Credits And Debits

Learning How to Use Credit Spread Strategies

BetterTrades Instructor

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Practice First

- There is risk involved in any form of trading!
- The strategies taught in this workshop are designed to teach advanced option strategies.
- You must practice these concepts and apply them in unfunded trading until you understand them and are comfortable with them before you ever use them in a funded trade!

Basic Concepts

- An option is a contract.
  - It gives the buyer certain rights
  - It requires an obligation from the seller
- Option premium can be bought, but it can also be sold.
- The market maker MUST buy what you are selling and sell what you are buying at market value.
- At Expiration an option can be assigned to the seller or exercised by the buyer.

THE CREDIT SPREAD

Get Paid First

Advantages

- **You are selling option premium as it decays.**
- **Higher probability trade.**
- **You are paid at the start of the trade.**

Disadvantages

- Limited profit.
- Risk is often greater than the trade credit.
- Can be costly to unwind.
- Requires knowledge and skill to manage.

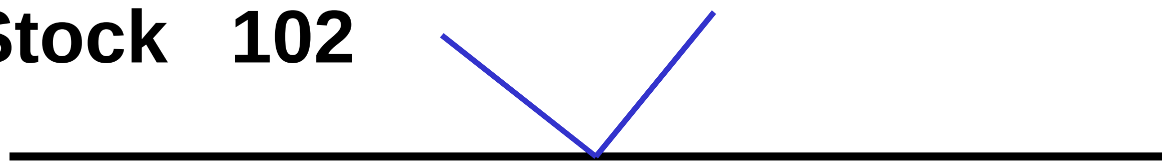
Take on an Obligation

- **A trader can sell a put option to the market even if he does not own it.**
  - **The seller takes on an obligation.**
- **When selling a put, the trader agrees to buy the stock at the strike price on or before expiration.**
- **This involves a large risk, potentially the full price of the stock minus the premium.**
- **The seller will be compensated for taking on the obligation; he collects the option premium.**

Sell a Put

Seller receives $2 per share option premium.
Seller is obligated to buy the stock at $100 per share
This would only be likely if the stock is below $100 at expiration.

Stock 102

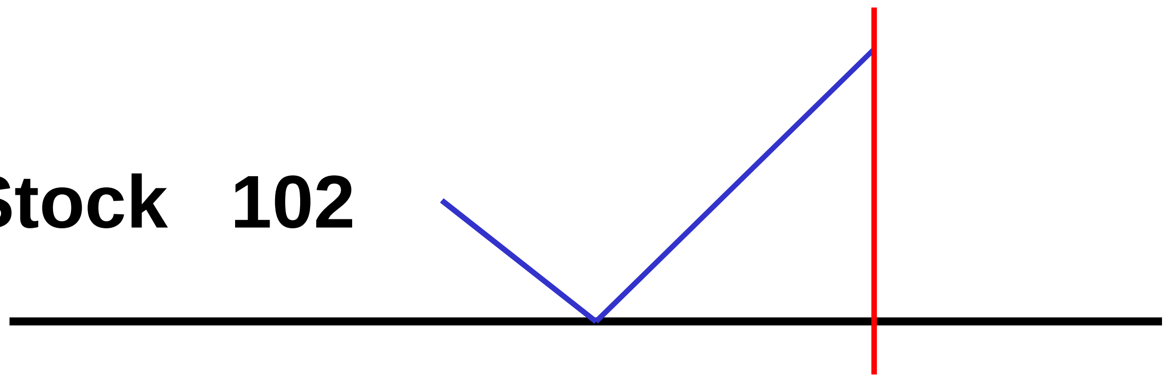


STO 100 P for $2 credit

At Expiration

As long as the put expires out of the money (OTM), premium goes to zero.
Contract expires worthless and seller's obligation is over.

Stock 102



STO 100 P for $2 credit
Expires worthless

Reduce the Risk

- A trader could take advantage of the premium selling strategy while reducing the risk.
  - The seller takes on an obligation.

- When selling a put, the trader agrees to ***buy*** the stock at the strike price, the market can "put" the stock to him.

