Educate Yourself

An initiative by SSL Research Centre

Educate yourself is an educational debate dedicated to the dissemination of stock market related terminologies in the use of fundamental and technical analysis for traders and investors. Market participants can explore self-developed skills to face the growing threats of volatility through Educate yourself. *Educate yourself is a great way to boost your knowledge in general investing lingo and helps you to trade strategically.*

Title of the topic :

Open Interest

Volume : **6/2020**

How to profit from OPEN INTEREST?

Introduction – Open Interest

“Volume & Open Interest are the most important parameters for judging the Futures & Options market. Volume can simply be defined as the number of contracts traded on a particular day. Open Interest is slightly more complex data.”

The Open Interest figure for a given future/option is the number of contracts outstanding at any given point of time. The Open Interest increases when trader “A” opens a new position by buying a future/option contract from trader “B” who did not previously hold any position in that future/option contract (“B” will be said to be holding a "Short Position" in the future/option contract). When trader “A” closes out the position by selling the future/option contract, the Open Interest would either remain the same or go down. In brief Open Interest is the total number of future/option contracts that are not closed or delivered on a particular day.

“Open Interest is the total number of outstanding contracts that are held by market participants at the end of the day”.

How to calculate Open Interest?

Trade Day	Trading Activity	Open Interest
Monday	Client A buys 2 futures contracts of Reliance and Client B sells 2 futures contracts of Reliance	**2**
Tuesday	Client C buys 10 futures contracts of Reliance and Client D sells 10 futures contracts of Reliance.	**12**
Wednesday	Client A sells 1 futures contract of Reliance and Client D buys 1 futures contract of Reliance.	**11**
Thursday	Client E buys 7 futures contracts of Reliance and Client C sells 7 futures contracts of Reliance	**11**

- ✓ On Monday Client A and Client B create 2 contracts that are left open this brings the open interest to 2 contracts.
- ✓ On Tuesday Client C and Client D create 10 more contracts that are left open this brings the total open interest to 12 contracts.
- ✓ On Wednesday Client A and Client D take an offsetting position and therefore open interest is reduced by 1.
- ✓ On Thursday, Client E simply replaces Client C and therefore open interest does not change.

Workings:

Open Interest is mostly used to confirm a trend for a particular futures contract, For e.g., let’s look at Reliance 2200 August CALL, the open interest might tell us that there have been 5 options open in the month of August, a trader might then wonder does this refer to the number of contracts bought or sold.

When a trader buy’s or sell’s an option, the transaction needs to be entered as either an opening or a closing transaction. If he buy’s 5 RELIANCE August 2200 CALL, he is buying the calls to ‘open’, i.e. he is opening his position in a futures contract, which causes the Open interest to rise by 5, and then after sometime (within) the month he decides to sell his contract i.e. close his position in a particular contract, then he is causing the open interest to go down by 5.

Open interest applies primarily to the futures market; it helps the measure the flow of money into the futures Market. For each seller of a futures contract (e.g. RELIANCE 2200 CALL) there must be a buyer of that contract. Thus, a seller and a buyer combine to create only one contract.

Therefore, to determine the total open interest for any given market we need only to know the total from one side or the other, buyers or sellers, not the sum of both. The open interest position that is reported each day represents the increase or decrease in the number of contracts for that day, and it is shown as a positive or negative number.

Using Open Interest Analysis to Find Bull / Bear Signals

Increasing open interest means that new money is flowing into the marketplace. The result will be that the present trend (up, down or sideways) will continue. Declining open interest means that the market is liquidating and implies that the prevailing price trend is coming to an end. Therefore, open interest provides a lead indication of an impending change of trend.

Open interest is one variable that many futures and option traders use in their analysis of the markets used in conjunction with other analysis to support trade decisions. Large changes in open interest can be an indicator when certain participants are entering or leaving the market and may give clues to market direction.

Open interest is usually used as an indication of the strength of a price movement, but on its own it does not provide any indication of the direction of the price movement. With the help of Open interest data, we can see positions that traders are making in futures and options index/stocks. The positions are usually classified as Long buildup, Short Buildup, Long Unwinding, Short covering. Combined with volumes, this can serve as important indicator in selecting stocks for intraday or short term. Moreover, Open interest is not the same as volume. With volume, both entries and exits cause volume to increase, but with open interest, entries cause open interest to increase, while exits cause open interest to decrease.

- ✓ **Increasing OI with increase in price trend (Long build up) is considered positive** – With increase in OI and the market price, the trend shows bullishness on the back of addition of more long positions in the futures market. Investors are turning positive and going long for the stock, which is evident by the upward price movement.

- ✓ **Increasing OI with decrease in price trend (Short build up) is considered negative** – With increase in OI and fall in the market price the trend shows bearishness on the back of addition of more short positions in the futures market. Investors are turning negative and price is falling with selling pressure coming due to increasing negativity in the specific stock.

- ✓ **Decreasing OI with increase in price trend (Short covering) is considered positive** – With decrease in OI and rise in the market price the trend shows bullishness on the back of covering up of short positions in the futures market. With the short covering happening due to investors getting caught on wrong foot the price escalates well over the normal levels.

- ✓ **Decreasing OI with decrease in price trend (Long Unwinding) is considered negative** – With decrease in OI and fall in the market price the trend shows bearishness on the back of closing up of long position in the futures market. Investors booking profits creates selling pressure and thus shows the bearish trend prevalent in the market.

The relationship between the prevailing price trend and open interest can be summarized by the following table.

Contract Price (%)	Open Interest (%)	Future Trend(predicts)
Rising	Rising	Market/Stock is likely to trade strong in the coming days
Rising	Falling	Market/Stock is likely to see some downside in the coming days
Falling	Rising	Market/Stock should not be entered as of now
Falling	Falling	Market/Stock can be entered, as its likely to go up

Open Interest Vs. Volume

Open interest information tells us how many contracts are open and live in the market. Volume on the other hand tells us how many trades were executed on the given day. For every 1 buy and 1 sell, volume adds up to 1. For instance, on a given day, 400 contracts were bought and 400 were sold, then the volume for the day is 400 and not 800. Clearly volumes and open interest are two different; buy seemingly similar set of information. The volume counter starts from zero at the start of the day and increments as and when new trades occur. Hence the volume data always increases on an intra-day basis. However, OI is not discrete like volumes, OI stacks up or reduces based on the entry and exit of traders. Unlike volumes, the change in Open interest does not really convey any directional view on markets. However, it does give a sense of strength between bullish and bearish positions.

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