Timing the Option Cycle *

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Abstract

We document empirically that the returns from shorting out-of-the-money S&P 500 put options are concentrated in the few days preceding their expiration. Back-month options generate almost no returns, and front-month options do so only towards the end of the option cycle. The concentration of the option premium at the end of the cycle reflects an increase in jump risk rather than an increase in volatility risk. Our results imply that speculators wishing to harvest the put option premium should short front-month options only during the last days of the cycle, while investors wishing to protect against downside risk should use back-month options to reduce hedging costs.

Keywords: option returns, out-of-the-money put options, market timing.

JEL Classification: G11, G12, G13, G14

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