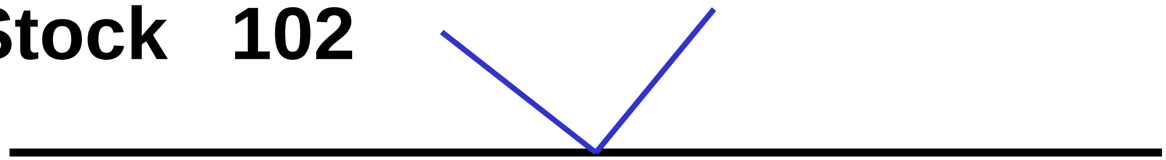
- When buying a put, the trader has the right to ***sell*** the stock to the market maker at the strike price, he can "put" the stock to the market .

- If a trader both sells a put ***and*** buys a put at different strikes, he has the right to put the stock back to the market if it is put to him.

The Bull Put Spread

Trader receives $1 per share option premium (net credit).
Trader is obligated to buy the stock at $100 per share.
Trader can obligate the market to buy the stock for $95 per share.
Risk is $5 minus the premium received and is typically only realized if the stock is below the short strike at expiration.

Stock 102



STO 100 P for $2

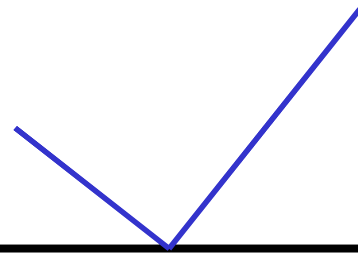
Net credit is $1

BTO 95 P for $1

Bull Put Spread at Expiration

Trader received $1 per share option premium (net credit).
As long as both option strikes expire OTM then both expire worthless and full credit is realized.

Stock 102



100 P from $2 to $0

95 P from $1 to $0

Net credit is $1

Risk/Reward

- In this example the trader will make (keep) the $1 credit if the stock price is above the short strike at expiration.

- If the stock price drops below the short strike, the stock will be “put” to him (assigned).

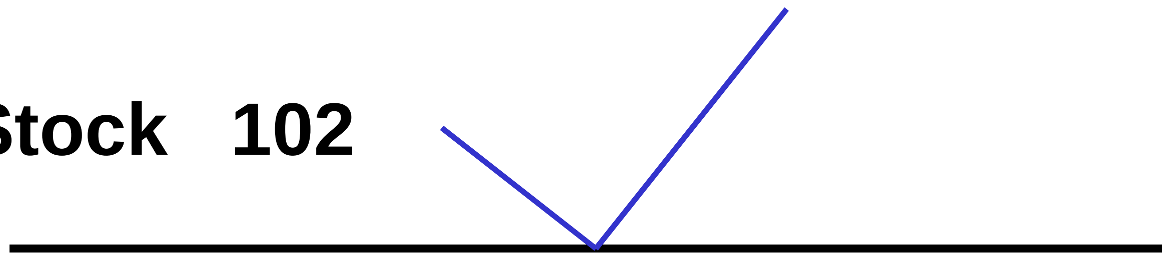
- The trader can exercise the long option to “put” the stock back to the market at the lower price (exercise).

- The trade will generate a loss equal to the difference between the strikes minus the premium received.

Bull Put Spread at Expiration

Trader received $1 per share option premium (net credit).
As long as both option strikes expire OTM then both expire worthless and full credit is realized.

Stock 102



100 P from $2 to $0

95 P from $1 to $0

Reward= Credit of $1

Risk= Diff in strikes $5
-Credit $1
$4 risk

The Same, But Different

- The Bull Put Spread may be used when a trader is mildly bullish to bullish on a stock.

- When a trader is mildly bearish to bearish, a similar strategy can be used by selling call option premium.

- The trade is set up in similar fashion and has a similar risk profile.

