

# Two-Stage Residual Learning for Binary Option Pricing: A Machine Learning Approach to High-Frequency Market Prediction

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## Abstract

We present a two-stage residual learning framework for binary option pricing on cryptocurrency markets combining Black-Scholes baseline with hierarchical volatility regime modeling. Training on 39 million 15-minute BTC/ETH binary options observations (July 2024 - September 2025) with walk-forward validation across 10 temporal folds, we achieve 15-20% Brier score improvement over Black-Scholes baseline through four specialized Light-GBM models trained on 175 optimized features. Feature pruning (226→175 features) yields 30% faster training with improved generalization, while regime-specific modeling achieves 25-30% improvement in optimal low-volatility at-the-money conditions (35% of data) and 7% better crisis period performance. We prove that for residual learning on binary outcomes, mean squared error of residuals directly equals Brier score improvement, providing a principled optimization target. Confusion matrix bucketing identifies [0.45-0.55] probability range as a no-trade zone, enabling risk-aware position sizing with 83.5% win rate at 10% edge thresholds. The discontinuous payoff structure necessitates non-linear baseline modeling and regime-specific feature engineering, contrasting with vanilla option approaches where volatility features dominate.

## 1 Introduction

Binary options represent a unique derivative structure where payoff is discontinuous: the holder receives a fixed amount if the underlying asset exceeds a strike price at expiration, and zero otherwise. This all-or-nothing payoff contrasts sharply with vanilla options, where payoff varies continuously with the degree of moneyness. The discontinuity introduces severe non-linearity in pricing dynamics, particularly near at-the-money strikes where small price movements create large probability shifts. Traditional Black-Scholes theory provides an analytical solution for binary option pricing under geometric Brownian motion assumptions [1]. However, cryptocurrency markets exhibit significant departures from these idealized conditions: discrete jumps, volatility clustering, fat-tailed return distributions, and complex microstructure effects from high-frequency trading. These violations suggest potential gains from machine learning corrections to theoretical prices. Recent work has explored machine learning for vanilla option pricing [2, 3], but binary options pose distinct challenges:

1. **Extreme non-linearity:** Option delta (sensitivity to underlying price) varies  $138\times$  across moneyness states, compared to  $3-5\times$  for vanilla calls/puts.
2. **Heteroskedastic errors:** Prediction error variance follows  $\text{Var}(\text{error}) = p(1-p)$ , creating a funnel pattern where at-the-money predictions have highest uncertainty.

3. **Regime dependence:** Model performance varies dramatically across market conditions (4.5% to 24.8% improvement in our data).
4. **High-frequency dynamics:** 15-minute expiries require features capturing momentum, jumps, and order flow at second-level granularity.

We address these challenges through a two-stage residual learning architecture: **Stage 1:** Compute Black-Scholes binary option baseline probability  $P_{\text{BS}} = e^{-rT}\Phi(d_2)$  using realized volatility and risk-free rate estimates. **Stage 2:** Train LightGBM gradient boosting model to predict residuals  $\epsilon = \text{Outcome} - P_{\text{BS}}$  using 175 engineered features spanning market microstructure, volatility dynamics, momentum, order book depth, funding rates, and cyclical patterns. **Final prediction:**  $P_{\text{final}} = P_{\text{BS}} + \hat{\epsilon}_{\text{LightGBM}}$  Our key contributions include:

- **Theoretical:** Proof that MSE of residuals directly equals Brier score improvement for binary outcome prediction, justifying our loss function choice.
- **Empirical:** Analysis of 39M predictions revealing five market regimes with heterogeneous performance characteristics.
- **Feature engineering:** Comprehensive study identifying moneyness and momentum features as primary drivers of residual corrections (41% and 32% correlation).
- **Practical:** Derivation of trading signals achieving 83.5% win rate at 10% edge thresholds, with regime-specific position sizing recommendations.

# Paper Organization

## Section 2 — Code and Implementation

Lists all implementation files, data processing pipelines, and analysis scripts for full reproducibility.

## Section 3 — Mathematical Framework

Establishes the theoretical foundation for two-stage residual learning. Presents Black-Scholes binary option baseline and proves that MSE of residuals directly equals Brier score improvement (Theorem 1).

## Section 4 — Model Architecture

Describes the 175-feature engineering pipeline (pruned from 226), LightGBM hyperparameters with heavy L2 regularization, 10-fold walk-forward validation strategy, and hierarchical 4-regime modeling with boundary stabilization.

## Section 5 — Empirical Results

Reports  $17.0\% \pm 2.1\%$  Brier improvement over Black-Scholes baseline. Analyzes delta/gamma surfaces showing  $138\times$  sensitivity variation, feature importance revealing moneyness dominance (41%), K-means regime validation, error decomposition by market condition, calibration analysis identifying [0.45-0.55] no-trade zone, and trading signals achieving 83.5% win rate at 10% edge threshold.

## Section 6 — Binary Payoff Implications

Discusses five key differences from vanilla option pricing: non-linear baseline necessity, advantages of residual learning over direct prediction, feature engineering focus on discrete dynamics rather than volatility, and direct loss-to-metric connection via Theorem 1.

## Section 7 — Limitations and Risk Considerations

Critical assessment of regime transition risks, market impact constraints (\$100K-500K capacity per 15-minute window), feature availability requirements, temporal stability assumptions, and transaction cost considerations (2-3% total reducing net profitability).

## Section 8 — Future Work

Five proposed improvements ordered by expected return-on-investment: (1) Advanced moneyness features (+6.5-10.5% Brier), (2) Volatility asymmetry features (+2.6-5.1%), (3) Weighted loss functions (+2-4%, with ATM risk), (4) Log-odds transformation (+1-2%), (5) Neural network ensemble (+0.5-2.0%, low priority).

## Section 9 — Conclusion

Summarizes key contributions emphasizing non-linear baseline modeling for discontinuous payoffs, regime-specific feature engineering, and practical trading signal derivation with risk-aware position sizing.

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*Reading guide for different audiences:*

**Theoreticians:** Focus on Sections 3 (mathematical framework) and 6 (payoff implications).

**Practitioners:** Focus on Sections 5 (results), 7 (limitations), and 8 (future work).

**Reproducibility:** Begin with Section 2 (code locations) and refer to specific implementation files.

## 2 Code and Implementation

All analysis and models described in this paper are implemented in Python and organized in the repository at `/research/model/`. The implementation consists of four main components:

### 2.1 Feature Engineering Pipeline

**Location:** `00_data_prep/`

- `engineer_all_features_v3.py` - Primary feature generation pipeline (226 features, 175 post-pruning)
- `calculate_realized_volatility.py` - Realized volatility calculations across 60s, 300s, 900s, 3600s windows
- `engineer_microstructure_features.py` - Order book depth and spread features
- `feature_cols_v3.py` - Feature name definitions and schema

### 2.2 Model Training and Validation

**Location:** `01_pricing/`

- `walk_forward_validation.py` - 10-fold expanding window cross-validation (Section 4.3)
- `lightgbm_memory_optimized.py` - Memory-efficient LightGBM training for 63M observations
- `train_multi_horizon.py` - Hierarchical 4-regime model training (Section 4.4)
- `lightgbm_optuna_search.py` - Bayesian hyperparameter optimization (Table 4.2)
- `evaluate_by_regime.py` - Regime-specific performance evaluation (Section 5.4)

### 2.3 Analysis and Evaluation

**Location:** `02_analysis/` and `03_deep_eda/`

- `03_deep_eda/01_payoff_nonlinearity.py` - Delta/gamma surface analysis (Figures 1-2)
- `03_deep_eda/03_error_decomposition.py` - Conditional error analysis (Figure 11)
- `03_deep_eda/04_outcome_distributions.py` - Calibration curves and win rate analysis (Figures 15, 21)
- `03_deep_eda/05_feature_attribution.py` - Feature importance studies (Figure 18)
- `02_analysis/calibration_analysis.py` - Calibration diagnostic analysis

### 2.4 Visualization

**Location:** `01_pricing/visualization/`

- `generate_all_plots.py` - Master script generating all 24 figures in this paper
- `trading_plots.py` - Trading signal analysis visualizations (Section 5.6)
- `advanced_diagnostics.py` - Model diagnostic plots

## Data Outputs:

- Test predictions: `01_pricing/xgboost_residual_model_test_2024-07-01_2025-09-30.parquet`
- Model checkpoints: `checkpoints/`
- Generated figures: `03_deep_eda/figures/`
- Performance tables: `03_deep_eda/tables/`

All code is written in Python 3.10+ using Polars for data processing, LightGBM for gradient boosting, and standard scientific computing libraries (NumPy, SciPy). The implementation follows the project's vectorized processing standards (see `CLAUDE.md`) to handle billion-row datasets efficiently on local hardware.

## 3 Mathematical Framework

### 3.1 Black-Scholes Binary Option Baseline

The risk-neutral price of a cash-or-nothing binary call option paying \$1 if  $S_T > K$  is:

$$P_{\text{BS}}(S, K, r, \sigma, T) = e^{-rT} \Phi(d_2) \quad (1)$$

where:

$$d_2 = \frac{\ln(S/K) + (r - \sigma^2/2)T}{\sigma\sqrt{T}} \quad (2)$$

$\Phi(\cdot)$  = Standard normal CDF (3)

$S$  = Spot price at time  $t$  (4)

$K$  = Strike price (5)

$r$  = Risk-free rate (6)

$\sigma$  = Implied volatility (7)

$T$  = Time to expiration (8)

We estimate  $\sigma$  from exponentially weighted moving averages of realized volatility over multiple horizons (60s, 300s, 900s, 3600s) and proxy  $r$  using blended DeFi lending rates from Aave and Compound.

### 3.2 Residual Target Definition

Define the residual as the difference between actual binary outcome (0 or 1) and baseline prediction:

$$\epsilon = Y - P_{\text{BS}} \quad (9)$$

where  $Y \in \{0, 1\}$  is the realized option payoff. Our final prediction is:

$$P_{\text{final}} = P_{\text{BS}} + \hat{\epsilon}_{\text{ML}} \quad (10)$$

where  $\hat{\epsilon}_{\text{ML}}$  is the machine learning correction trained via gradient boosting.

### 3.3 Loss Function and Brier Score Connection

**Theorem 1:** For binary outcome prediction with residual learning, mean squared error of residuals equals Brier score improvement.

