Option Credit Spreads

Lesson 5

Beginner Options Teaching Lessons

Credit Spread Trades

SHADOW TRADER

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Topics for this Lesson:

Put Credit Spread Trades

- Bullish Put Spread Setup – (Bull Put)
- Endpoint Definitions
- Strategy and Adjustments

Call Credit Spread Trades

- Bearish Call Spread Setup – (Bear Call)
- Endpoint Definitions
- Strategy and Adjustments

Put Credit Spread Trades

Bullish Put Spread Setup

– Bull Put

– Put Vertical (confusing)

Agenda

- Understanding Instruments Used
- Applying the Strategy
- Defining Exit Points
- Intro to Strategy Adjustments

Bull Put

- Optimizes a bullish/stagnant trend

Short Put (primary expectation instrument)
Long Put (risk limiting instrument)

- Expectation is a bullish trend
- Both options in the same expiration series
  - Recommend 30 days or less time for trade trend to continue
- Long put limits the risk capital (margin) in the trade
- Trade risk = strike differential minus the net credit
- Maximum Potential Reward: net credit when opened
- Primary exit: allow trade to expire worthless
- Secondary exit: Close the trade at a percent net gain or adjust to another spread trade

Bullish Put Spread Setup – (Bull Put ; Put Vertical - bullish)

SELL 19 JUL 19 195 PUT @3.50 **+** BUY 19 JUL 19 185 PUT @1.30 Results in our Bull Put Spread

or in a single transaction

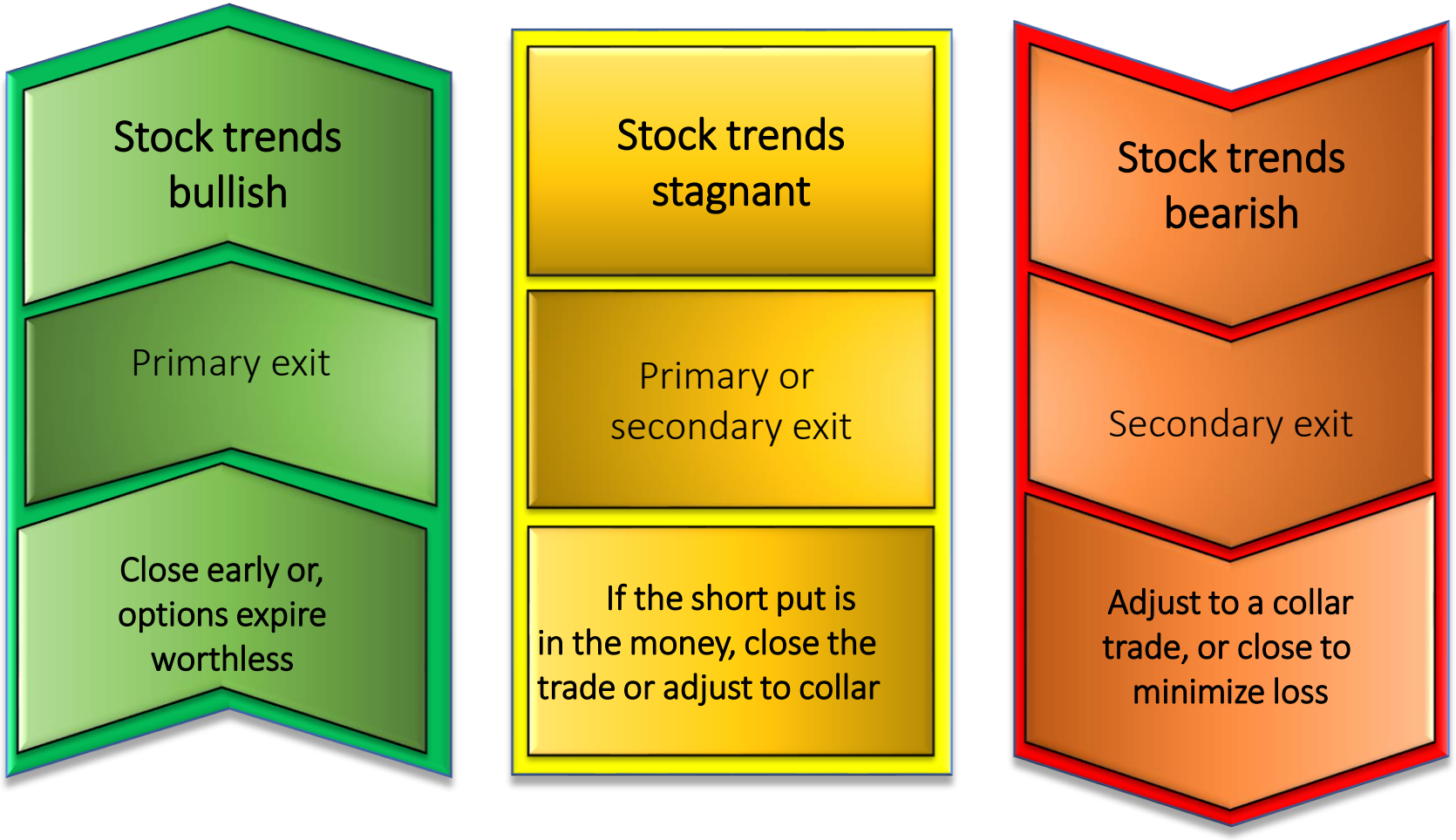
SELL VERTICAL XXX 100 19 JUL 19 195/185 PUT @2.20