Take on an Obligation

- **A trader can sell a call option to the market even if he does not own it.**
  - **The seller takes on an obligation.**
- **When selling a call, the trader agrees to deliver the stock at a set price on or before expiration.**
- **This involves a large, potentially unlimited risk, as the price of the stock may rise during the option term.**
- **The seller will be compensated for taking on the obligation; he collects the option premium.**

Reduce the Risk

- **A trader could take advantage of the premium selling strategy while reducing the risk.**
  - **The seller takes on an obligation.**

- **When selling a *call*, the trader agrees to *sell* the stock at the strike price, the market can "call" the stock from him.**

- **When buying a *call*, the trader has the right to *buy* the stock from the market maker at the strike price, he can "call" the stock from the market .**

- **If a trader both sells a call *and* buys a call at different strikes, he has the right to call the stock from the market if it is called away from him.**

The Bear Call Spread

BTO 110 c for $1

Net credit is $1

STO 105 c for $2

Stock 104

Trader receives $1 per share option premium (net credit).
Trader is obligated to deliver the stock at $105 per share.
Trader can obligate the market to sell him the stock for $110 per share.
Risk is $5 minus the premium received and is typically only realized if the stock is above the short strike at expiration.

THE DEBIT SPREAD

Lower The Cost

Advantages

- You are buying option premium at a “discount”.

- Potential for greater reward than risk.

- Can be a low maintenance trade.

Disadvantages

- Limited profit.
- Directional in nature, lower probability trade.
- Cost up front.

Be a Buyer

- A trader can take a directional position by buying a call option (bullish) or a put option (bearish).
- If the underlying stock moves in favor of the trader, profits can be significant.
- Frequently the stock moves against the trader, or moves sideways.
- When this happens, the full risk is limited to the initial price of the option.