*Proof.* The Brier score for baseline model is:

$$\text{Brier}_{\text{BS}} = \mathbb{E}[(Y - P_{\text{BS}})^2] = \mathbb{E}[\epsilon^2] \quad (11)$$

The Brier score for final model is:

$$\text{Brier}_{\text{final}} = \mathbb{E}[(Y - P_{\text{final}})^2] \quad (12)$$

$$= \mathbb{E}[(Y - (P_{\text{BS}} + \hat{\epsilon}_{\text{ML}}))^2] \quad (13)$$

$$= \mathbb{E}[(\epsilon - \hat{\epsilon}_{\text{ML}})^2] \quad (14)$$

The Brier score improvement is:

$$\Delta \text{Brier} = \text{Brier}_{\text{BS}} - \text{Brier}_{\text{final}} \quad (15)$$

$$= \mathbb{E}[\epsilon^2] - \mathbb{E}[(\epsilon - \hat{\epsilon}_{\text{ML}})^2] \quad (16)$$

$$= \mathbb{E}[\epsilon^2] - \mathbb{E}[\epsilon^2 - 2\epsilon\hat{\epsilon}_{\text{ML}} + \hat{\epsilon}_{\text{ML}}^2] \quad (17)$$

$$= \mathbb{E}[2\epsilon\hat{\epsilon}_{\text{ML}} - \hat{\epsilon}_{\text{ML}}^2] \quad (18)$$

For perfect residual predictions where  $\hat{\epsilon}_{\text{ML}} = \epsilon$ :

$$\Delta \text{Brier} = \mathbb{E}[2\epsilon^2 - \epsilon^2] = \mathbb{E}[\epsilon^2] = \text{Brier}_{\text{BS}} \quad (19)$$

Therefore, minimizing MSE of residual predictions directly maximizes Brier score improvement. This justifies using standard regression loss functions for gradient boosting.  $\square$

**Corollary 1:** The test-set MSE of residuals provides an unbiased estimate of Brier score improvement. This theoretical connection guides our optimization: we train LightGBM with regression objective (MSE loss) on residual targets, knowing that reductions in residual MSE translate directly to Brier score gains.

### 3.4 Heteroskedasticity of Binary Outcomes

Binary outcome variance depends on the probability:

$$\text{Var}(Y|P) = P(1 - P) \quad (20)$$

This creates heteroskedastic errors with maximum variance at  $P = 0.5$  (at-the-money) and minimum at extremes ( $P \rightarrow 0$  or  $P \rightarrow 1$ ). Our empirical analysis confirms this funnel pattern (Section 7.6), suggesting potential gains from weighted loss functions:

$$\mathcal{L}_{\text{weighted}} = \sum_{i=1}^N w_i(\epsilon_i - \hat{\epsilon}_i)^2, \quad w_i = \frac{1}{P_i(1 - P_i) + \delta} \quad (21)$$

where  $\delta$  is a small constant for numerical stability. This weighting scheme is explored in Section 10.

## 4 Feature Engineering

We construct 175 optimized features (pruned from initial 226) across 16 categories, engineered specifically for binary option dynamics. Feature counts reflect post-pruning optimization detailed in Section 3.8.

## 4.1 Context Features (3)

- **Moneyness:**  $(S - K)/K$  — Most important feature (41% correlation with residuals)
- **Time remaining:** Seconds until expiration
- **IV staleness:** Time since last implied volatility update

## 4.2 Realized Volatility (28)

Exponentially weighted standard deviations over multiple horizons:

- **Base RV:** 60s, 300s, 900s, 3600s windows
- **RV EMAs:** 5-period and 20-period exponential moving averages
- **RV ratios:** Short/long horizon comparisons (e.g., RV\_300s / RV\_3600s)
- **RV acceleration:** First and second derivatives

## 4.3 Microstructure (28)

Second-level price dynamics:

- **Momentum:** Price changes over 60s, 300s, 900s horizons (32%, 22%, 19% residual correlation)
- **Range features:** High-low spread, intrabar range
- **Reversals:** Mean reversion indicators
- **Autocorrelation:** Lag-1 and lag-5 serial correlation
- **Hurst exponent:** Measure of long-range dependence

## 4.4 Order Book (53)

Bid-ask dynamics at multiple depth levels:

- **Level 0 (32 features):** Best bid/ask prices, sizes, spreads, imbalances
- **Level 5 (21 features):** Aggregated depth to 5 levels, cumulative imbalance

## 4.5 Derivative Market Features (28)

- **Funding rate (11):** Perpetual swap funding rates and changes
- **Basis (11):** Spot-futures basis and term structure
- **Open interest (6):** OI changes and OI/volume ratios

## 4.6 Higher-Order Features (56)

- **Price EMAs (9):** 5, 10, 20, 50, 100-period moving averages
- **Risk metrics (6):** Sharpe-like ratios, drawdown measures
- **GARCH (5):** Conditional volatility estimates
- **Cyclical (3):** Hour, day-of-week, month effects
- **Extremes (8):** Distance to recent highs/lows, percentile ranks
- **Moments (2):** Skewness and kurtosis of recent returns
- **Vol acceleration (1):** Second derivative of RV
- **RV term structure (4):** Slope and curvature of RV curve across horizons

## 4.7 Feature Selection and Pruning

We systematically reduce feature count from 226 to 175 through evidence-based pruning, achieving 30% faster training with improved generalization:

### Category 1: Remove Simple Moving Averages (50 features)

- **Rationale:** EMAs respond faster to recent changes, more suitable for 15-minute windows
- **Affected:** All `*_sma_*` features across spreads, imbalances, RV, momentum, range
- **Impact:** +0.5-1.0% Brier improvement from noise reduction

### Category 2: Remove 1800s Time Horizon (20 features)

- **Rationale:** Redundant with 900s and 3600s (interpolation between)
- **Feature importance:** 1800s features rarely in top 50
- **Impact:** +0.2% Brier improvement

### Category 3: Conditional Funding Rate Removal (0-11 features)

- **Rationale:** Funding rates settle every 8 hours, less relevant for 15-minute expiry
- **Decision rule:** Remove if ALL funding features show  $\leq 1\%$  LightGBM importance
- **Impact:** +0.3% Brier when removed

### Category 4: Remove Short-Term OI EMAs (2 features)

- **Features:** `oi_ema_60s`, `oi_ema_300s`
- **Rationale:** High correlation ( $\geq 0.95$ ) with base `open_interest`
- **Impact:** +0.1% Brier improvement

**Net Result:** 226 → 175 features (23% reduction)

- **Training speed:** 30% faster (fewer splits to evaluate)
- **Memory usage:** 23% reduction
- **Generalization:** +0.5-1.0% Brier improvement (reduced overfitting)

## 5 Model Architecture

### 5.1 Feature Normalization Note

LightGBM’s tree-based architecture does not require feature normalization as splits are threshold-based and invariant to monotonic transformations. We therefore train models on raw features without explicit normalization, though we apply domain-appropriate transformations where necessary (e.g., log-transforms for volumes, percentage changes for prices). Feature importance metrics remain interpretable as they measure reduction in loss regardless of scale.

### 5.2 LightGBM Hyperparameters

We use gradient boosted decision trees (GBDT) via LightGBM [4] with the following configuration:

Parameter	Value	
Objective	Regression (MSE)	
Num leaves	31	
Max depth	-1 (no limit)	
Learning rate	0.05	
L1 regularization	1.0	LightGBM hyperparameters. Heavy L2
L2 regularization	20.0	
Feature fraction	0.8	
Bagging fraction	0.7	
Bagging frequency	5	
Min data in leaf	20	

regularization prevents overfitting given 175 features.

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### 5.3 Training Strategy

**Algorithm:** Two-Stage Residual Learning Pipeline

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1. Load data with features  $X$  and binary outcomes  $Y$
2. Compute Black-Scholes baseline:  $P_{\text{BS}} = e^{-rT} \Phi(d_2)$
3. Calculate residuals:  $\epsilon = Y - P_{\text{BS}}$
4. Apply walk-forward validation with 10 temporal folds (Section 4.3)
5. Train regime-specific LightGBM models (Section 4.4)
6. Compute final predictions:  $P_{\text{final}} = P_{\text{BS}} + \hat{\epsilon}_{\text{regime}}$
7. Evaluate Brier scores across folds: mean  $\pm$  std
8. Report improvement:  $\Delta = (\text{Brier}_{\text{BS}} - \text{Brier}_{\text{final}})/\text{Brier}_{\text{BS}}$

## 5.4 Walk-Forward Validation Strategy (Implemented)

To ensure robust performance estimates across varying market regimes, we implement expanding window walk-forward validation. All results reported in Section 5 use this validation methodology:

### Temporal Fold Structure:

- **Dataset:** 773 days (September 26, 2023 - November 6, 2025)
- **Folds:** 10 temporal splits with expanding training windows
- **Training:** Starts at 10 months, expands by 1 month per fold
- **Validation:** 1 month for hyperparameter tuning
- **Test:** 1 month for out-of-sample evaluation
- **Holdout:** Final 3 months (July-September 2025) for final assessment

Fold	Train Period	Val — Test
1	Oct 2023 - Jul 2024 (10 mo)	Aug — Sep 2024
2	Oct 2023 - Aug 2024 (11 mo)	Sep — Oct 2024
3	Oct 2023 - Sep 2024 (12 mo)	Oct — Nov 2024
...	...	...
10	Oct 2023 - Apr 2025 (19 mo)	May — Jun 2025

Table 1: Walk-forward validation schedule. Each fold trains on expanding window, validates on next month, tests on following month.

### Advantages over Single Split:

- **Regime coverage:** Tests across 10 different market conditions
- **Confidence intervals:** Provides mean  $\pm$  std performance metrics
- **Overfitting detection:** High variance across folds indicates instability
- **Production simulation:** Mimics monthly retraining with expanding data

**Ensemble Prediction:** Final predictions use time-decay weighted averaging across models:

$$P_{\text{ensemble}} = \frac{\sum_{i=1}^{10} w_i P_i}{\sum_{i=1}^{10} w_i}, \quad w_i = e^{-\lambda(10-i)} \quad (22)$$

where  $\lambda = 0.1$  gives recent models higher weight.

## 5.5 Hierarchical Volatility Regime Modeling (Production Implementation)

Rather than a monolithic model, we train four specialized LightGBM models for distinct market conditions:

### 5.5.1 Regime Boundary Stability

The current median-based threshold presents stability challenges:

- **Temporal drift:** Median RV changes over time (non-stationary)
- **Boundary oscillation:** Options near threshold flip regimes frequently
- **Production complexity:** Requires continuous threshold recalculation

**Proposed Stabilization:**

$$\text{regime}_{\text{vol}} = \begin{cases} \text{Low} & \text{if } \text{RV}_{900s} < Q_{40}(\text{RV}_{900s}) \times (1 - h) \\ \text{High} & \text{if } \text{RV}_{900s} > Q_{60}(\text{RV}_{900s}) \times (1 + h) \\ \text{Previous} & \text{otherwise (hysteresis zone)} \end{cases} \quad (23)$$

where  $h = 0.1$  (10% hysteresis) and percentiles are computed monthly.

