■.800. Why did this really happen?

The reason is simple. There was only one buyer and only one seller. Hence, very few people here are controlling the price. Whenever this happens, the price will change easily.

And that is what we call the ‘volatility’ or ‘fluctuation’ in price. The magnitude of price fluctuation will be huge here.

5. CASE 2: More buyers and more sellers
Now, let us change the situation.





Say, there are many buyers and many sellers for a commodity. Now the sellers are ready to sell the product varying from ■. 1000 to ■. 1008 and the buyers are willing to buy the product varying from ■. 990 to ■. 1000.

In this case, as there are many buyers and sellers, there will be difficulty in arriving at the price consensus. Remember one simple thing, the transaction will happen only when the buyer and the seller have consensus and they arrive at a common price.

In this case, you may say that the buyer who is ready to buy at ■. 1000 and the seller who is ready to sell at ■. 1000 can successfully trade. The others will then have to modify their price quote to trade successfully.

When this happens you would see the price will **change quickly **but the **magnitude of price change would be small**.

Now consider a new buyer entering this scene and quoting a price of ■. 800! Can you imagine any seller willing to sell this new buyer at ■. 800? If there are many buyers in the market, the seller would certainly hesitate selling his commodity at such lower price.

The same is true conversely as well. Imagine a new seller entering this scene and quoting a price of ■. 1200. No buyer would be willing to buy from this seller. Well, why would one buy at such high price.

6. To sum up, the magnitude of price fluctuation would be less if there are many buyers and sellers.
Two major things to observe from both these two cases,

■**The magnitude of price fluctuation** is inversely related to the number of buyer(s) and seller(s). Lesser the number of buyer(s) and seller(s), the price is bound to change with greater magnitude (case 1).

However, as the number of people trading the commodity increases, the magnitude of price fluctuation falls (case 2).

■**The speed of price fluctuation **is directly related to the number of buyer(s) and seller(s). More the buyers and sellers, the price is bound to change quickly, though the magnitude of the price fluctuation will be less.

This happens because when we increase the number of buyers and sellers, the price consensus will be difficult to arrive at.

7. You must have seen how quickly the price of large cap companies change with a blink of an eye. You press the refresh button and bang! the price has changed already.

8. This happens because as discussed above, there are too many buyers and too many sellers and therefore the price quoted by buyers and sellers changes too damn quickly.

9. The ditto happens in case of ‘Foreign Exchange’ rates. In a fraction of a second we see the rate has changed. Again, you can note that in case of foreign exchange rate, the market is bigger than a stock market.

10. I mean, anyone sitting at any corner of the world can buy and sell the foreign currency. It is the largest market in the world.

11. Thus, the price is bound to change rapidly, but the magnitude of the price fluctuation is less. That is to say there will be only a range bound movement.

12. But, then why do we not see huge jump in the prices in such cases? Or why is the price fall not too deep? As discussed, when there are so many buyers and sellers, one person can not influence the price.

13. Hence, if a small investor like me buys 1 share of Apple Inc., there won’t be any change in its price. That’s because there are millions of buyers like me and an equivalent number of sellers.

14. In case of penny stocks, the market capital is less. Hence, if someone buys a good amount of shares, there will be a sudden surge in the price. Same goes the other way round. If there is a little increase in supply, the share price will dive deep and go all red!

15. The End.
This was originally posted by me on medium. Here is a link if you wish to read the post https://t.co/08dfK4jtoJ

@Dinesh_Sairam, @ShubhamAggarwl, @RJGyanchandani, @finbloggers