

What You Can Learn From the Bid-Ask Spread

By Michael Sincere

Stock Trading Just like buying a car or house, there is a tug of war between buyers and sellers of stocks. The difference between what someone is willing to pay and the price at which someone is willing to sell is the bid-ask spread, or the spread, as it is commonly called.

Although ignored by some traders, the “spread” can provide clues about what might happen in the immediate future.

How is it determined?

A stock’s spread is carefully determined by the specialists on the floor of the New York Stock Exchange (NYSE) and the market makers on the Nasdaq electronic exchange, who publicly display the current bid and ask price. The only exception is if you trade via an Electronic Communication Network (ECN). (An ECN is an electronic order matching system in which investors and other market participants may participate. You can place orders through the ECN during the extended hours trading sessions. The ECN in which Fidelity participates may be linked to other ECNs, which increases the potential for an order to be matched.) In this case, traders themselves determine the spread.

Specialists are required to maintain a fair and orderly market and one way to accomplish this is to post reasonable bid and ask prices. While they accommodate the market, because they trade for their own accounts, they also are in business to make money. It’s important to remember that specialists have access to the so-called “order book,” a list of all the buy and sell orders from customers.

What the spread reveals

Although the spread won’t help you pick the right stock or choose the best entry or exit price, it can help you determine short-term trends. For example, you can see whether the spread is leaning toward buyers or sellers. “If you notice that people are buying on the ask price, then momentum might be developing,” says Howard Kornstein, an independent trader with over 25 year’s experience. “If buyers are willing to pay what the sellers are asking, the stock is trending up. This is an important clue.”

Conversely, if stocks are selling at the bid price, this could be the beginning of a downward trend.

Look for changes

There are other clues in observing the spread. Deron Wagner, founder and portfolio manager of Morpheus Trading Group, a trader education service, suggests being careful when buying the offer or selling the bid. He suggests that professional traders study individual stocks and how specialists trade them.

“When a stock is about to reverse direction after trending up throughout the day, sometimes the bid-ask spread suddenly widens,” Wagner explains. “If you are trading the stock intraday you might see the average spread is \$.05 between the bid and ask. All of a sudden the spread widens to \$.10 or \$.15. This often precedes a reversal in the momentum in the stock.”

Wagner also points out that if the stock is going up and is about to go back down, although the bid will start

dropping, the specialists might not lower the ask price at the same time. “Buyers coming into the market might pay the higher price,” Wagner observes. “Soon, you might see the momentum reverse and the stock goes in the opposite direction. Be careful about paying the offer price under these conditions.”

Conversely, if the bid goes up, but the ask price doesn't, Wagner says that indicates stronger demand, which can precede a big upward move. In addition, “on days when there is a lot of demand and volume, a stock with a typical spread of 10 cents may trade with a tighter spread of two or three cents because there is more demand. So people are bidding higher and not willing to sell as much as the spread tightens.”

“If you have a certain stock, learn to observe the bid-ask spread. Then you can determine what the average spread is on individual stocks so you can see changes. It's not important how wide the spread is but the changes that occur,” he says. “Look for the shift in supply and demand.”

Spread info in Fidelity Active Trader Pro®

Fidelity's Windows-based trading platform, Active Trader Pro,¹ provides information about spreads via Time and Sales data.

Although not foolproof, Time and Sales will give you some clues as to the trend of the market based on the bid-ask spread. Think of Time and Sales as a quick snapshot of the market action. Below is a display of Time and Sales:

27.01		↑	0.41	Bid	27.00	
	↑	↓	Last Price	Last Size	Last Eych	Bid Price
↑			27.01	100	N	27.00
↓			27.00	500	DF	27.00
↑			27.01	4000	N	27.00
↓			27.00	100	N	27.00
			27.01	100	P	27.00
			27.01	1400	N	27.00
			27.01	100	N	27.00
			27.01	3200	N	27.01
			27.01	300	P	27.01
			27.01	300	P	27.01
			27.01	799	P	27.01
			27.01	1000	P	27.01
			27.01	500	P	27.01
			27.01	100	P	27.01
			27.01	200	P	27.01
			27.01	200	P	27.01
			27.01	100	P	27.01
			27.01	600	P	27.01
			27.01	300	DF	27.01
			27.01	5300	C	27.01

Snapshot of Market Action -- For illustrative purposes only.