- Max Trade risk = strike spread ($1000) minus net credit ($220) = $780
- Max Profit = credit $220
  - For this example that's a 27% ROR

Volume	Open.Int	Bid X	Ask X	Exp	Strike	Bid X	Ask X	Volume	Open.Int
(26) 100									26.81% (
172	6,880	29.20 E	29.70 E	19 JUL 19	170	.32 D	.35 D	1,037	14,748
38	21,181	24.35 N	24.80 E	19 JUL 19	175	.48 N	.50 Q	653	35,426
173	19,381	19.70 X	20.15 W	19 JUL 19	180	.76 P	.80 P	1,297	30,754
224	15,566	15.30 P	15.55 N	19 JUL 19	185	1.25 P	1.30 P	11,708	57,308
1,259	30,501	11.15 N	11.50 X	19 JUL 19	190	2.12 N	2.19 M	3,083	36,576
890	16,726	7.65 X	7.80 M	19 JUL 19	195	3.50 M	3.60 M	2,716	13,492
5,208	41,816	4.75 H	4.85 D	19 JUL 19	200	5.60 D	5.70 E	8,451	21,016
2,798	23,722	2.65 H	2.72 M	19 JUL 19	205	8.50 P	8.60 X	163	6,290
5,700	25,415	1.31 P	1.35 P	19 JUL 19	210	12.10 M	12.30 X	126	6,533
1,869	17,112	.61 P	.64 P	19 JUL 19	215	16.35 M	16.85 E	35	6,370
1,498	14,204	.30 Z	.32 D	19 JUL 19	220	21.05 W	21.60 W	218	105
889	10,105	.16 Q	.18 E	19 JUL 19	225	25.30 E	27.25 E	0	41
365	8,616	.10 Q	.11 Q	19 JUL 19	230	29.55 N	33.05 H	0	21

ROR = credit / (strike diff minus credit)