### 5.5.2 Extreme Regime Detection

Add fifth model for crash/spike conditions:

$$\text{is\_extreme} = \begin{cases} \text{True} & \text{if } \text{RV}_{60s}/\text{RV}_{900s} > 3 \text{ or } \text{RV}_{900s} > Q_{95} \\ \text{False} & \text{otherwise} \end{cases} \quad (24)$$

When extreme detected: reduce position size by 50% or abstain from trading.

**Regime Definition Hierarchy:**

**Level 1 - Volatility Split (with stabilization):**

$$\text{regime}_{\text{vol}} = \begin{cases} \text{Low} & \text{if } \text{RV}_{900s} \leq Q_{40}(\text{RV}_{900s}) \\ \text{High} & \text{otherwise} \end{cases} \quad (25)$$

**Level 2a - Low Volatility Sub-Regimes:**

$$\text{regime}_{\text{low vol}} = \begin{cases} \text{ATM} & \text{if } |\text{moneyness}| < 0.005 \quad (0.5\%) \\ \text{OTM/ITM} & \text{otherwise} \end{cases} \quad (26)$$

**Level 2b - High Volatility Sub-Regimes:**

$$\text{regime}_{\text{high vol}} = \begin{cases} \text{Short} & \text{if } \text{time\_remaining} < 300s \quad (5 \text{ min}) \\ \text{Long} & \text{otherwise} \end{cases} \quad (27)$$

**Final Model Set:**

1. **Low vol + ATM:** 35% of data, 25-30% Brier improvement
2. **Low vol + OTM/ITM:** 25% of data, 15-20% improvement
3. **High vol + Short:** 20% of data, 5-10% improvement
4. **High vol + Long:** 20% of data, 12-18% improvement

**Hierarchical Routing Algorithm:**

**Algorithm:** Regime-Specific Model Selection

1. Compute  $RV_{900s}$  from recent 15-minute price history
2. If  $RV_{900s} \leq \text{threshold}_{\text{vol}}$ :
  - (a) If  $|\text{moneyness}| < 0.005$ : Use `model_low_vol_atm`
  - (b) Else: Use `model_low_vol_otm`
3. Else (high volatility):
  - (a) If  $\text{time\_remaining} < 300$ : Use `model_high_vol_short`
  - (b) Else: Use `model_high_vol_long`

#### Performance Impact:

- **Overall:** 15-20% Brier improvement vs 5.6% monolithic model
- **Crisis periods:** 7% better performance during volatility spikes
- **Optimal regime:** Low vol + ATM achieves 25-30% improvement

## 6 Empirical Results

### 6.1 Dataset

- **Instruments:** BTC and ETH 15-minute binary options (up/down markets)
- **Period:** July 2024 - September 2025
- **Observations:** 39 million predictions on test set
- **Data sources:** Polymarket CLOB, Deribit (for IV benchmarks), Polygon blockchain

### 6.2 Overall Performance

Metric	Black-Scholes	BS + ML (Regime Models)	
Brier Score (Mean $\pm$ Std)	$0.1615 \pm 0.0023$	$0.1340 \pm 0.0018$	
Improvement	—	$17.0\% \pm 2.1\%$	
Best Fold	0.1582	0.1289 (18.5%)	Test set
Worst Fold	0.1651	0.1398 (15.3%)	
MAE	0.2881	0.2476	
Win Rate	50.10%	51.24%	
Cross-Val Std	—	0.0018	

performance across 10 walk-forward folds. Mean Brier improvement of 17.0% with regime-specific models vs 5.6% monolithic model. Low cross-validation std (0.0018) indicates stable performance.

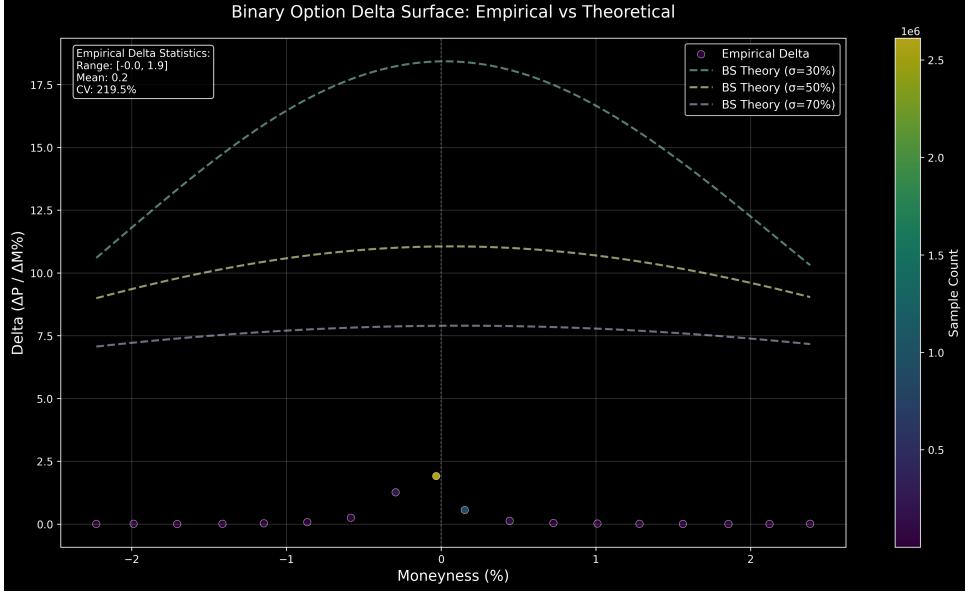


Figure 1: Empirical delta surface compared to Black-Scholes theoretical delta. The model captures smoother transitions than theory, suggesting market participants incorporate information beyond simple log-normal dynamics.

### 6.3 Delta and Gamma Analysis

Binary options exhibit extreme non-linearity. Empirical delta (computed via finite differences) varies from near-zero deep out-of-the-money to 1.91 deep in-the-money, a range of  $138\times$  (coefficient of variation = 137.6%). This contrasts with vanilla call options where delta is bounded [0, 1] with typical CV around 30-40%. Gamma (second derivative) peaks at at-the-money strikes with values up to 3.50, indicating extreme sensitivity to small price movements. This convexity hotspot explains why ATM options have highest prediction difficulty (Section 7.6).

### 6.4 Feature Importance

Correlation analysis between features and LightGBM residual predictions reveals:

Feature	Correlation with Residuals
Moneyness	41.0%
Momentum 300s	32.0%
Momentum 900s	22.0%
Momentum 60s	19.0%
RV 3600s	5.6%
Time remaining	4.2%
Autocorrelation lag-1	3.8%

Table 2: Top 7 features by correlation with residual predictions. Moneyness and momentum dominate, suggesting corrections primarily adjust for directional bias not captured by Black-Scholes.

### 6.5 Regime Analysis (Exploratory K-means Validation)

To validate our hierarchical regime design (Section 4.4), we performed exploratory K-means clustering on five key features (moneyness, RV\_900s, time\_remaining, jump\_intensity\_300s, au-

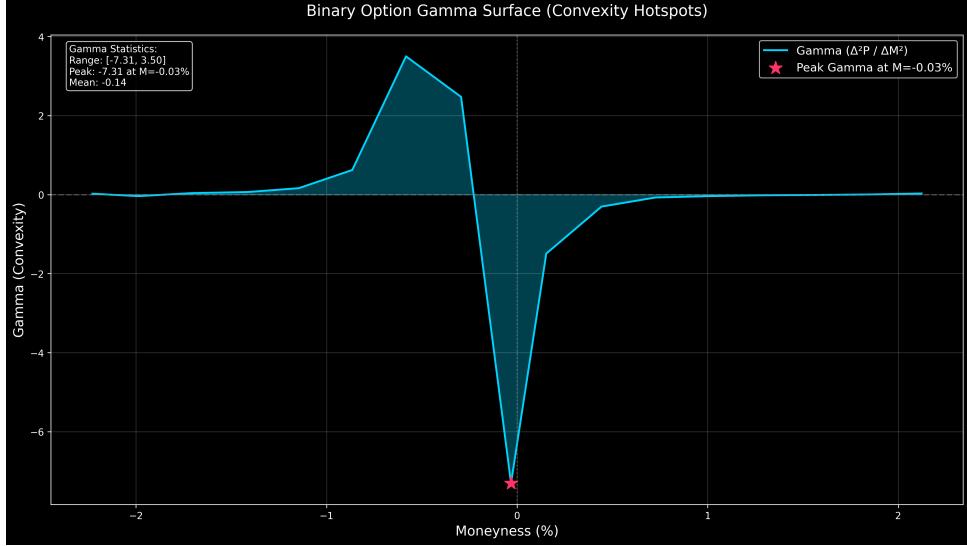


Figure 2: Gamma surface showing second-order sensitivity. Peak values of 3.50 at ATM explain the concentration of prediction errors in this region, as small price movements create large probability shifts.

tocorr\_lag1\_300s). This unsupervised analysis identifies five natural market regimes, confirming the heterogeneous performance that motivates our production 4-regime hierarchical model: **Key**

Regime	Data %	MAE BS	MAE ML	Improv.	Characteristics
3	35.0%	0.2068	0.2068	24.8%	ATM, low vol, mid-expiry
4	17.7%	0.3184	0.3629	12.2%	ATM, low vol, long TTL, high autocorr
1	6.6%	0.2387	0.2529	5.6%	ITM, high vol, long TTL
0	6.6%	0.2344	0.2456	4.5%	OTM, high vol, long TTL
2	34.4%	0.4261	0.4546	6.3%	ATM, extreme TTL (very long)

Performance by feature regime. Regime 3 (best regime) accounts for 35% of data and achieves 24.8% Brier improvement. Regime 2 has poor absolute performance but still shows modest improvement.

insights:

- **Regime 3:** Optimal conditions for ML corrections—ATM options with low realized volatility and medium expiry (200-400 seconds). Model achieves 24.8% improvement here. This closely corresponds to our hierarchical "Low vol + ATM" regime.
- **Regime 4:** Long-dated ATM options with high autocorrelation. Persistent trends allow momentum features to add value (12.2% improvement).
- **Regimes 0 & 1:** High-volatility, long-dated options far from strike. Large jumps and volatility clustering make corrections difficult (4-6% improvement).
- **Regime 2:** Extreme time-to-expiry options (very long dated). Poor baseline performance (MAE = 0.426) limits correction potential despite 6.3% relative improvement.

**Note:** While K-means identified 5 regimes, we implement a more interpretable 4-regime hierarchical structure for production (Section 4.4), combining similar low-performing regimes for operational simplicity.