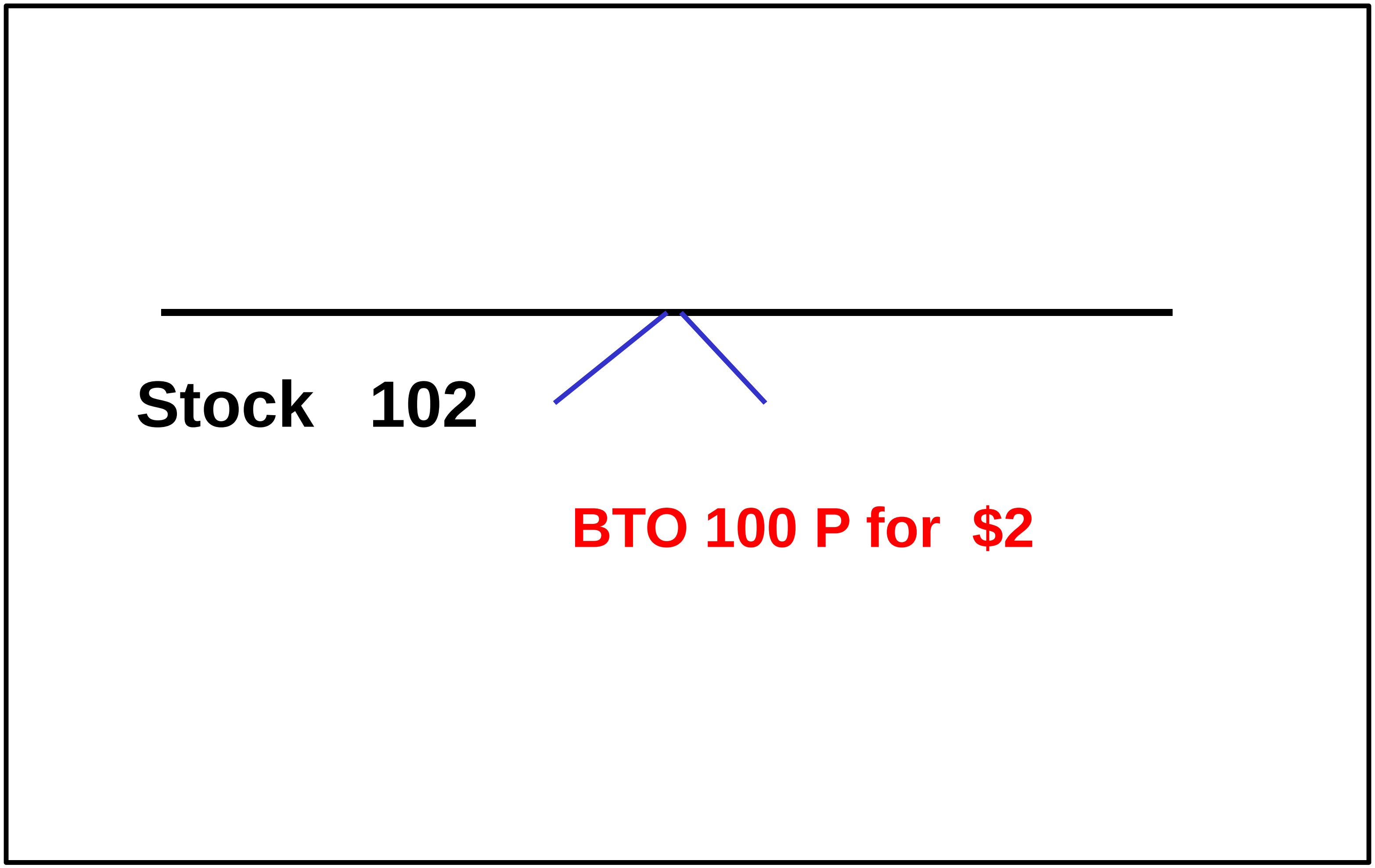
Take on an Obligation

- A trader can sell a put option to the market even if he does not own it.
  - The seller takes on an obligation.
- When selling a put, the trader agrees to buy the stock at the strike price on or before expiration.
- This involves a large risk, potentially the full price of the stock minus the premium.
- The seller will be compensated for taking on the obligation; he collects the option premium.

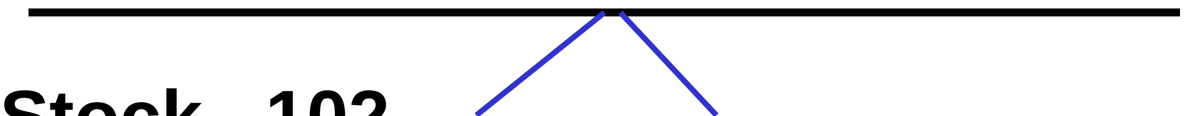
Reduce the Cost; Be a Buyer ***and*** a Seller

- **A trader can take a bearish directional position by buying a put option.**
- **The trader can lower cost and limit profit, selling a put option further out of the money (OTM).**
- **At expiration, both options will be worthless if OTM or will be exercised against each other for a profit..**

Buy the Put



Sell the OTM Put
(The Bear Put Debit Spread)