Defining Exit Points

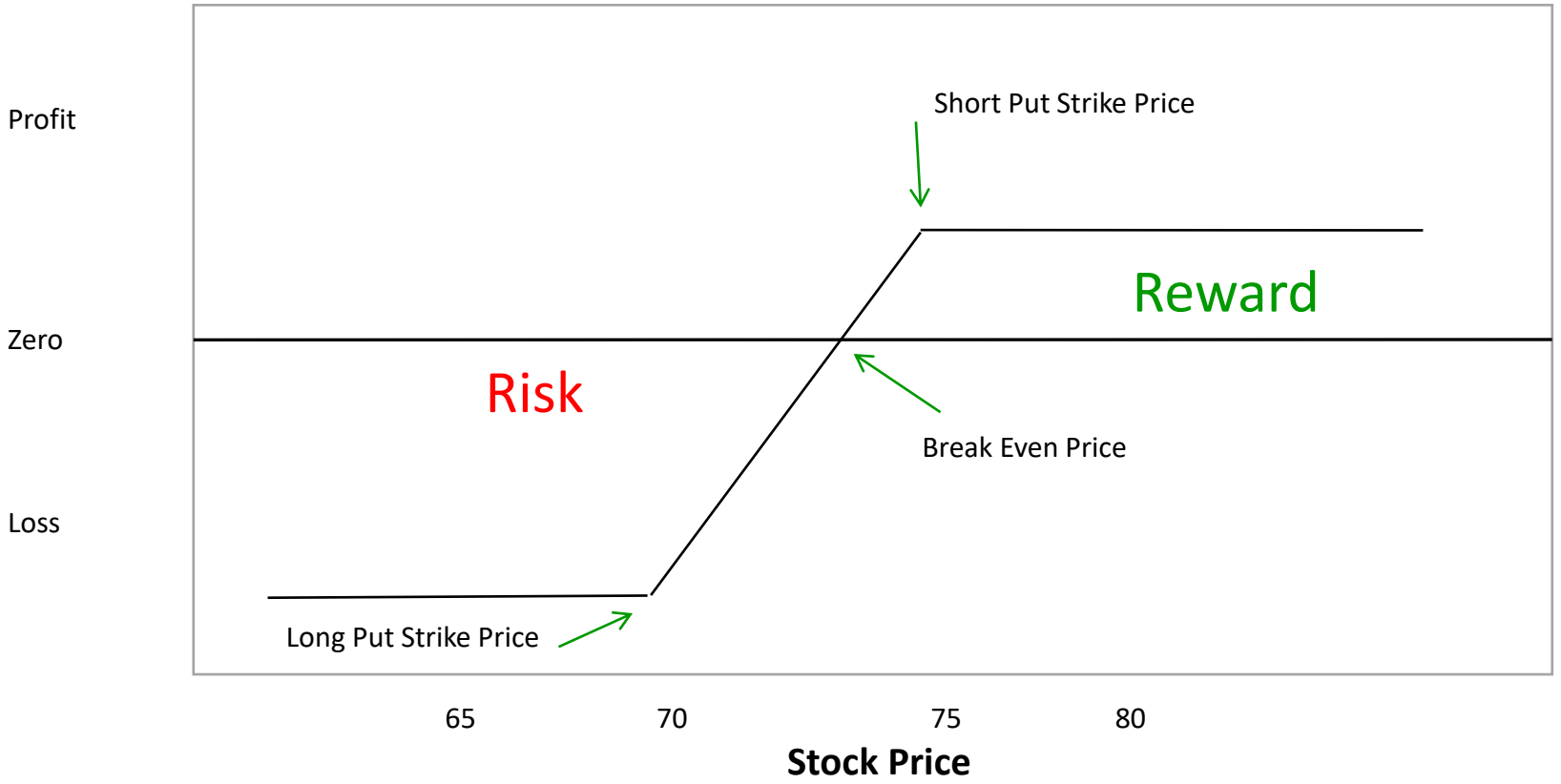


Considerations

Bull put- Combines the short put and the long put. The short put is placed at a *higher* value strike price than the long put in the same expiration month- preferably using current month options

- Where is the risk in this trade?
  - We have an OBLIGATION to buy the equity at the strike price of the short put
  - We have the RIGHT to sell the same equity at the strike price of the long put
  - Our risk is the difference between those two actions
  - (However, we do get to keep the net credit!)
- Short put is best placed at or below support
- Do not place this trade during an option series where a scheduled news event (like earnings) could cause the equity to change its direction rapidly!
- Long Put is used to minimize and control risk
  - You can use spreads as small as $0.50 when available if you wish…

