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Options Illiquidity: Determinants and Implications for Stock Returns

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University of Toronto - Rotman School of Management

Shengzhe Tang (https://papers.ssrn.com/sol3/cf_dev/AbsByAuth.cfm?per_id=1812228)

University of Toronto - Rotman School of Management

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Abstract


We study the determinants of options illiquidity measured with relative bid-ask spreads of intraday transactions for S&P 500 firms over an extended time period. We find that market makers' hedging costs significantly impact options illiquidity with the future rebalancing cost dominating the initial delta-hedging cost. Inventory demand pressure and adverse selection also contribute to variations in options illiquidity, with the latter effect intensifying around information events. We find option-induced order flows predict their underlying returns only when options illiquidity simultaneously increases. This suggests that shocks to options illiquidity help distinguish abnormal order flows that contain private information from those induced by liquidity trading. We show a simple strategy that uses high-option-illiquidity stocks and yields 16.5% in risk-adjusted returns per year.

Keywords: Market microstructure; Options; Liquidity; Market making

JEL Classification: G12; G14; G24

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