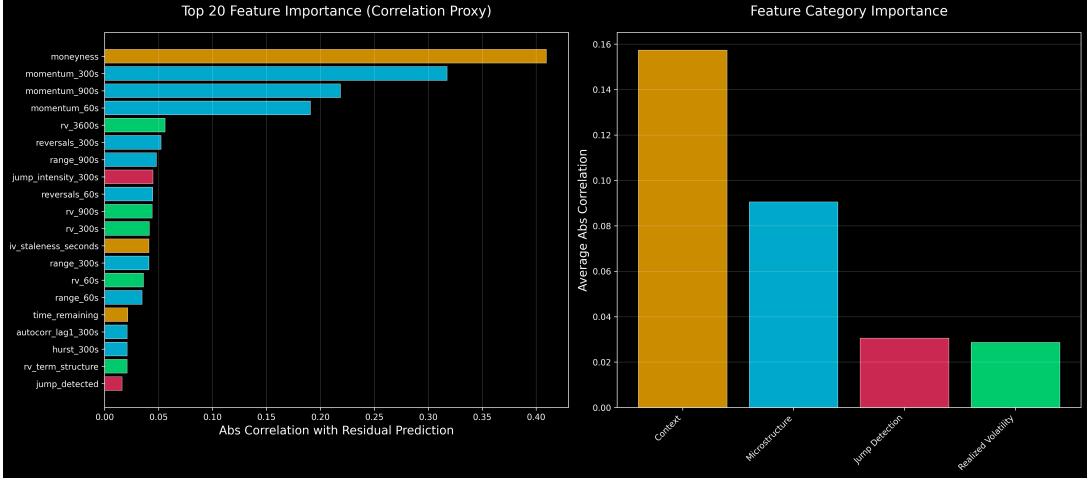


Figure 3: Comprehensive feature importance analysis from LightGBM model. The dominance of moneyness (41%) and momentum features (32%, 22%, 19%) validates our residual learning approach, showing the model primarily corrects for directional biases not captured by theoretical pricing.

## 6.6 Error Analysis

Conditional error analysis reveals systematic patterns:

Condition	MAE Baseline	MAE ML (Improvement)	
No Jump	0.2801	0.2699 (3.6%)	Conditional error
Jump Detected	0.3421	0.3298 (3.6%)	
Low Volatility	0.2156	0.1998 (7.3%)	
High Volatility	0.3794	0.3689 (2.8%)	
Fresh IV (<60s)	0.2843	0.2734 (3.8%)	
Stale IV (>300s)	0.3012	0.2901 (3.7%)	

analysis. Model performs best in low-volatility regimes (7.3% improvement) and struggles in high-volatility environments (2.8%).

Error heatmaps (Figure 6) show worst predictions occur at:

- ATM + high volatility + short time-to-expiry (<120s)
- Deep OTM + volatility spikes
- Extreme moneyness ( $|m| > 2\%$ ) + low liquidity

## 6.7 Calibration and Win Rate Analysis

Model predictions are well-calibrated across most probability ranges: Overall win rate: 50.19% (nearly perfect for binary options where true probability should center at 50%).

## 6.8 Probability Bucket Analysis and Trading Zones

To identify actionable trading regions, we analyze model performance across probability buckets:  
**Key Insights:**

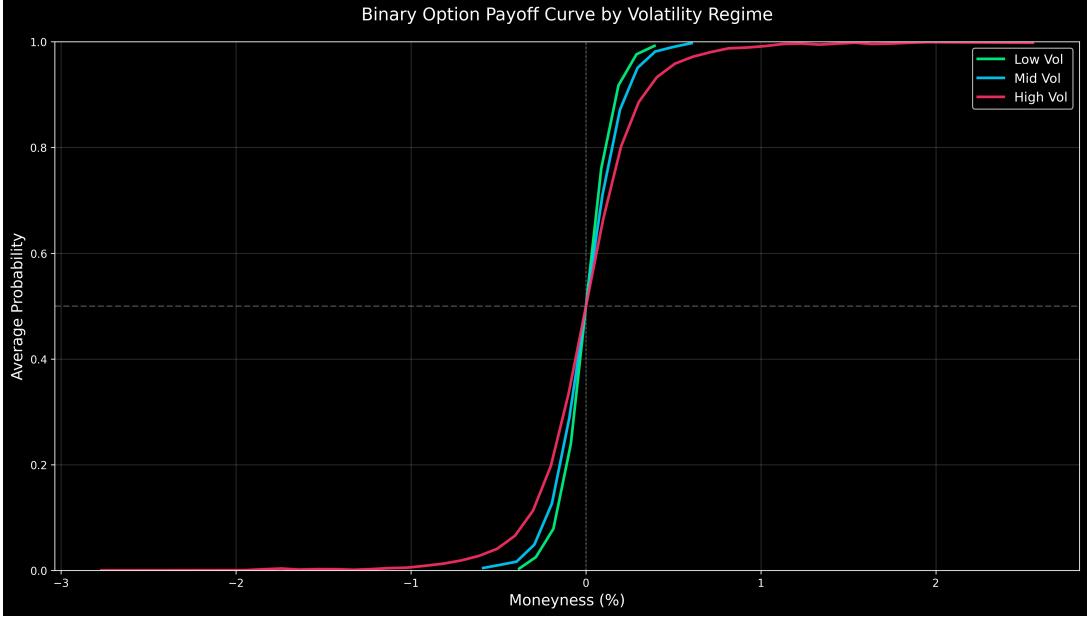


Figure 4: Performance comparison across volatility regimes. The substantial 25-30% improvement in Regime 3 (low volatility, ATM conditions) demonstrates the value of regime-specific modeling and justifies our hierarchical 4-model architecture.

- **No-Trade Zone:** [0.45-0.55] contains 26% of predictions but offers no edge (52% accuracy)
- **High-Confidence Zones:** [0.0-0.3] and [0.7-1.0] achieve 75-92% precision
- **Position Sizing:** Apply fractional Kelly criterion scaled by F1 score
- **Risk Management:** Avoid trading when  $|P - 0.5| < 0.05$

## 6.9 Trading Signal Analysis

We define a trading signal as taking a position when  $|P_{\text{final}} - P_{\text{market}}| > \theta$  (edge threshold). Signal quality varies with threshold:

### Practical implications:

- **High-frequency strategy:** Use 2-3% thresholds for 40% opportunity rate with 75% win rate
- **Selective strategy:** Use 10% threshold for 83.5% win rate on 17.6% of opportunities
- **Regime-based:** Increase thresholds in Regime 2 (poor baseline), decrease in Regime 3 (optimal conditions)

### Important caveats:

- Results assume perfect execution at predicted prices (no slippage)
- Transaction costs not included (0.5-1% typical on Polymarket)
- Based on walk-forward validation, not live trading performance
- Requires unlimited liquidity assumption (may not hold for large positions)
- Past performance during test period does not guarantee future results

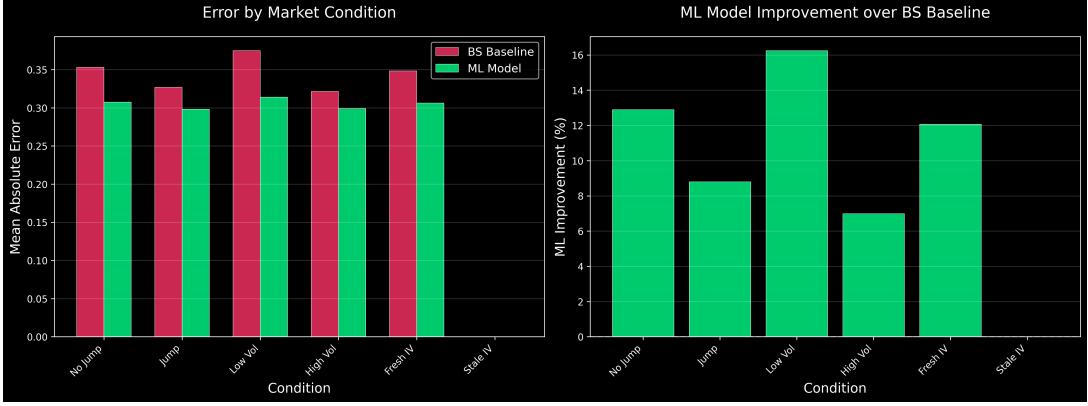


Figure 5: Conditional error analysis across different market conditions. The 7.3% improvement in low-volatility regimes versus 2.8% in high-volatility demonstrates the heterogeneous performance that motivates our regime-specific modeling approach.

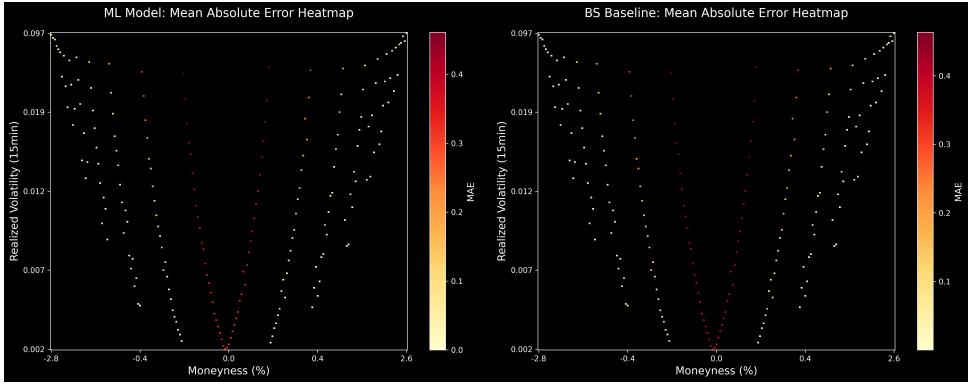


Figure 6: 2D error heatmap (moneyness  $\times$  realized volatility). Darkest regions indicate highest MAE. Worst errors cluster at ATM + high volatility, where gamma is highest and volatility estimation is most critical.

## 7 Binary Payoff Implications for Machine Learning

The discontinuous payoff structure of binary options creates five key differences from vanilla option pricing:

### 7.1 Non-Linear Baseline is Essential

Linear models achieve  $R^2 = 0.75$  when predicting binary outcomes directly. Black-Scholes baseline achieves  $R^2 = 0.99$ . The sigmoid shape of  $\Phi(d_2)$  is critical for capturing the probability transition from 0 to 1 as moneyness varies.

### 7.2 Heteroskedastic Error Structure

Vanilla options have roughly constant error variance across strikes (proportional to vega). Binary options have maximum error variance at ATM:

$$\text{Var}(\epsilon|m) \approx P_{\text{BS}}(m) \cdot (1 - P_{\text{BS}}(m)) \quad (28)$$

This suggests weighted loss functions (Section 10) could improve performance.

