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DIRECTIONAL INFORMATION EFFECTS OF OPTIONS TRADING: EVIDENCE FROM THE BANKING INDUSTRY

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Abstract

This study examines the transmittance of *directional* information from the options trading process to equity values and the *mechanism* in which informed option trades translates to underlying asset valuations. We construct proxies for positive (negative) informed trades and find that they are associated with a value premium (discount). We demonstrate that information asymmetries in the banking industry accentuate the price discovery role of option trades, especially negatively informed trades. The results are consistent with the arguments in Miller (1977), which contends that overvaluation is pronounced in securities which are short-sale constrained and highly informationally opaque. During the short-sale ban of financial stocks in 2008, negative informed trades have a positive effect on short interest, suggesting that value implications are the result of hedging-related behavior by market makers.

JEL Classification: G01; G13; G20; G21; G28

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