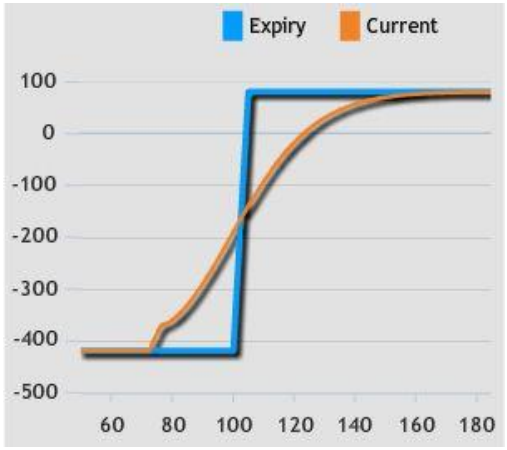
Bull Put Profit and Loss Graph



- The “Theoretical” break even point is the point at which you have given back the net credit you received when you opened the trade initially
- Mathematically it is the strike of the short put MINUS the net credit
- In this example, it would be 75.00 - 0.55 cr = 74.45

Bull Put – Conclusion

- The bull put is a trade that optimizes a stagnant to bullish trend using the put instruments
- The primary instrument is the short put
- The risk limiting instrument is the long put
- The maximum reward is the net credit of the two options
- The maximum risk is the difference between strikes minus the net credit received from the trade
- The secondary exit is to follow through on your short put obligation (buy the equity) and collar the trade or to simply close the trade



Call Credit Spread Trades

Bearish Call Spread Setup

– Bear Call

– Call Vertical (confusing)

Agenda

- Understanding Instruments Used
- Applying the Strategy
- Defining Exit Points
- Intro to Strategy Adjustments

Bear Call

- Optimizes a bearish/stagnant trend

Short Call (primary expectation instrument)
Long Call (risk limiting instrument)

- Expectation is a bearish trend
- Both options in the same expiration series
  - Recommend 30 days or less time for trade trend to continue
- Long call limits the risk capital (margin) in the trade
- Trade risk = strike differential minus the net credit
- Maximum Potential Reward: net credit when opened
- Primary exit: allow trade to expire worthless
- Secondary exit: Close the trade at a percent net gain or adjust to another spread trade

Bearish Call Spread Setup – (Bear Call ; Call Vertical - bearish)

SELL 19 JUL 19 200 CALL @4.75 **+** BUY 19 JUL 19 210 CALL @1.35 Results in our Bear Call Spread

or in a single transaction

SELL VERTICAL XXX 100 19 JUL 19 200/210 CALL @3.40

- Max Trade risk = strike spread ($1000) minus net credit ($340) = $660
- Max Profit = credit $340
  - For this example that's a 51.5% ROR