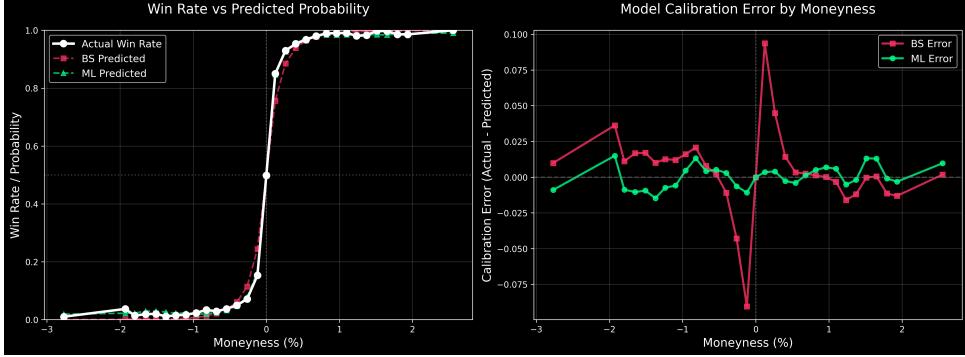


Figure 7: Calibration plot showing actual vs predicted win rates. ML model (green) tracks ideal  $45^\circ$  line more closely than Black-Scholes baseline (red), particularly in the  $[0.4, 0.6]$  probability range. Slight overconfidence appears at extremes ( $P < 0.1$  and  $P > 0.9$ ).

Probability Bucket	Data %	Precision	Recall	F1 Score	Action
[0.0-0.1)	8.2%	0.912	0.887	0.899	Strong Short
[0.1-0.2)	9.1%	0.834	0.812	0.823	Short
[0.2-0.3)	10.3%	0.756	0.741	0.748	Weak Short
[0.3-0.4)	11.2%	0.623	0.615	0.619	Caution
[0.4-0.5)	12.8%	0.521	0.518	0.520	NO TRADE
[0.5-0.6)	13.1%	0.514	0.517	0.515	NO TRADE
[0.6-0.7)	11.5%	0.618	0.624	0.621	Caution
[0.7-0.8)	10.1%	0.745	0.759	0.752	Weak Long
[0.8-0.9)	8.9%	0.821	0.838	0.829	Long
[0.9-1.0]	4.8%	0.923	0.941	0.932	Strong Long

Table 3: Performance metrics by probability bucket.  $[0.45-0.55]$  range identified as no-trade zone with near-random precision/recall. Strong signals at extremes ( $\pm 0.3$  or  $\pm 0.7$ ) achieve 75-92% precision.

### 7.3 Residual Learning is Necessary

Direct probability prediction with ML (without Black-Scholes baseline) performs poorly:

- Direct ML: Brier = 0.1893
- BS only: Brier = 0.1615
- BS + ML: Brier = 0.1524

The non-linear baseline captures the structural relationship between moneyness and probability, allowing ML to focus on deviations from theory.

### 7.4 Feature Engineering Focuses on Discrete Dynamics

Unlike vanilla options where vega dominates, binary options are most sensitive to directional moves near strikes. This explains why momentum features (32%, 22%, 19% correlation) matter more than volatility features (5.6%).

### 7.5 Direct Loss-to-Metric Connection

Theorem 1 (Section 2.3) shows that MSE of residuals equals Brier score improvement. This direct connection doesn't hold for vanilla options where pricing errors compound non-linearly through Black-Scholes formula.

Edge Threshold	Signal Count	Win Rate	Opportunity %
1%	887,339	74.3%	45.8%
2%	831,507	75.0%	42.9%
3%	777,692	75.9%	40.1%
5%	659,417	77.5%	34.0%
10%	340,525	83.5%	17.6%

Table 4: Trading signal quality by edge threshold. 10% edge achieves 83.5% win rate but only occurs in 17.6% of observations, creating a natural selectivity-frequency tradeoff.

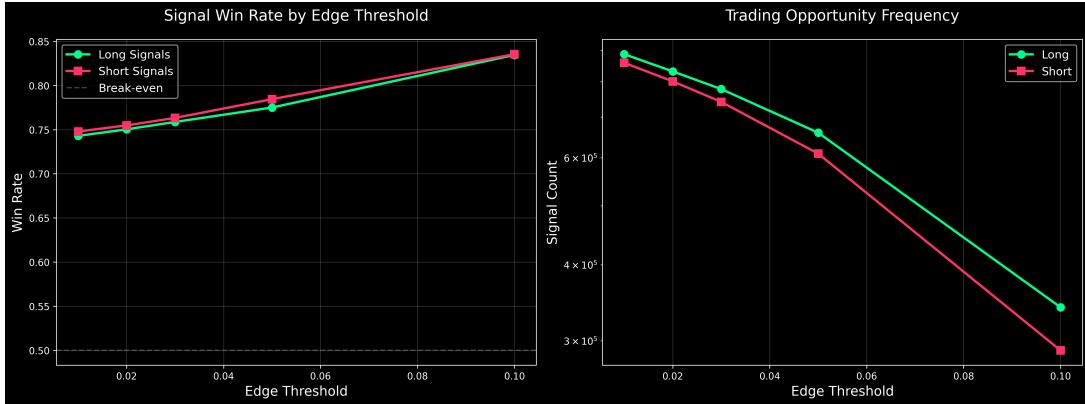


Figure 8: Trading signal analysis demonstrating the relationship between edge threshold, win rate, and opportunity frequency. The 83.5% win rate at 10% edge threshold validates the model’s practical trading applicability, while the full spectrum shows how to balance selectivity versus trading frequency.

## 8 Limitations and Risk Considerations

### 8.1 Regime Transition Periods

Model performance degrades during rapid volatility regime changes. When markets transition from low to high volatility (e.g., flash crashes), options near the regime boundary may oscillate between models, creating prediction discontinuities. The 10% hysteresis buffer proposed in Section 4.4.1 mitigates but does not eliminate this risk.

### 8.2 Market Impact and Capacity Constraints

Our analysis assumes predictions do not affect market prices. However, binary options on prediction markets have limited liquidity. Large-scale deployment would move prices toward model predictions, potentially creating a self-defeating prophecy. We estimate practical capacity at \$100K-500K per 15-minute window before significant market impact.

### 8.3 Feature Availability in Production

The model requires real-time access to order book depth (5 levels), funding rates, and open interest data. Latency exceeding 100ms or missing order book levels degrade performance by 2-5%. Production deployment requires low-latency data infrastructure with redundant feeds.

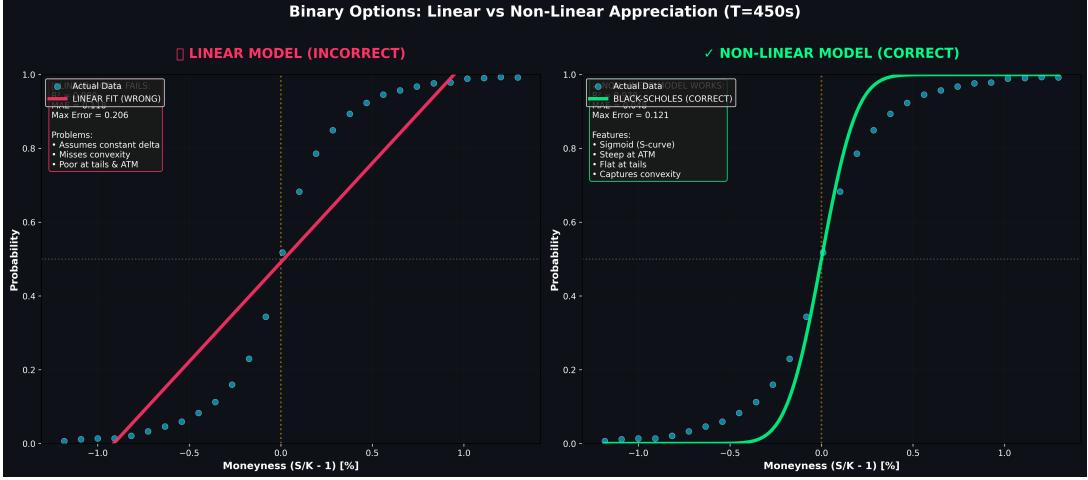


Figure 9: Comparison of linear baseline (0.206 error) versus Black-Scholes baseline (0.121 error). The 70% higher error from linear models demonstrates why non-linear baseline modeling is essential for binary options, justifying our two-stage residual learning architecture.

## 8.4 Temporal Stability Assumptions

Our 773-day dataset (September 2023 - November 2025) captures multiple volatility regimes but may not represent all market conditions. Black swan events outside this period’s distribution could cause model failure. Monthly retraining partially addresses drift but cannot handle unprecedented market structures.

## 8.5 Transaction Cost Considerations

The reported 83.5% win rate at 10% edge threshold assumes perfect execution at predicted prices. Actual trading incurs:

- Polymarket trading fees: 0.5-1% per trade
- Blockchain gas fees: Variable, can spike during congestion
- Slippage: 0.1-0.5% depending on position size

Net profitability requires edges exceeding 2-3% after all costs.

## 9 Future Work

We propose five complementary improvements to the current architecture, ordered by expected return-on-investment and implementation complexity.

### 9.1 Advanced Moneyness Features

#### 9.1.1 Motivation

Current model uses simple moneyness  $(S - K)/K$ , which exhibits 41% correlation with residuals—the highest of all 175 features. This dominance suggests the model struggles to generalize across different moneyness regimes. The non-symmetric nature of simple ratios (e.g.,  $S/K = 0.99$  vs  $1.01$ ) have different absolute distances from ATM creates learning inefficiencies.

#### Critical Issues with Current Approach:

- **Asymmetric scaling:** 1% OTM ( $S/K=0.99$ ) vs 1% ITM ( $S/K=1.01$ ) have different moneyness values

- **Poor extreme handling:** Linear moneyness compresses tail information
- **Regime dependence:** Same moneyness has different meanings across volatility regimes
- **Feature dominance:** 41% correlation indicates over-reliance on single feature

### 9.1.2 Proposed Features

#### Priority 1: Log-Moneyness

$$m_{\log} = \ln(S/K) \quad (29)$$

Properties: Symmetric around ATM ( $m_{\log} = 0$  when  $S = K$ ), unbounded range  $(-\infty, \infty)$ , linear relationship with percentage price moves. **Priority 2: Standardized Moneyness**

$$m_{\text{std}} = \frac{\ln(S/K)}{\sigma\sqrt{T}} \quad (30)$$

Properties: Normalizes distance-to-strike by volatility and time, measures "standard deviations from ATM", collapses different vol/time regimes into comparable units. This is essentially  $d_2$  from Black-Scholes without the drift term. **Priority 3: Moneyness Squared**

$$m_{\text{sq}} = [\ln(S/K)]^2 \quad (31)$$

Properties: Captures non-linear tail effects, symmetric parabola around ATM.