In the above example, the green and red arrows on the left give you visual clues of the changes in the last price. In other words, if the last sale price is higher than the previous sale price, you'll see a green arrow. If lower, you will see a red arrow. If the last sale remains the same, there will be no arrow.

Size	1207	Ask	27.01
Bid Size	Bid Eych	Ask Price	Ask Size
1207	N	27.01	187
1207	N	27.01	187
1207	N	27.01	187
1207	N	27.01	247
1205	N	27.01	205
1205	N	27.01	205
1205	N	27.01	205
1	P	27.01	170
32	N	27.02	211
32	N	27.02	211
32	N	27.02	211
32	N	27.02	211
32	N	27.02	211
32	N	27.02	211
32	N	27.02	211
32	N	27.02	211
32	N	27.02	211
32	N	27.02	211
32	N	27.02	211
32	N	27.02	211
32	N	27.02	211
32	N	27.02	161

Snapshot of Market Action -- For illustrative purposes only.

Another clue is the Bid Size and Ask Size, sometimes referred to as the “bid-ask ratio.” In the example above, the Bid Size of the last trade is 1,207 and the Ask size is 187. (The first line in the chart is the last trade.) For that second, there are more buyers than sellers. It’s possible that buying momentum is developing and buyers are competing with each other to get filled.

In addition, if you also look at the size of the orders coming across the screen (in the first table above), you’ll notice large order blocks, for example, 4,000 shares and 3,200 shares. Putting these clues together, you could deduce that the momentum favors the sellers, that there is more pressure on the sell side if many of the trades are occurring at or near the bid price.

Before decimalization and ECNs, volume was a more important indicator. Because of specialized software, however, it is possible for some traders to hide their true share size. Nevertheless, if you see numerous large blocks hitting on either the bid or the ask, it is not something you want to ignore.

Another clue on Time and Sales is Last Price. By observing the Last Price, you can see whether the bid or ask price is being hit. If sellers with large positions are willing to sell the stock at the bid price, it could be a clue sellers are taking charge at that moment. Perhaps the stock will head lower.

Studying the spread

Another action you can take is studying the actual spread. Independent trader Kornstein points out this phenomenon: “In my opinion, the wider the spread on the stock, the greater the volatility and the more cautious you have to be.”

Keep in mind that what is wide or narrow is relative. For example, a \$500 stock might have a \$.50 spread but that’s very narrow on such an expensive stock. On the other hand, a \$50 stock with a \$.50 spread is very wide.

So you should account for the price of the stock when determining if a stock has a wide or narrow spread. Wagner agrees with Kornstein about being cautious with stocks with wide spreads. Wagner adds that stocks with wide spreads are often lower volume stocks. “A stock that is only trading 50,000 shares a day will likely have a wide spread,” Wagner says. “You could have a tough time getting out of the stock because there isn’t enough liquidity.”

On the other hand, both Kornstein and Wagner will pay the current price or even more than the ask price, especially on a momentum trade. Kornstein says: “It might be only a three or four cent difference. It’s not worth it to me to miss out on a momentum trade for a few cents. I am willing to pay more if I see it moving up.” In other words, don’t lose a potentially profitable trade by pinching pennies. But that does not mean you must pay the ask price (or above) every time you buy stock.

If you are an active trader, you can’t ignore the bid-ask spread no matter how insignificant it might seem. The spread, although not as useful as it once was because of decimalization, still provides valuable information for astute traders. By observing and studying the spread on individual securities, you can attain valuable clues that can help you determine immediate trends.

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1. Fidelity Active Trader Pro® is available to those customers with annual household trading activity of 36 or more trades. Streaming watch lists and static Level II quotes are available to customers with 72 or more trades a year. Certain features, including streaming Level II quotes, streaming interactive charting, time and sales data, and directed trading, are available to those customers with annual household trading activity of 120 or more trades.

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