Volume	Open.Int	Bid X	Ask X	Exp	Strike	Bid X	Ask X	Volume	Open.Int
(26) 100									26.81% (
172	6,880	29.20 E	29.70 E	19 JUL 19	170	.32 D	.35 D	1,037	14,748
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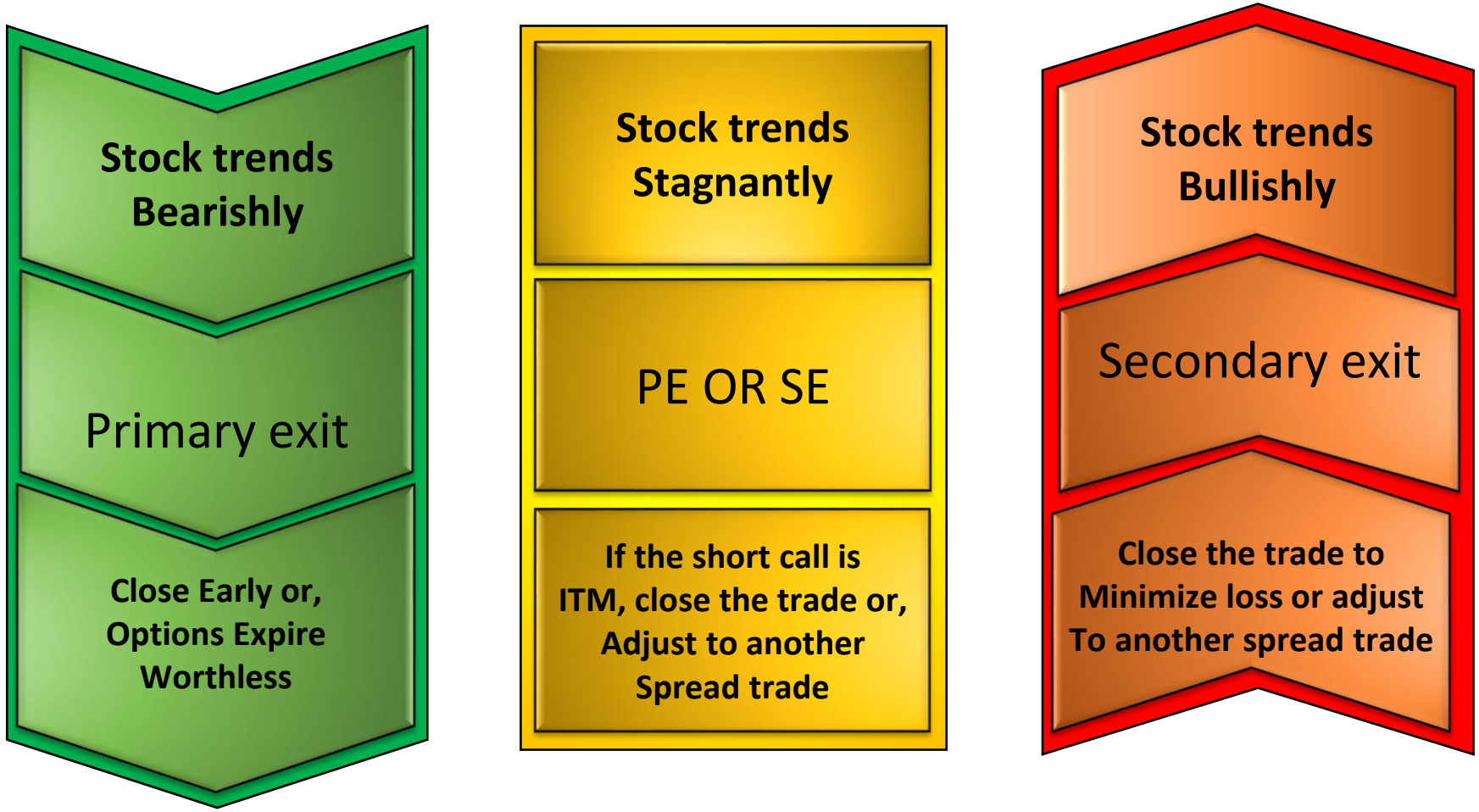
Defining exit Points