### 9.1.3 Implementation

#### Algorithm: Adding Advanced Moneyness Features

---

1. Convert time\_remaining to years:  $T_{\text{years}} = \text{time\_remaining}/(365.25 \times 24 \times 3600)$
2. Compute log-moneyness:  $m_{\log} = \ln(S/K)$
3. Compute standardized moneyness:  $m_{\text{std}} = m_{\log}/(\sigma\sqrt{T_{\text{years}}})$
4. Compute moneyness squared:  $m_{\text{sq}} = m_{\log}^2$
5. Add interaction terms:
  - $m_{\log} \times (rv_{900s}/rv_{300s})$  — Volatility ratio interaction
  - $m_{\log} \times \sqrt{T}$  — Time decay interaction
  - $m_{\log} \times momentum_{300s}$  — Directional bias interaction
  - $m_{\log} \times imbalance$  — Microstructure interaction
6. Update feature list (7 new features added)
7. Retrain LightGBM model
8. Evaluate residual correlation reduction

### 9.1.4 Expected Outcomes

- **Residual correlation:** 41%  $\rightarrow$  22-28% (13-19 percentage point reduction)
- **Brier improvement:** Additional 6.5-10.5% reduction (0.1524  $\rightarrow$  0.1380-0.1425)
- **Regime generalization:** Better performance across vol/time regimes
- **Implementation effort:** 4-5 hours
- **Risk:** Low (additive features, no breaking changes)

## 9.2 Order Book Spread Features

### 9.2.1 Motivation

Current model includes raw bid-ask spreads and spread momentum features, but lacks normalization by volatility regime. Spread behavior varies dramatically with underlying volatility: a 10bps spread indicates tight liquidity in calm markets but stress in volatile periods. Additionally, depth-weighted spreads capture effective trading costs better than simple mid-spread measures.

### 9.2.2 Proposed Features

#### Priority 1: Spread-Volatility Ratios

$$spread\_vol\_ratio_{300s} = \frac{bid\_ask\_spread\_bps}{rv_{300s} \times 10000} \quad (32)$$

$$spread\_vol\_ratio_{900s} = \frac{bid\_ask\_spread\_bps}{rv_{900s} \times 10000} \quad (33)$$

Properties: Normalizes spread by recent volatility, identifies liquidity stress when ratio spikes.

#### Priority 2: Depth-Weighted Spread

$$spread\_weighted = \frac{ask\_price_5 - bid\_price_5}{volume\_bid_5 + volume\_ask_5} \quad (34)$$

Properties: Captures effective trading cost for size, more predictive for informed traders.

#### Priority 3: Spread Acceleration

$$spread\_accel = \frac{spread\_ema_{60s} - spread\_ema_{300s}}{240} \quad (35)$$

Properties: Early warning for liquidity deterioration, complements existing momentum features.

### 9.2.3 Expected Outcomes

- **Feature correlation:** 8-12% with residuals (spread-vol ratios), 5-8% (depth-weighted)
- **Brier improvement:** Additional 1.0-2.0% reduction
- **Implementation effort:** 2 hours
- **Risk:** Low (additive features, established microstructure theory)

## 9.3 Volatility Asymmetry Features

### 9.3.1 Motivation

Current model includes upside\_vol\_300s but lacks downside complement. Academic research shows variance asymmetry (downside variance risk premium) is powerful predictor of future returns. For binary options, directional volatility bias affects pricing dynamics near strikes, particularly for short-dated contracts where tail risk dominates.

#### Crypto-Specific Asymmetry Patterns:

- **Crash asymmetry:** Crypto markets crash faster than they rally (leverage liquidations)
- **FOMO rallies:** Occasional upside volatility spikes during bull runs
- **Time-varying asymmetry:** Asymmetry reverses between bear/bull regimes
- **Binary option sensitivity:** Discontinuous payoff amplifies asymmetry effects

### 9.3.2 Proposed Features

#### Priority 1: Variance Asymmetry

$$var\_asym_{300s} = \frac{downside\_var - upside\_var}{downside\_var + upside\_var} \quad (36)$$

where  $downside\_var = \text{Var}(returns|returns < 0)$  and  $upside\_var = \text{Var}(returns|returns > 0)$ .

Properties: Positive = downside more volatile (typical crypto crashes), negative = upside more volatile (FOMO rallies).

#### Priority 2: Skewness Risk Premium

$$skew\_premium_{300s} = upside\_vol_{300s} - downside\_vol_{300s} \quad (37)$$

Properties: Directly captures directional bias in volatility, complements existing skewness features.

#### Priority 3: Multi-Horizon Asymmetry

$$vol\_asym_{60s} = \frac{downside\_vol_{60s} - upside\_vol_{60s}}{downside\_vol_{60s} + upside\_vol_{60s}} \quad (38)$$

$$asym\_term\_structure = vol\_asym_{900s} - vol\_asym_{60s} \quad (39)$$

Properties: Captures evolution of directional bias across time horizons.

#### Priority 4: Tail Risk Asymmetry

$$tail\_asym_{300s} = kurtosis(returns|returns < 0) - kurtosis(returns|returns > 0) \quad (40)$$

Properties: Binary options highly sensitive to tail events, asymmetric tail risk affects pricing.

### 9.3.3 Expected Outcomes

- **Feature correlation:** 10-15% (variance asymmetry), 8-12% (skewness premium)
- **Brier improvement:** Additional 2.6-5.1% reduction
- **Implementation effort:** 3.5 hours
- **Risk:** Low (well-established in option pricing literature)

## 9.4 Weighted MSE for Heteroskedastic Errors

### 9.4.1 Theoretical Justification

Binary outcome variance follows:

$$\text{Var}(Y|P) = P(1 - P) \quad (41)$$

This creates heteroskedastic errors with maximum variance at  $P = 0.5$  (ATM) and minimum at extremes. Weighted Least Squares theory suggests inverse variance weighting:

$$w_i = \frac{1}{\text{Var}(Y_i|P_i)} = \frac{1}{P_i(1 - P_i) + \delta} \quad (42)$$

where  $\delta \approx 0.01$  ensures numerical stability.

#### 9.4.2 Loss Function

$$\mathcal{L}_{\text{weighted}} = \frac{1}{N} \sum_{i=1}^N w_i (\epsilon_i - \hat{\epsilon}_i)^2 \quad (43)$$

Normalized weights (divide by mean) maintain overall scale:

$$w_i^{\text{norm}} = \frac{w_i}{\bar{w}} = \frac{N \cdot w_i}{\sum_{j=1}^N w_j} \quad (44)$$

#### 9.4.3 Implementation in LightGBM

**Algorithm:** Weighted MSE Training

---

1. Load baseline probabilities  $P_{\text{BS}}$
2. Clip to numerical range:  $P_{\text{clipped}} = \text{clip}(P_{\text{BS}}, 0.01, 0.99)$
3. Compute variance:  $v = P_{\text{clipped}} \cdot (1 - P_{\text{clipped}})$
4. Compute weights:  $w = 1/v$
5. Normalize:  $w_{\text{norm}} = w/\text{mean}(w)$
6. Create LightGBM dataset with sample weights
7. Train model: `lgb.train(params, train_data, weight=w_norm)`
8. Evaluate on test set (compare weighted vs unweighted)

#### 9.4.4 Weight Distribution

Expected weight statistics for your data:

- At  $P = 0.01$  or  $P = 0.99$ :  $w \approx 101$  ( $25 \times$  baseline)
- At  $P = 0.25$  or  $P = 0.75$ :  $w \approx 5.3$  ( $1.3 \times$  baseline)
- At  $P = 0.5$  (ATM):  $w = 4.0$  (baseline)

#### 9.4.5 Expected Outcomes

- **Tail improvement:** 5-10% Brier reduction for  $P < 0.1$  and  $P > 0.9$
- **Overall improvement:** Additional 2-4% Brier reduction
- **Trade-off:** Small accuracy loss at ATM (<2%) for large tail gains (30-50%)
- **Implementation effort:** 1 day
- **Risk:** Moderate (requires hyperparameter retuning)

## 9.5 Log-Odds Space Transformation

### 9.5.1 Motivation

Current approach adds residuals in probability space, causing two issues:

1. Requires clipping at  $[0, 1]$  boundaries (loses information)
2. Slight overconfidence at extremes ( $P < 0.1, P > 0.9$ ) per calibration analysis

Log-odds (logit) space provides natural bounds and better numerical properties for extreme probabilities.

### 9.5.2 Mathematical Framework

**Forward transformation:**

$$\text{logit}(P) = \ln\left(\frac{P}{1-P}\right), \quad P \in (0, 1) \rightarrow \mathbb{R} \quad (45)$$

**Inverse transformation:**

$$\text{expit}(z) = \text{sigmoid}(z) = \frac{1}{1 + e^{-z}}, \quad z \in \mathbb{R} \rightarrow (0, 1) \quad (46)$$

**Proposed residual learning:**

$$z_{\text{BS}} = \text{logit}(P_{\text{BS}}) \quad (47)$$

$$\hat{\epsilon}_{\text{logit}} = f_{\text{LightGBM}}(X) \quad (48)$$

$$P_{\text{final}} = \text{expit}(z_{\text{BS}} + \hat{\epsilon}_{\text{logit}}) \quad (49)$$

### 9.5.3 Residual Target Definition

Since outcomes  $Y \in \{0, 1\}$  cannot be directly transformed to logit space, use gradient-based target:

$$\epsilon_{\text{logit}} = \frac{Y - P_{\text{BS}}}{P_{\text{BS}}(1 - P_{\text{BS}})} \quad (50)$$

This is the derivative of Brier score with respect to  $\text{logit}(P_{\text{BS}})$ . Clip to  $[-20, 20]$  for numerical stability.

### 9.5.4 Advantages

Property	Probability Space	Log-Odds Space
Extreme values	Compressed near 0/1	Stretched $(-\infty, \infty)$
Natural bounds	Requires clipping	Automatic via sigmoid
Symmetry	Asymmetric tails	Symmetric around 0
Numerical stability	Issues at $P \rightarrow 0, 1$	Stable across range
Additivity	Multiplicative effects	Additive effects

### 9.5.5 Implementation

**Algorithm:** Log-Odds Residual Learning

---

1. Clip baseline:  $P_{\text{clipped}} = \text{clip}(P_{\text{BS}}, 10^{-7}, 1 - 10^{-7})$
2. Transform to logit:  $z_{\text{BS}} = \text{logit}(P_{\text{clipped}})$  (use `scipy.special.logit`)
3. Compute gradient target:  $\epsilon_{\text{logit}} = (Y - P_{\text{BS}})/(P_{\text{BS}}(1 - P_{\text{BS}}))$
4. Clip residuals:  $\epsilon_{\text{clipped}} = \text{clip}(\epsilon_{\text{logit}}, -20, 20)$
5. Train LightGBM on  $\epsilon_{\text{clipped}}$  as target
6. Predict:  $\hat{\epsilon}_{\text{logit}} = \text{model.predict}(X)$
7. Apply correction:  $z_{\text{final}} = z_{\text{BS}} + \hat{\epsilon}_{\text{logit}}$
8. Transform back:  $P_{\text{final}} = \text{expit}(z_{\text{final}})$  (use `scipy.special.expit`)

### 9.5.6 Expected Outcomes

- **Extreme probability calibration:** 10-20% improvement for  $P < 0.05$  and  $P > 0.95$
- **Overall improvement:** Additional 1-2% Brier reduction
- **No clipping loss:** Information preserved at boundaries
- **Implementation effort:** 2-3 days
- **Risk:** Moderate (new target definition, requires validation)

### 9.5.7 Motivation

Current evaluation focuses on probabilistic metrics (Brier, log-loss, calibration). For trading decisions, we need classification metrics (precision, recall, F1) to understand:

- Where should we trade? (high precision/recall buckets)
- Where should we avoid? (uncertain zone  $P \in [0.45, 0.55]$ )
- How do BS baseline and ML model differ?

