How Acute are Today's Stock Market Investors? Tracking Conventional Wisdom through Implied Volatility

Evan T. Djikas
Illinois Wesleyan University

Narendra K. Jaggi, Faculty Advisor
Illinois Wesleyan University

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Evan T. Djikas and Narendra K. Jaggi*
Department of Physics, Illinois Wesleyan University

In 1973, Fischer Black and Myron Scholes¹, and Robert Merton² developed a novel, deterministic algorithm, which could, given a realistic set of assumptions about the volatility of the market, compute the rational price of European call options. This pioneering work placed options-pricing on a rational footing, and was recently (1997) honored by awarding the Nobel prize in Economics. We have inverted this algorithm to impute, by iteration, the implied volatility of the underlying stock³ and infer market opinion of future price movements.

We have tracked options on stocks under heavy speculation to discern the investor sentiment surrounding these stocks, by extracting the implied volatility of the stock price. Issues surrounding the accuracy of investor sentiment on these stocks will be addressed.