Stock 102

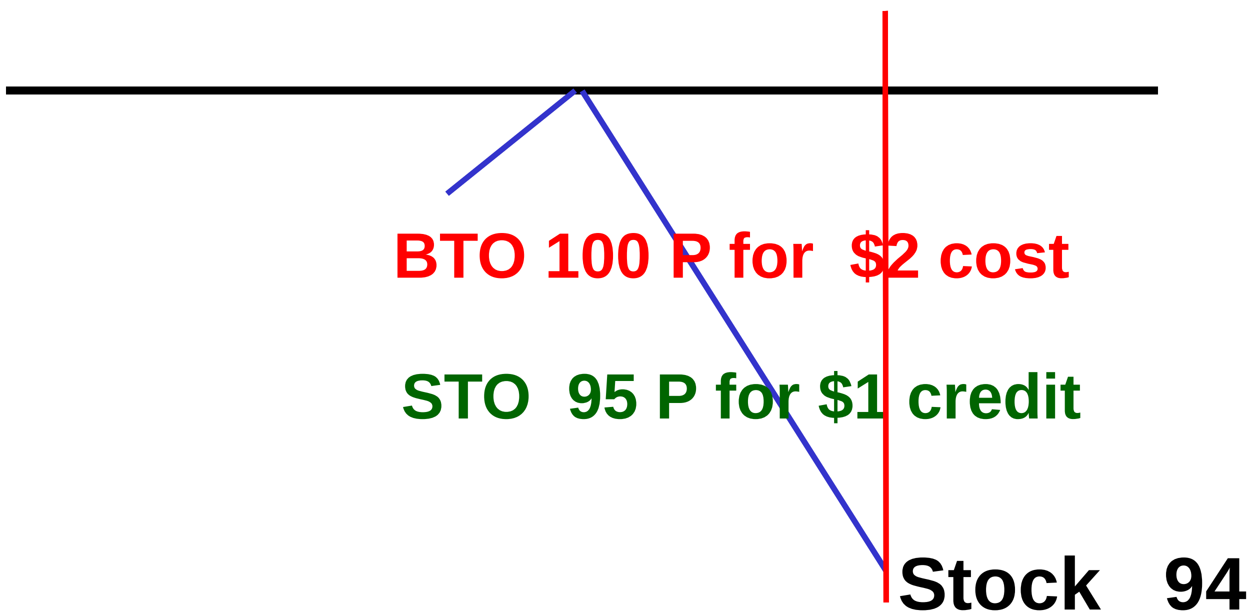
BTO 100 P for $2 cost

Net debit is $1

STO 95 P for $1 credit

At Expiration

The stock is “put” to you at 95
You “put” it to the market maker for 100
The profit is $5 minus the $1 debit = $4



Risk/Reward

- In this example the trader will make the $5 profit minus the $1 debit if the stock is below the short strike at expiration.

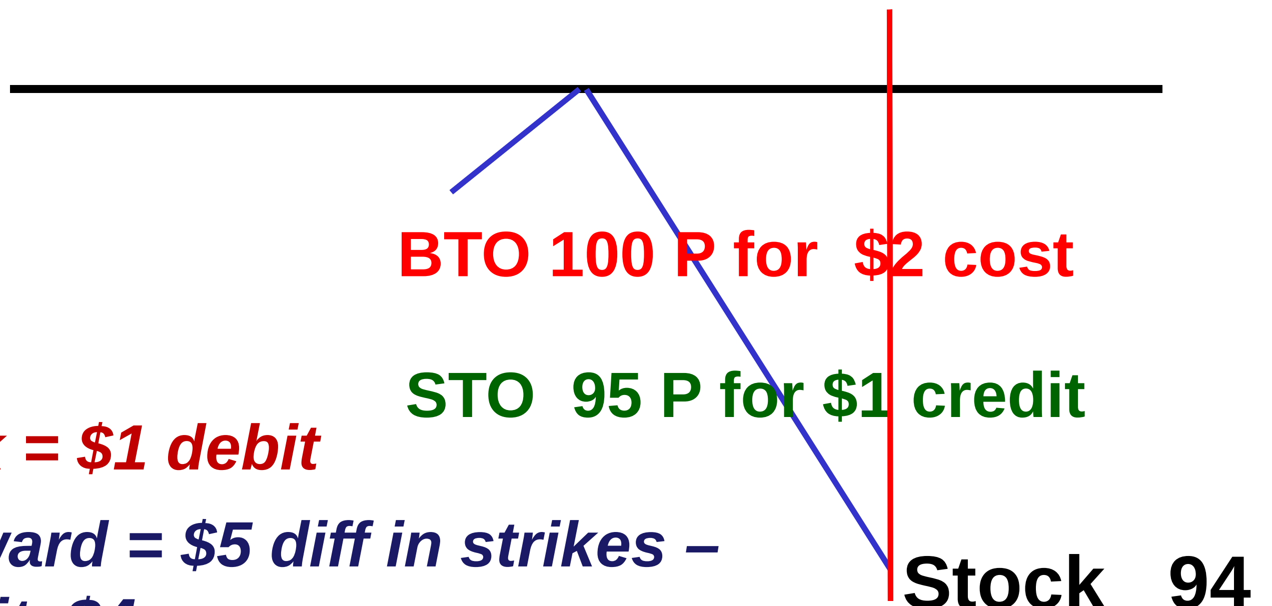
- If the stock price drops below the short strike, the stock will be “put” to him (assigned).

- The trader can exercise the long option to “put” the stock back to the market at the higher strike price (exercise).

- The trade will generate a profit equal to the difference between the strikes minus the debit paid.