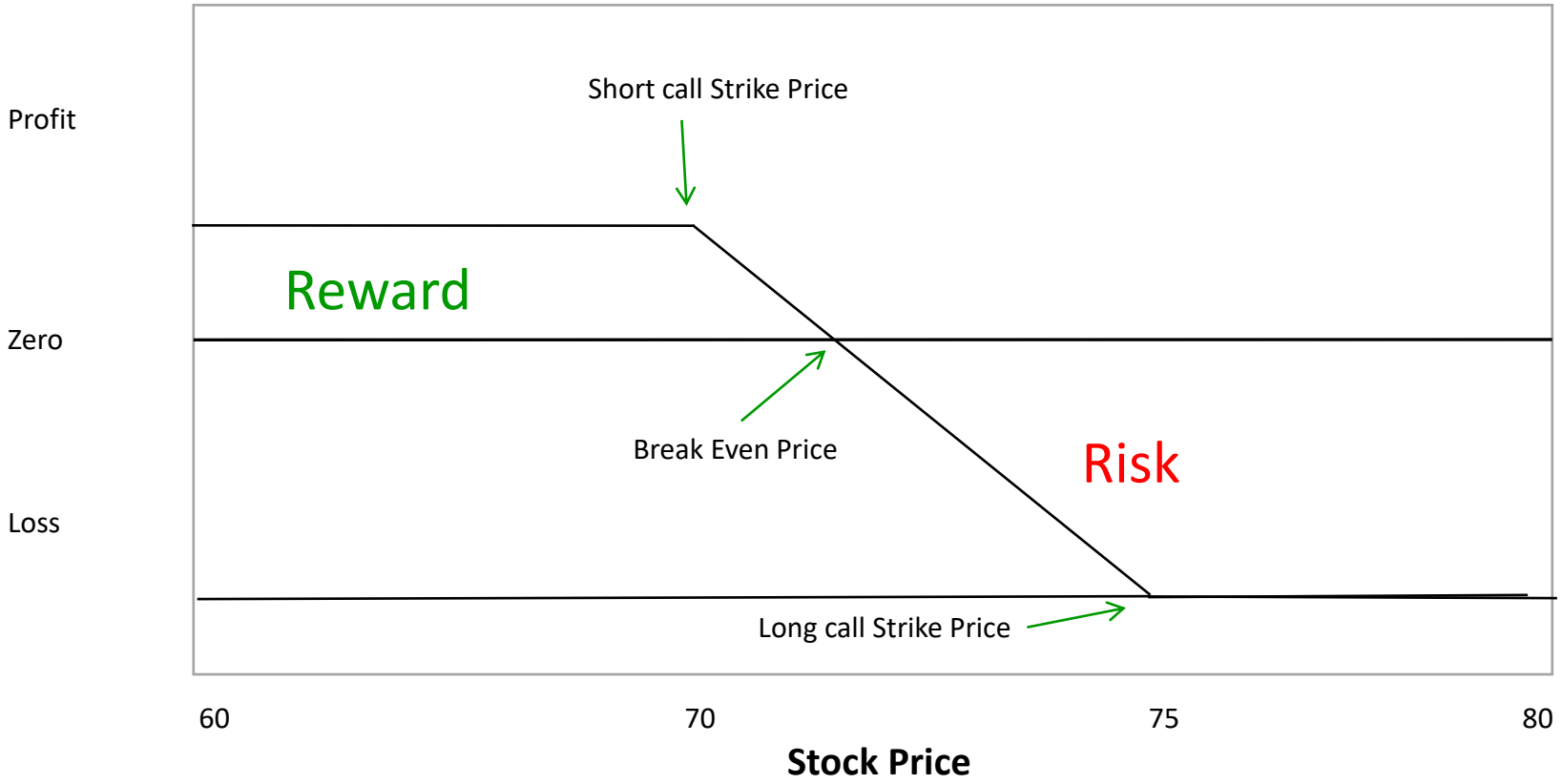


Applying the Bear Call - Considerations

Bear call -Combines the short call and the long call. The short call is placed at a *lower* value strike price than the long call in the same expiration month- preferably using current month options

- Find a relatively weak stock
- Preferably 30-day time period or less
- Apply above resistance to improve the probability of the bear call expiring worthless
- Be aware of fixed news events
- Do not place prior to earnings
- Primary exit – options expire worthless or close early to capture profits
- Secondary exit – close to minimize loss or adjust to another spread trade

Bear Call Profit and Loss Graph



- The “Theoretical” break even point is the point at which you have given back the net credit you received when you opened the trade initially
- Mathematically it is the strike of the short call PLUS the net credit
- In this example, it would be 70.00 + 0.55 cr = 70.55

Bear Call – Conclusion

- The bear call is a trade that optimizes a stagnant to bearish trend using the call instruments
- The primary instrument is the short call
- The risk limiting instrument is the long call
- The maximum reward is the net credit of the two options
- The maximum risk is the difference between strikes minus the net credit received from the trade
- The secondary exit is to simply close the trade or adjust using longer term long calls or buy the stock.