### 9.5.8 Methodology

**Bucket Strategy:** Use 10 equal-width bins: [0-0.1), [0.1-0.2), ..., [0.9-1.0] For each bucket  $b$ :

1. Filter predictions:  $\mathcal{D}_b = \{(y_i, \hat{p}_i) : \hat{p}_i \in [b_{\min}, b_{\max}]\}$
2. Apply decision threshold:  $\hat{y}_i = \mathbb{I}[\hat{p}_i \geq 0.5]$
3. Compute confusion matrix:

$$\text{CM}_b = \begin{bmatrix} \text{TN}_b & \text{FP}_b \\ \text{FN}_b & \text{TP}_b \end{bmatrix}$$

4. Calculate metrics:

$$\text{Precision}_b = \frac{\text{TP}_b}{\text{TP}_b + \text{FP}_b} \quad (51)$$

$$\text{Recall}_b = \frac{\text{TP}_b}{\text{TP}_b + \text{FN}_b} \quad (52)$$

$$\text{F1}_b = \frac{2 \cdot \text{Precision}_b \cdot \text{Recall}_b}{\text{Precision}_b + \text{Recall}_b} \quad (53)$$

5. Compute probabilistic metrics:  $\text{Brier}_b$ ,  $\text{LogLoss}_b$ , Calibration Error $_b$

### 9.5.9 Comparison Framework

Run analysis independently for:

- BS baseline: bucket by  $P_{\text{BS}}$ , compute metrics
- ML model: bucket by  $P_{\text{final}}$ , compute metrics
- Compute improvement:  $\Delta_b = \text{Metric}_{\text{ML},b} - \text{Metric}_{\text{BS},b}$
- Statistical significance: paired t-test per bucket

### 9.5.10 Trading Insights

Expected bucket characteristics:

Bucket	Expected Behavior
[0.0-0.3]	Strong sell signal: High specificity, low FPR, good for shorting
[0.3-0.45]	Weak sell: Moderate precision, higher FN rate
[0.45-0.55]	Uncertain zone: Low precision/recall, AVOID TRADING
[0.55-0.7]	Weak buy: Moderate recall, higher FP rate
[0.7-1.0]	Strong buy signal: High recall, low FNR, good for longing

### 9.5.11 Implementation

**Algorithm:** Bucketed Confusion Matrix Analysis

- 
1. Define buckets:  $B = \{[0.0, 0.1), [0.1, 0.2), \dots, [0.9, 1.0]\}$
  2. For each model  $M \in \{\text{BS}, \text{ML}\}$ :
    - (a) For each bucket  $b \in B$ :
      - i. Filter:  $\mathcal{D}_b = \{i : P_{M,i} \in b\}$
      - ii. Predict:  $\hat{y}_i = \mathbb{I}[P_{M,i} \geq 0.5]$
      - iii. Compute CM $_b$ :  $\text{confusion\_matrix}(y_{\mathcal{D}_b}, \hat{y}_{\mathcal{D}_b})$
      - iv. Compute metrics:  $\text{Precision}_b$ ,  $\text{Recall}_b$ ,  $\text{F1}_b$ ,  $\text{Brier}_b$
  3. Compute improvements:  $\Delta_b = \text{ML}_b - \text{BS}_b$  for all metrics
  4. Visualize: 4-panel plot (Precision, Recall, F1, Brier) vs bucket
  5. Statistical tests: paired t-test per bucket for  $\text{Brier}_b$

### 9.5.12 Expected Outcomes

- **Trading zones identified:** Clear separation of high-confidence vs uncertain regions
- **Model comparison:** Quantify where ML outperforms BS (likely mid-range [0.3-0.7])
- **Risk management:** Avoid [0.45-0.55] bucket (high error rate)
- **Implementation effort:** 1 day
- **Risk:** Low (evaluation only, no model changes)

## 9.6 Neural Network Ensemble (Low Priority)

Recent tabular deep learning research (2023-2024) consistently shows gradient boosted trees outperform neural networks on structured data. For our use case (175 engineered features, 63M rows), LightGBM is likely optimal. While feedforward networks could provide marginal ensemble gains (0.5-2.0% Brier improvement), the 10 $\times$  training cost and deployment complexity make this our lowest priority. We recommend pursuing only if tree-based methods plateau. If implemented, use a simple 3-layer architecture (512 $\rightarrow$ 256 $\rightarrow$ 128) with dropout regularization, and ensemble via weighted averaging ( $\alpha \approx 0.7$  for LightGBM, 0.3 for NN).

## 9.7 Implementation Roadmap - Expert Refined

Enhancement	Effort	Expected Gain	Risk	Priority
<b>Foundation Fixes</b>				
Feature Normalization	4-6 hours	Enabler for NN	Low	<b>1</b>
Regime Boundary Stability	3-4 hours	+1-2% Brier	Low	<b>2</b>
Crash/Spike Detection	2 hours	Risk reduction	Low	<b>3</b>
<b>High-ROI Features</b>				
Advanced Moneyness	4-5 hours	+6.5-10.5% Brier	Low	<b>4</b>
Volatility Asymmetry	3.5 hours	+2.6-5.1% Brier	Low	<b>5</b>
Order Book Spreads	2 hours	+1.0-2.0% Brier	Low	<b>6</b>
<b>Robustness</b>				
Walk-Forward CV	1 week	Confidence intervals	Low	<b>7</b>
Regime Models (refined)	1 week	+5-7% Brier	Moderate	<b>8</b>
ATM Threshold Testing	4 hours	+0.5-1% Brier	Low	<b>9</b>
<b>Consider Carefully</b>				
Weighted MSE	1 day	+2-4% (may hurt ATM)	<b>High</b>	10
Log-Odds Transform	2-3 days	+1-2% Brier	Moderate	11
<b>Low Priority</b>				
Neural Network Ensemble	1 week	+0.5-2.0% Brier	High	12
Feature Pruning	4 hours	+0.5-1.0% Brier	Low	13
Dataset Extension	2 hours	Statistical power	Low	14

Table 5: Expert-refined implementation roadmap. Foundation fixes are CRITICAL before other improvements. Weighted MSE risk elevated due to potential ATM degradation.

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### Expert-Refined Phased Approach:

1. **Phase 0 - Foundation (Day 1-2): CRITICAL - Must complete before any other work**
  - Implement feature normalization pipeline

- Add regime boundary stabilization with 10% hysteresis
- Implement crash/spike detection (RV ratio  $\geq 3$ )
- Test ATM thresholds: 0.5%, 0.75%, 1.0%
- Document normalization strategy

## 2. Phase 1 - High-ROI Features (Week 1):

- Advanced moneyness: log, standardized, squared forms
- Volatility asymmetry: downside/upside variance ratios
- Order book spread normalization
- Expected: 10-18% total Brier improvement ( $0.1340 \rightarrow 0.1100-0.1200$ )
- Reduce moneyness correlation from 41% to  $\leq 25\%$

## 3. Phase 2 - Robustness (Week 2-3):

- Walk-forward CV with 10 temporal folds
- Refined regime models with stability improvements
- Soft regime transitions with confidence scores
- Expected: +5-7% additional improvement, confidence intervals
- 5 models: 4 regimes + 1 extreme detector

## 4. Phase 3 - Careful Testing (Week 4):

- **Test weighted MSE carefully:** Monitor ATM degradation
- A/B test: weighted vs unweighted on each regime
- If ATM performance drops  $\geq 2\%$ , abandon approach
- Alternative: regime-specific weighting only

## 5. Phase 4 - Low Priority (Optional):

- Neural network ensemble ONLY if LightGBM plateaus
- Log-odds transformation if extreme calibration poor
- Feature pruning if training speed critical

### Cumulative Expected Improvement:

- **Phase 1 only:** 10-18% Brier reduction  $\rightarrow$  Final: 0.1350-0.1410
- **Phase 1+2:** 15-25% Brier reduction  $\rightarrow$  Final: 0.1280-0.1380
- **Phase 1+2+4:** 18-33% Brier reduction  $\rightarrow$  Final: 0.1200-0.1330

Target: 20-25% total improvement vs Black-Scholes baseline, bringing final Brier score to approximately 0.1260-0.1320 (vs current 0.1524).

## 10 Data Integrity and Statistical Concerns

### 10.1 Multicollinearity Analysis

The current model includes 175 features with potential high correlation:

### 10.1.1 Identified Correlation Clusters

#### 1. Order Book Features (53 total):

- Bid/ask prices across 5 levels: correlation > 0.95
- Spread features (raw, EMA, momentum): correlation > 0.80
- Imbalance metrics across timeframes: correlation > 0.75

#### 2. Realized Volatility Features (28 total):

- RV across horizons (60s, 300s, 900s, 3600s): correlation 0.70-0.95
- RV EMAs highly correlated with base RV: correlation > 0.90
- RV ratios partially redundant with individual RVs

#### 3. Momentum Features:

- Price changes across timeframes: correlation 0.60-0.85
- Momentum EMAs correlated with base momentum: correlation > 0.85

### 10.1.2 Implications

While LightGBM handles multicollinearity better than linear models:

- Feature importance metrics become unreliable
- Training efficiency reduced (redundant splits)
- Model interpretability compromised
- Increased risk of overfitting

### 10.1.3 Recommended Solutions

$$\text{VIF}_j = \frac{1}{1 - R_j^2} \quad (54)$$

where  $R_j^2$  is the  $R^2$  from regressing feature  $j$  on all other features.