At Expiration

The stock is “put” to you at 95
You “put” it to the market maker for 100
The profit is $5 minus the $1 debit = $4



Risk = $1 debit

Reward = $5 diff in strikes – debit $4

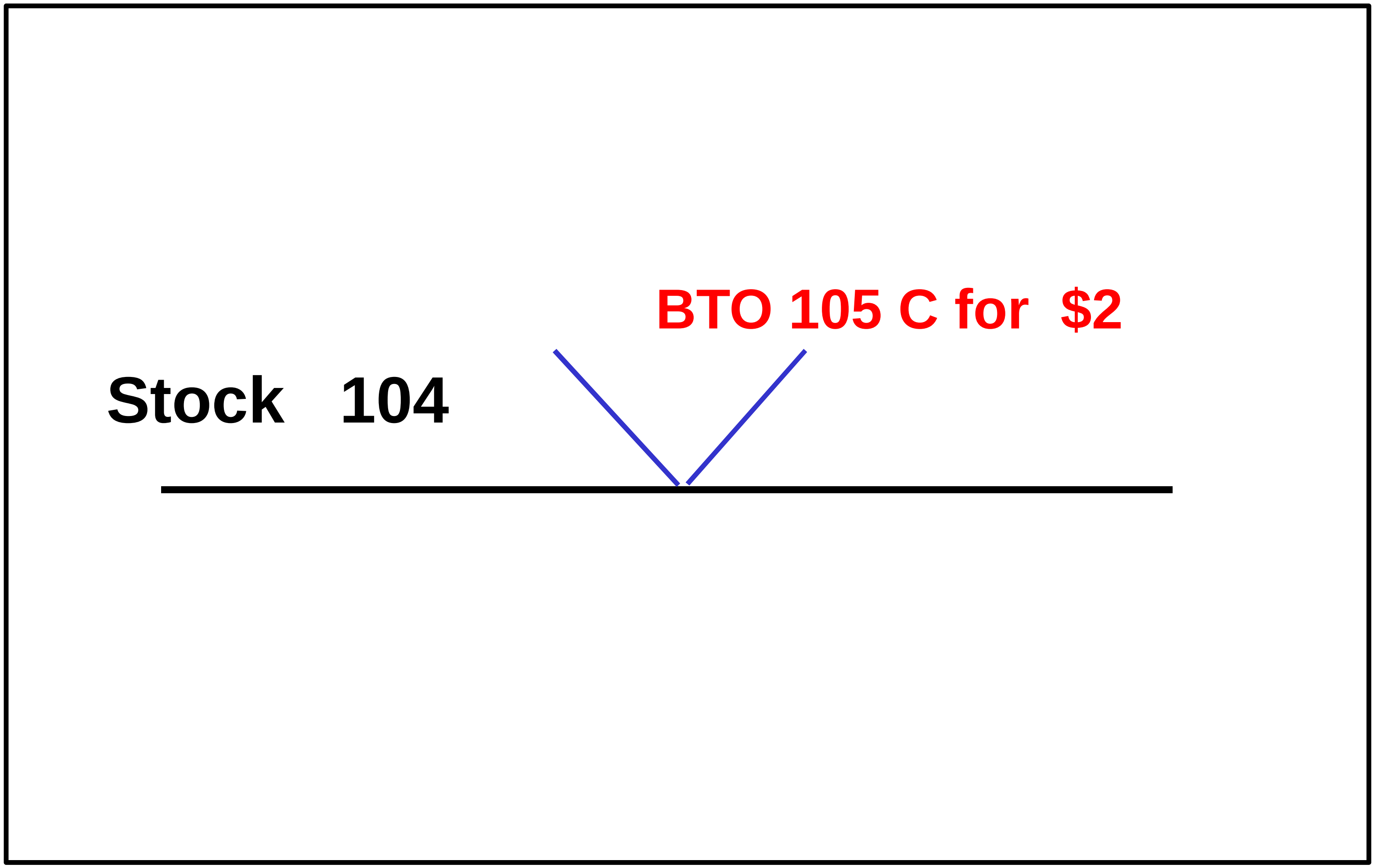
The Same, But Different

- The Bull Call Spread can be used when a trader is bullish on a stock.

