

Investor Sentiment and Option Price Discovery: Evidence from Combination Option Trading

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Abstract

This study examines the role of investor sentiment in reversal and conversion option trading and its impact on the price discovery for futures market. Using intraday transaction data from Taiwan's index option market, our results show that traders are more likely to benefit from conversion trades during market optimism while reversal trades are more profitable during pessimistic periods. Also, we find that the net volume between reversal and conversion trades predict futures market returns, with the predictive power being associated with investor sentiment. When the market is optimistic, a decrease in futures returns follows increased conversation trades. Conversely, the return effect becomes less during periods of pessimism-induced reversal trades. Our research highlights the importance of combination option trades in price discovery.

Keywords

Investor sentiment, price discovery, reversal trade, conversion trade.

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