

Volatility trading in options market: How does it affect where informed traders trade?

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Abstract: Although it is widely accepted that options implied volatility is a good estimate of market expectations, very little work has focused on the impact of volatility trading on market microstructure. The present article attempts to fill this gap. We develop a multimarket sequential trades model with asymmetric information in which directional-traders and volatility-traders interact strategically. The major finding is that volatility-traders evict directional-traders from the options market. Indeed, we provide conditions under which volatility trades have a positive impact on options bid-ask spread so that directional-traders choose the spot market. While these results do not confirm that option returns lead spot returns, they are consistent with previous empirical findings.

Keywords: Options market microstructure, volatility trading, informed traders, sequential trades model, asymmetric information.

JEL Classification: C32, G12, G14.