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The Strange-But-True Story About How A Stock Price Is Born

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It isn't all about supply and demand. We'll show you how it really works...

Question: How is a stock quote born?

The Investing Answer: Have you ever walked into the grocery store, noticed that the price of chocolate milk went up 14 cents since last week, and wondered: Who sets the price on this thing? Why $0.14? Why not $0.15, or $0.13? Or $0.44?

#-ad_banner-#People often wonder the same thing about stock prices. Most of us are taught that the laws of supply and demand determine how much something is worth, and in the grand scheme of things, that's true.

But as we all know, at the end of the day, the "laws of supply and demand" aren't putting price tags on the chocolate milk -- a guy back in the storeroom is doing that.

What shocks most investors is that the same thing often happens in the stock market. That is, the laws of supply and demand do eventually determine how much a stock is worth, but when you get down to the nitty gritty, oftentimes there are a handful of financial institutions "back in the storeroom" putting price tags on stocks.

This isn't some big conspiracy or illegal behavior. In fact, it's a vital activity that keeps the markets liquid.

Think about it this way: You're probably taking for granted that there's even any chocolate milk to buy. You just assume that if you want some, you can go to the grocery store and get it. People think the same way about stocks. They figure that if they want to buy, surely there's someone out there who wants to sell.

The truth is, that's not always the case. And that's where our folks in the storeroom come in. They're called market makers.

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What Are Market Makers?

In the simplest terms, a market maker is a financial institution that is always prepared to buy and always prepared to sell a certain security, even when nobody else wants to. In grocery terms, they'll sell you their own chocolate milk if nobody else has any to sell to you. And if, for some reason, you want to sell your chocolate milk but can't find any buyers, the market maker will take it off your hands.

Why would a market maker want to do that? First of all, they do it to facilitate a security's liquidity -- and often because they've agreed to do it. (That often happens if the financial institution was also the issuer's investment bank and helped take the issuer public.)

But the other reason is money. Market makers profit by charging a spread. A spread is the difference between a security’s bid price (what someone is willing to pay for the security) and its ask price (what someone is willing to sell it for).

For instance, if a market maker says it is willing to buy a stock for $3 and it maintains a $1 spread, that means it is also willing to sell the stock for $4. If the market maker's bid goes up to $4, then its ask is $5. If it bid goes down to $1, then its ask is $2.

This is akin to slapping price tags on chocolate milk. The market maker might not offer a price that you like, but if nobody else is willing, then it's better than having no buyer or seller at all.

Of course, nobody is sitting in the back room putting price tags on the stock. Nowadays, computer algorithms make the decisions. (At least that's how it works on the Nasdaq. On the New York Stock Exchange, human specialists act as market makers.)

Basically, market makers post the price at which they will buy and the price at which they will sell. Sometimes, there is more than one market maker for a certain security, so you have more than one market maker always willing to buy or sell the stock even when nobody else wants to. The presence of more than one market maker means more competition and thus better prices.

Anyway, if the market maker can attract a seller at $4 and then attract a buyer at $5, it "makes the spread," and gets a $1 profit per share. If the market maker gets an order to buy and an order to sell at the same time, it can make a $1 profit per share risk-free.

Things rarely happen simultaneously, though, and that's why the market maker's profit isn't really risk-free. Often, when few people are interested in trading the stock, there is a risk that a stock the market maker buys can only be sold at a lower price, creating a loss. To mitigate this risk, the market maker widens its bid-ask spread. That's one reason illiquid or lightly traded stocks tend to have larger spreads than frequently traded stocks.

One final thought: Although the laws of supply and demand do dictate how much things are worth, at some point, somebody has to pick a number and stick it on a price tag. Market makers have that job.

It's a risky business because they have to hold securities in their inventory, and they don't always get to buy and sell at favorable prices. However, market makers can save the day, because they promote market efficiency by keeping markets liquid for you. To ensure impartiality for the benefit of their clients, brokerage houses that act as market makers are legally required to separate their market making activities from their brokerage sales operations.

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