Faculti Summary
https://faculti.net/the-early-exercise-risk-premium/

This video video provides an in-depth analysis of the profitability of options investment strategies, specifically focusing on single stock put option strategies. The study distinguishes between American options, which can be exercised at any time before expiration, and European options, which can only be exercised at maturity. The authors introduce the concept of the "early exercise risk premium," which is the expected return difference between equivalent American and European put options due to the flexibility of early exercise.

Through theoretical exploration and Monte Carlo simulations, the authors find that the early exercise risk premium is positive under reasonable market conditions. They also identify direct relationships between this premium and factors such as the financial "moneyness" of options, time to maturity, and underlying asset volatility.

Testing yielded two primary conclusions: the early exercise risk premium is indeed positive, and it correlates positively with options that are likely to be exercised early.

In examining 15 prior strategies that suggest profitable trading methods with put options, the authors replicate these strategies and find they continue to yield significant profits. However, allowing for optimal early exercise changes profitability outcomes for many strategies. Notably, nine strategies become more profitable when considering early exercise, while five lose their profitability altogether.

Overall, the study emphasizes the importance of accounting for the early exercise feature of American options in studies about option profitability. It cautions investors against assuming the profitability levels reported in earlier literature are accurate, as some strategies may be less effective than previously indicated.