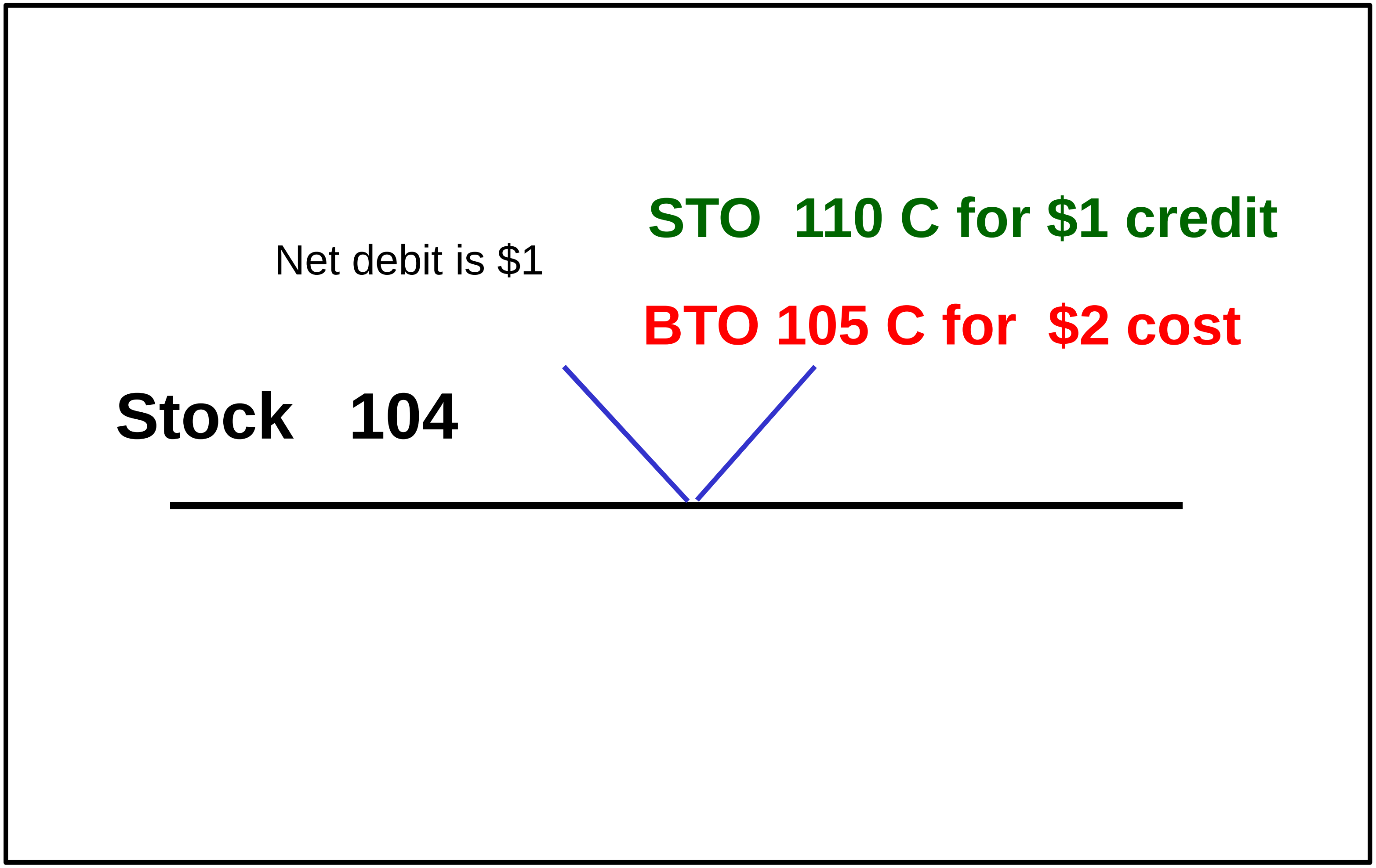
- The cost of a directional call option can be reduced by selling further OTM call option premium.

- The trade is set up in similar fashion and has a similar risk profile.

