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Time / Diagonal Spreads

TIME SPREADS

Time Spreads, also known as Calendar Spreads, are an ideal way to take advantage of time decay and changes in implied volatility. The time spread strategy focuses on the movement of time and volatility more than on the movement of the stock. Therefore, this strategy is ideal for use when you anticipate either stagnant or explosive periods in a stock.

The time spread, like other spreads, has its risks and rewards. The risk is very limited for the buyer, but substantial for the seller. The seller's risk can be avoided or contained with due diligence at the expiration of the near month's option. Also, there are a variety of strategies that can affect the seller's risk.

The advantage of this strategy is that the investor can pursue a time decay or volatility position without the large capital outlay necessary for the purchase of the stock.

Construction of the Time Spread

The construction of the time spread involves the purchase of one option and the sale of another in different months, but with both having the same strike. You can construct a time spread using either two calls or two puts.

A long time spread is constructed by purchasing the out month option and selling the nearer month option. For example, you buy the September 45 call and sell the August 45 call or buy April 30 puts and sell February 30 puts. A short time spread is constructed by selling the farther out month and buying the nearer month. For instance, sell July 50 calls and buy May 50 calls.

The important elements in the construction of the time spread are: use two call or two put options on the same stock, use the same strike for both, choose different months for each and use a one to one ratio. A one to one ratio means that you must purchase one option for every one you sell or sell one option for every one you buy. A time spread can utilize any two months as long as it has the same strike price and the trade is done in a one-to-one ratio.

Most time spreads are executed at-the-money because at-the-money options have the greatest amount of extrinsic value. An option's extrinsic value is what decays over time and is the basis of the time spread's strategy. Since the time spread is built to take advantage of time decay it is naturally better suited for at-the-money options.

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This does not mean that the time spread can not be used effectively with in-the-money or out-of-the-money options. In-the-money and out-of-the-money options have less extrinsic value than at-the-money options.

However, the rate of decay (discussed below) of an in-the-money or out-of-the-money option with one month until expiration is still greater than an in-the-money or out-of-the-money option of the same strike that has three months to go before expiration. This being said, the time spread can be constructed using any option regardless if it is in, out, or at-the-money.

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