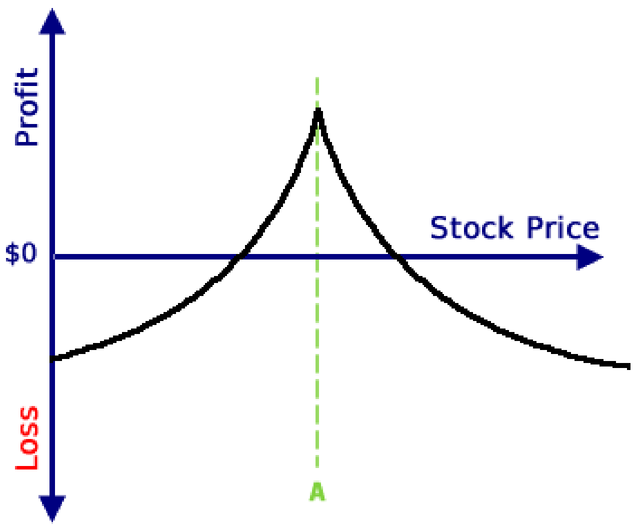
OPTION PIT

Sign In | Sign Up Search

# How option time premium decays over the weekend

Submitted by Mark Sebastian on Thu, 10/29/2009 - 10:05am

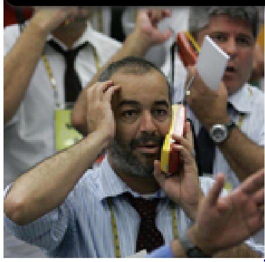



(https://web.archive.org/web/20181011221749/http://apture.s3.amazonaws.com/00000124a0f5cca4028<A style=)
Several weeks ago I was mentoring a student on a Monday. This student had a calendar spread (https://web.archive.org/web/20181011221749/http://en.wikipedia.org/wiki/Calendar%20spread) on that was going very well. On a certain Friday, his calendar position was up about 18%. This student then opened his options analysis tool and moved his days forward from Friday afternoon to Monday morning. He was really excited because if he could just hold on through the weekend he was going to collect another 4% return on his capital.

The following Monday when I met with him he was quite despondent. He had held his position over the entire weekend and after the market movement that Monday morning he was actually down money from Friday! He asked me “Mark, I don’t get it, I did my analysis! I should be up at least a few hundred dollars from last Friday! How come I didn’t make anything over the weekend?”

ww.optionpit.com/sites/optionpit.com/files/images/00000124a0f71726b23901e6007f000000000001.timeDecay.png)
Option traders, this may sound quite familiar to you, it may actually BE you! Here is the short answer; weekend theta (https://web.archive.org/web/20181011221749/http://en.wikipedia.org/wiki/The%20Greeks) is essentially decayed out of a position by Friday afternoon at 4:00. Let me explain: Most retail traders assume that theta decay’s rather linearly. Basically, as time passes, your theta decays at the rate that the trader’s trade software says it does.

For instance, if a certain trade software said a position had a positive decay of 10, most retail traders would assume they would have an extra 10 dollars by the following trading morning. Here is the problem, what about the weekend? Market makers are not stupid (well, some are). They don’t like giving away free money. If the weekend didn’t decay out before Friday’s close, other traders would come in, sell a large amount of premium at the end of the day on Friday, and then buy it back first thing on Monday morning. The traders who sold the premium would be very happy. They would have gotten the entire weekend’s decay, 2 1/2 days (Friday 4 pm to Monday 9:30 am), for the price of one wake up (Sunday 4:00 Pm till Monday morning).


(/web/20181011221749/http://www.optionpit.com/sites/optionpit.com/files/images/stock-traders.jpg)

So what do market makers do? It's pretty simple. We begin to decay the entire weekend as early as we possibly can. Although every market maker manages this weekend decay differently, I can give an example of what I might have done when I was on the floor. On Thursday about mid-day I would turn off all of my quotes. I would then go into my options quoting software and begin moving my software's theoretical day forward Friday (this is actually very similar to using the date function in TOS, OV, or Trade Station).

In this case I would move my theoretical date from Thursday to Friday. Why? I would notice around then that other traders would begin trying to sell me premium. I obviously do not want to be buying a bunch of premium that will decay for two days that the market is closed. So I had two choices. **I could lower my theoretical volatility.** This would lower my options prices based on the all of the premium sellers I was seeing, **or I could move my theoretical date forward**. If I move my theoretical date forward, I can lessen the theoretical value of the options using theoretical days to expiration instead of lowering the implied volatility (this is the one time where the days to expiration portion of the five functions of a pricing model can mater as much as volatility).

On Friday morning, I would already have my theoretical date to set Saturday's date. This was to stay ahead of the game. By mid-day I might notice that I was seeing some premium sellers (by mid-day I mean about 11 am eastern time). Once I saw these sellers I would move my theoretical date forward to Sundays date. At the close of the day on Friday, I would basically have my system set to 4 pm eastern time on Sunday.

Essentially, my system would have 1 wake up (Sunday 4 pm to Monday 9:30 am) of theoretical decay left priced into the options I was trading. **There was no 'free' premium.** So how does this knowledge affect the retail options trader? Traders should note that the current software out there does not take this weekend decay function into account.

But, the savvy option trader can! If I am in an option trade that is on the cusp of exit on a Friday afternoon, I am out of the position. There is not 2 ½ days of premium to be made over the weekend, I have already made a chunk of that theta. I would also like to note that a few people may read this article and think that they can make money by BUYING premium; this is also not the case because the trader will still have to pay the wake up decay (Sunday at 4pm till Monday at 9:30 am). Essentially traders, **there is no 'weekend edge'**. There is only the traders edge-the savvy option trader's ability to be better than other traders!

Follow us on twitter @optionpit

Blog Image:

Tags:
VIX (/web/20181011221749/http://www.optionpit.com/category/tags/vix)
time premium (/web/20181011221749/http://www.optionpit.com/category/tags/time-premium)
theta decay (/web/20181011221749/http://www.optionpit.com/category/tags/theta-decay)
weekend decay (/web/20181011221749/http://www.optionpit.com/category/tags/weekend-decay)
SHARE