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Index Options: The Early Evidence: Discussion

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DISCUSSION

JAMES D. MACBETH*: The authors have done a good job in explaining the properties of these new financial instruments. Their data analysis is rigorous, and I concur with their conclusions. Our option valuation models do not explain all that is going on in the market place.

It is of interest to note that the nature of the mispricing of index options has been consistent with the nature of mispricing of futures contracts on the S&P500 Index. From April 1983 to September 1983 S&P100 calls appeared to have been overpriced relative to puts. During this period, S&P500 futures contracts were underpriced relative to the S&P500 index (given a tax-free environment). This type of mispricing provided an opportunity for equity indexers to outperform the index with a long position in calls (and bills) coupled with a short position in puts, in the case of the S&P100 index, or a long position in futures (and bills), in the case of the S&P500 index. In the last half of 1983, numerous indexers took advantage of these opportunities, very often with tax-exempt pension fund dollars. It is not clear that indexers necessarily caused a reversal of the mispricing but for some reason the nature of the mispricing of futures contracts changed in the last quarter of 1984. In 1984, S&P100 calls have been underpriced relative to puts, and S&P500 futures have been overpriced relative to the index. I speculate that this type of mispricing has persisted because investors who could easily exploit it are those who wish to hedge their equity investments. From casual observation of the financial press, I conclude that there are not a lot of these investors around. I find it encouraging to observe some consistency in the shortcomings of our valuation models across different financial instruments.

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