
Option Trading Basics: Open Interest

The importance of open interest when trading options

Jim Graham

08/01/2004

One concept that option traders need to understand is Open Interest. Although it is always one of the data fields, along with bid price, ask price, volume, and implied volatility on almost all option quote displays, many traders ignore open interest all together. But while it certainly less important than the option's price, open interest does provide important information that should be considered when entering an option position.

Unlike stocks, where there are a fixed number of shares that are traded, you can actually cause a new option contract to be created when you place an option trade. Open Interest is the total number of option contracts that are currently open. In other words, they have been traded, but not yet liquidated by either by an offsetting trade or by exercise or assignment.

For example, looking at Microsoft, it says there have been 81,700 options opened for the March 27.5 call option. You may be wondering if that means bought or sold. The answer is you have no way to know for sure.

When buy or sell an option, the transaction needs to be put in as either an opening or a closing transaction. If you buy 10 of the Microsoft March 27.5 calls because you expect the stock to go up in price, you would buy the calls to "open". That purchase will add 10 to the open interest figure. When you want to get out of the position, you would sell those same options to "close". Open interest will then fall by 10.

Selling an option can also add to the open interest. If you owned 1,000 shares of Microsoft and wanted to do a covered call by selling 10 of the March 27.5 calls, you would enter a sale to "open". Since it is an opening transaction, it would add 10 to the open interest. If you later want to repurchase the options, you would enter a transaction to buy to "close". Open interest would then decrease by 10.

It gets a little more complicated if the options you trade are not "created" by the transaction, but instead the other side is taken by someone doing the opposite transaction as you. For instance, if you are buying 10 of the Microsoft March 27.5 calls to "open", and you are matched with someone that is selling 10 of the Microsoft March 27.5 calls to "close", the open interest number will not change.

So when you are looking at the total open interest of an option, there is no way to know whether the options were bought or sold. I think that is the reason many option traders ignore open interest altogether. But that doesn't mean the open interest figure provides no important information.

One use of open interest is to look at the open interest relative to the volume of contracts traded. A day where the volume exceeds the existing open interest suggests that the trading in that option was exceptionally high that day. So open interest can help you determine whether there is unusually high or low volume for any particular option.

Open interest also offers important information regarding the liquidity of an option. If there is no open interest for an option, it also means there is no secondary market for that option. Options with large open interest means there are a large number of buyers and sellers. And an active secondary market will increase the odds of getting option orders filled at good prices. So, everything else being equal, the bigger the open interest figure, the more attractive the option is.