New approach predicts price trends in the stock options market

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A new research paper from the University of Luxembourg outlines a novel method to identify how options traders exploit mutual fund non-fundamental price pressure on aggregate stock prices.

Decisions of retail investors in the stock market are often influenced by short-term perceptions, which sometimes leads to a form of herding behaviour. If the general mood towards a certain asset or class of assets is positive, investment funds receive massive orders and money inflows. The funds' money managers then carry out the orders—often regardless of the fundamental data behind the companies or markets—pushing up prices in those segments. These temporary booms are often followed by price slumps.

Sophisticated investors often avail themselves of these patterns by short selling the stocks during the short-lived price hike. Short selling basically means that the investor borrows a share that he/she expects to plummet, sells it on the market and, ideally, buys it back later at a lower price. The price difference between the sale and the buyback of the share leads to a profit for the investor, but the approach usually exacerbates the expected price plunge of the share.

The pattern that strong inflows into mutual funds create short-term price continuation, followed by a protracted period of price reversal has been documented before. In a new research paper published in the *Journal of Derivatives*, Thorsten Lehnert, Professor of Finance at the Luxembourg School of Finance, University of Luxembourg, has studied for the first time the options market as a means to predict the price developments at the index level after massive cash inflows. In the options market, investors trade contracts that give them the right to buy or sell an asset at a specified price at a specified time in the future.

"Until now, we only were able to observe the flows and then study the subsequent returns over a certain period of time. The advantage of options is you immediately get a good picture of the expectations of market participants," explains Prof. Lehnert. "As most participants in the options market are sophisticated traders and not retail investors, you get a very realistic picture of expectations about future returns at a very early stage."

While the study is currently mainly interesting from a scientific point of view, Prof. Lehnert expects that his findings will help traders in the future to profit from the predictability in mutual fund trading patterns.

More information: Thorsten Lehnert, Mutual Funds, Price Pressure, and Index Options, *The Journal of Derivatives* (2016). DOI: 10.3905/jod.2016.24.1.030

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