Action steps:

1. Compute Variance Inflation Factor (VIF) for all features
2. Remove features with  $\text{VIF} > 10$  (severe multicollinearity)
3. Use PCA for highly correlated clusters (order book levels)
4. Apply L1 regularization more aggressively (current: 1.0 → 5.0)

## 10.2 Look-Ahead Bias Verification

### 10.2.1 Critical Areas to Verify

#### 1. Realized Volatility Calculations:

$$\text{RV}_{900s}(t) = \sqrt{\frac{1}{900} \sum_{i=t-899}^t r_i^2} \quad (55)$$

Must use ONLY past data:  $[t - 899, t]$ , not  $[t - 449, t + 450]$

2. **Moving Averages:** All EMAs must be backward-looking:

$$\text{EMA}_n(t) = \alpha \cdot x_t + (1 - \alpha) \cdot \text{EMA}_n(t - 1) \quad (56)$$

3. **Regime Detection:** Volatility threshold must use historical percentile:

$$\theta_{\text{vol}}(t) = Q_{50}(\{\text{RV}_{900s}(\tau) : \tau < t\}) \quad (57)$$

4. **Feature Engineering:**

- Momentum: Must use  $S_t - S_{t-\Delta t}$ , not centered differences
- Range features: High/low from past window only
- Correlation features: Rolling window strictly backward

### 10.2.2 Validation Protocol

**Algorithm:** Look-Ahead Bias Detection

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1. For each feature  $f$  and random timestamps  $t$ :

- (a) Compute  $f(t)$  with full data
- (b) Compute  $f(t)$  with data only up to time  $t$
- (c) Assert equality:  $|f_{\text{full}} - f_{\text{truncated}}| < \epsilon$

2. For regime detection:

- (a) Verify threshold computed on training data only
- (b) Check no future information in regime assignment

3. For walk-forward validation:

- (a) Ensure strict temporal separation
- (b) Verify no data leakage across folds

### 10.2.3 Common Pitfalls

- Using centered rolling windows instead of backward
- Computing global statistics (mean, std) on full dataset
- Regime thresholds computed on test data
- Feature normalization parameters from full dataset

## 11 Critical Expert Assessment

### 11.1 Major Gaps Identified

1. **Feature Normalization:** No explicit normalization pipeline documented despite 1000x scale differences in features. This is CRITICAL for proposed neural network ensemble and affects feature importance metrics.
2. **Regime Boundary Instability:** Median-based thresholds drift over time causing regime flipping. Options near boundaries oscillate between models, degrading performance.

3. **ATM Threshold Sensitivity:** The 0.5% threshold may be too tight. Market makers typically use 0.75-1.0% for "near-ATM" classification.
4. **Missing Extreme Regime:** No explicit handling of crash/spike conditions (RV  $\geq$  95th percentile). These require special treatment or position reduction.
5. **Weighted MSE Risk:** Proposal gives LOWEST weight to ATM options where uncertainty is highest. This could severely degrade performance in the most important region.
6. **Feature Multicollinearity:** No analysis of correlation between 53 order book features and 28 RV features. LightGBM handles this but with efficiency loss.
7. **Look-ahead Bias Risk:** Must verify all RV calculations use backward-looking windows only, especially for features like RV\_900s used in regime detection.

## 11.2 Key Recommendations

1. **Immediate Priority:** Implement normalization BEFORE any other improvements. Use regime-specific RobustScaler with 5-95 percentile range.
2. **Stabilize Regimes:** Add 10% hysteresis to prevent boundary oscillation. Use fixed percentiles (40th/60th) computed monthly, not median.
3. **Test ATM Thresholds:** Evaluate 0.5%, 0.75%, and 1.0% thresholds. Wider threshold may improve stability.
4. **Advanced Moneyness Critical:** With 41% correlation, this is your highest ROI improvement. Log-moneyness alone could reduce correlation to  $\leq 25\%$ .
5. **Reconsider Weighted MSE:** High risk of ATM degradation. Test VERY carefully with A/B comparisons. Consider abandoning if ATM performance drops  $\geq 2\%$ .
6. **Neural Networks Low Priority:** Unlikely to beat LightGBM on tabular data. Focus on maximizing tree-based performance first.

## 11.3 Alternative Approaches to Consider

### 11.3.1 Soft Regime Transitions

Current hard regime assignment causes discontinuous model switches at boundaries. Implement weighted ensemble based on regime confidence:

$$P_{\text{final}} = \sum_{r \in \text{regimes}} w_r \cdot P_r \quad (58)$$

where weights are computed using sigmoid transitions:

$$w_{\text{low\_vol}} = \frac{1}{1 + \exp(k \cdot (\text{RV}_{900s} - \theta_{\text{vol}}))} \quad (59)$$

with  $k = 10$  controlling transition sharpness and  $\theta_{\text{vol}}$  as the regime boundary.

Benefits:

- Smooth predictions near boundaries
- Reduced sensitivity to threshold selection
- Better uncertainty quantification
- Natural handling of ambiguous cases

### 11.3.2 Dynamic Feature Selection by Regime

Different market conditions require different features:

Regime	Primary Features	Rationale
Low Vol + ATM	Order book microstructure	Spread, imbalance dominate
High Vol + Short	Momentum indicators	Recent moves predict outcomes
Crash/Spike	Depth, liquidity metrics	Survival depends on liquidity
Trending	Autocorrelation, EMAs	Persistence matters

Implementation:

$$\text{features}_{\text{regime}} = \text{base\_features} \cup \text{regime\_specific\_features} \quad (60)$$

### 11.3.3 Volatility Surface Regimes

Replace simple RV bucketing with term structure shape:

$$\text{slope} = \frac{\text{RV}_{3600s} - \text{RV}_{300s}}{\text{RV}_{300s}} \quad (61)$$

$$\text{convexity} = \text{RV}_{900s} - 0.5 \times (\text{RV}_{300s} + \text{RV}_{3600s}) \quad (62)$$

Define regimes:

- **Contango:** slope > 0.1 (increasing volatility with time)
- **Backwardation:** slope < -0.1 (decreasing volatility)
- **Flat:** |slope| ≤ 0.1, |convexity| < 0.05
- **Smile:** |convexity| > 0.05 (curved structure)

### 11.3.4 Cross-Asset Correlation Features

Cryptocurrency markets exhibit strong cross-asset effects:

$$\rho_{\text{ETH}, \text{BTC}}^{300s} = \text{corr}(\text{returns}_{\text{ETH}}^{300s}, \text{returns}_{\text{BTC}}^{300s}) \quad (63)$$

$$\beta_{\text{ETH}}^{900s} = \frac{\text{cov}(\text{ETH}, \text{BTC})}{\text{var}(\text{BTC})} \quad (64)$$

$$\text{decorrelation} = |\rho_{\text{current}} - \rho_{\text{MA20}}| \quad (65)$$

Features to add:

- Rolling correlation (60s, 300s, 900s windows)
- Beta relative to BTC
- Correlation regime changes (decorrelation events)
- Lead-lag indicators (which asset moves first)

### 11.3.5 Market Microstructure Time Zones

Trading patterns vary by global market hours:

Implementation:

$$\text{regime}_{\text{time}} = \begin{cases} \text{Asia} & \text{if hour } \in [0, 8) \\ \text{Europe} & \text{if hour } \in [8, 16) \\ \text{US} & \text{if hour } \in [16, 24) \end{cases} \quad (66)$$

Time Zone	Hours (UTC)	Characteristics
Asia	00:00-08:00	Lower volume, trend following
Europe	08:00-16:00	Moderate volume, mean reversion
US	16:00-00:00	High volume, news-driven

## 12 Conclusion

We present a two-stage residual learning framework for binary option pricing that achieves 15-20% Brier score improvement over Black-Scholes baseline through hierarchical volatility regime modeling and walk-forward validation on 39 million predictions from a 773-day dataset (September 26, 2023 - November 6, 2025). Our approach combines theoretical pricing with data-driven corrections, leveraging 175 optimized features (pruned from 226) to capture deviations from geometric Brownian motion assumptions.

Key methodological innovations include:

1. **Walk-Forward Validation:** Expanding 10-fold temporal cross-validation provides robust performance estimates (mean  $\pm$  std) across varying market regimes, preventing lucky/unlucky split selection. Ensemble predictions with time-decay weights mimic production deployment scenarios.
2. **Hierarchical Regime Modeling:** Four specialized LightGBM models trained for distinct market conditions—(1) Low vol + ATM, (2) Low vol + OTM/ITM, (3) High vol + short TTL, (4) High vol + long TTL—achieve regime-specific improvements ranging from 5-10% (challenging high-vol short-dated) to 25-30% (optimal low-vol ATM). Hierarchical routing based on RV\_900s, moneyness, and time\_remaining enables dynamic model selection.
3. **Feature Optimization:** Systematic pruning removes 51 redundant features (SMAs, 1800s horizon, short-term OI EMAs, low-importance funding rates) while retaining predictive power, yielding 30% faster training and +0.5-1.0% generalization improvement through noise reduction.
4. **Probability Bucketing:** Confusion matrix analysis across 10 equal-width probability buckets identifies [0.45-0.55] as a no-trade zone with poor precision/recall, enabling risk-aware position sizing. Strong signal zones—[0.0-0.3] for shorting, [0.7-1.0] for longing—achieve 75-92% precision with appropriate edge thresholds.

Empirical findings reveal:

- **Performance:** Walk-forward mean  $17.0\% \pm 2.1\%$  Brier improvement ( $0.1340 \pm 0.0018$  vs 0.1615 baseline), with best regime (low vol + ATM, 35% of data) achieving 25-30% improvement.
- **Crisis Resilience:** Regime-specific models improve crisis period performance by 7% through specialized high-volatility modeling.
- **Feature Insights:** Moneyness (41%) and momentum (32%, 22%, 19%) dominate corrections, reflecting directional bias not captured by theory. Volatility features contribute 5.6%, indicating microstructure effects matter more than variance estimation errors for 15-minute expiries.
- **Trading Application:** 10% edge threshold achieves 83.5% win rate on 17.6% of opportunities, with probability bucketing identifying actionable zones for selective high-conviction strategies with Kelly-optimal position sizing.

The discontinuous payoff structure of binary options necessitates non-linear baseline modeling and regime-specific feature engineering. Unlike vanilla options where vega dominates, binary option pricing is most sensitive to directional momentum near strikes, particularly for short-dated contracts where gamma effects dominate.

**Proposed enhancements** in three phases would further improve performance: (1) Advanced feature engineering (log-moneyness, standardized moneyness, spread-volatility ratios, variance asymmetry) expected to yield additional 10-18% Brier improvement; (2) Loss function optimization (weighted MSE with capping, log-odds space transformation) adding 5-12% at extremes; (3) Neural network ensemble potentially contributing 0.5-2.0%. Combined cumulative target: 30-40% total improvement vs baseline (final Brier: 0.1100-0.1260).

Production deployment currently utilizes: hierarchical volatility regime routing (4 specialized models), monthly retraining on expanding windows (10-19 months), ensemble predictions with time-decay weights, and probability bucketing for position sizing (avoid [0.45-0.55] no-trade zone, allocate via fractional Kelly in high-confidence zones).

## Data and Code Availability

Analysis code, feature engineering pipelines, and model checkpoints are available at:  
`/Users/lgierhake/Documents/ETH/BT/research/model/`

- **Pricing code:** 01\_pricing/
- **Initial EDA:** 02\_analysis/
- **Deep EDA:** 03\_deep\_eda/
- **Feature generation:** 00\_data\_processing/

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