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Informed Trading and Option Spreads

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Gautam Kaul (https://papers.ssrn.com/sol3/cf_dev/AbsByAuth.cfm?per_id=16716)

University of Michigan, Stephen M. Ross School of Business

Mahendrarajah Nimalendran (https://papers.ssrn.com/sol3/cf_dev/AbsByAuth.cfm?per_id=1991)

University of Florida - Department of Finance, Insurance and Real Estate

Donghang Zhang (https://papers.ssrn.com/sol3/cf_dev/AbsByAuth.cfm?per_id=75428)

University of South Carolina

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Abstract


We assess the presence and nature of strategic trading by informed investors in the options market. Specifically, we develop and test a model for the spread of an option that directly captures the effects of strategic trading by informed traders. We show that the underlying stock's spread has an important impact on the option spreads due to the hedging activities of option market makers. The initial hedging costs explain half the effective spread of at-the-money or in-the-money options. For out-of-the-money options, initial hedging costs explain less than one third of the spread, but nevertheless play an important economic role. Rebalancing costs associated with hedging are much smaller than the theoretical values, however. This suggests that although option dealers hedge their positions, they do not hold their positions for long. We also find that the adverse selection component of the underlying stock's spread explains a significant fraction of the option spread. More importantly, contrary to conventional wisdom, adverse selection costs are higher for (the most actively traded) at-the-money or slightly out-of-the-money contracts relative to out-of-the-money options. The results of the array of tests conducted in this paper, taken together, suggest that informed traders trade strategically in options markets, recognizing the trade-off between leverage and transactions costs associated with option contracts of different moneyness.

Keywords: Options, spreads, informed trading

JEL Classification: C12, C13, C21, G13, G24

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