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Demand-Based Option Pricing

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Abstract

We model demand-pressure effects on option prices. The model shows that demand pressure in one option contract increases its price by an amount proportional to the variance of the unhedgeable part of the option. Similarly, the demand pressure increases the price of any other option by an amount proportional to the covariance of the unhedgeable parts of the two options. Empirically, we identify aggregate positions of dealers and end-users using a unique dataset, and show that demand-pressure effects make a contribution to well-known option-pricing puzzles. Indeed, time-series tests show that demand helps explain the overall expensiveness and skew patterns of index options, and cross-sectional tests show that demand impacts the expensiveness of single-stock options as well.

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