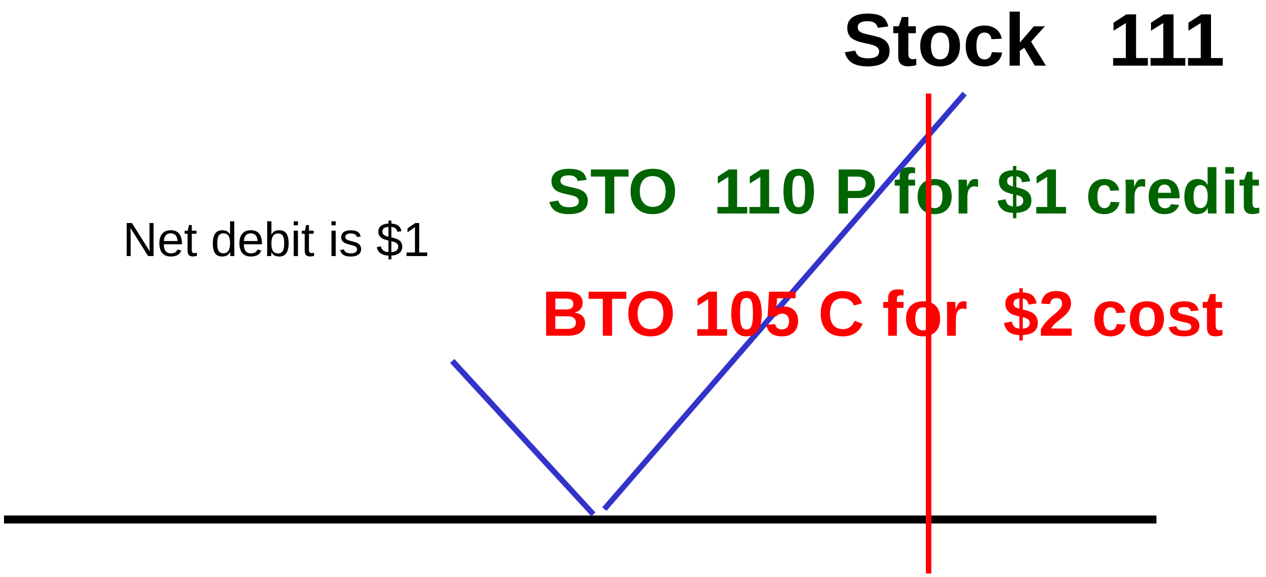
Buy the Call



Sell the Call



At Expiration



The stock is “called away” from you you at 110
You “call” it away from the market maker for 105
The profit is $5 minus the $1 debit = $4

The Debit Spread in Action

- Bull Call Spreads and Bear Put Spreads can be used as a potential risk hedge.

- This allows a savvy trader to possibly take a long option position and convert it to a debit spread if the trade reverses.

- Debit spreads can also be used to take lower cost directional trades on news and earnings.

The Credit Spread as Defense

- Bull Put Spreads and Bear Call Spreads can be used as a potential risk hedge.
- This allows a savvy trader to possibly take a long option position and convert it to a credit spread if the trade reverses direction.
- Timing, knowledge and experience are critical to execution of the hedge strategy.

THE CONDOR

All Together Now

- By Doing the Credit Spread and Debit Spread at the same time on the same stock we create a CONDOR.
- The expirations are all the same.
- The option type is the same.
- This creates a limited risk (smaller) and limited reward (typically larger).

Buy the CONDOR

BTO 125 C for $.10 cost

Net credit is $.50

STO 120 C for $.60credit

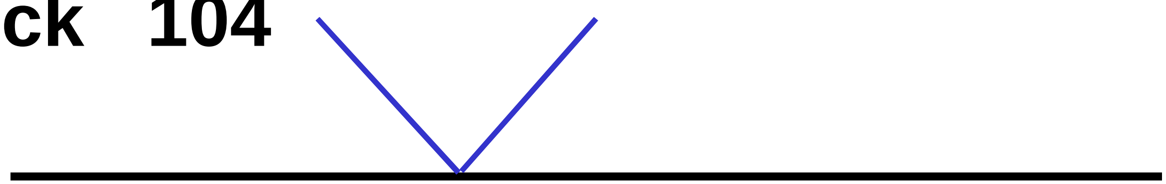
Net debit is now $.50

STO 110 C for $1 credit

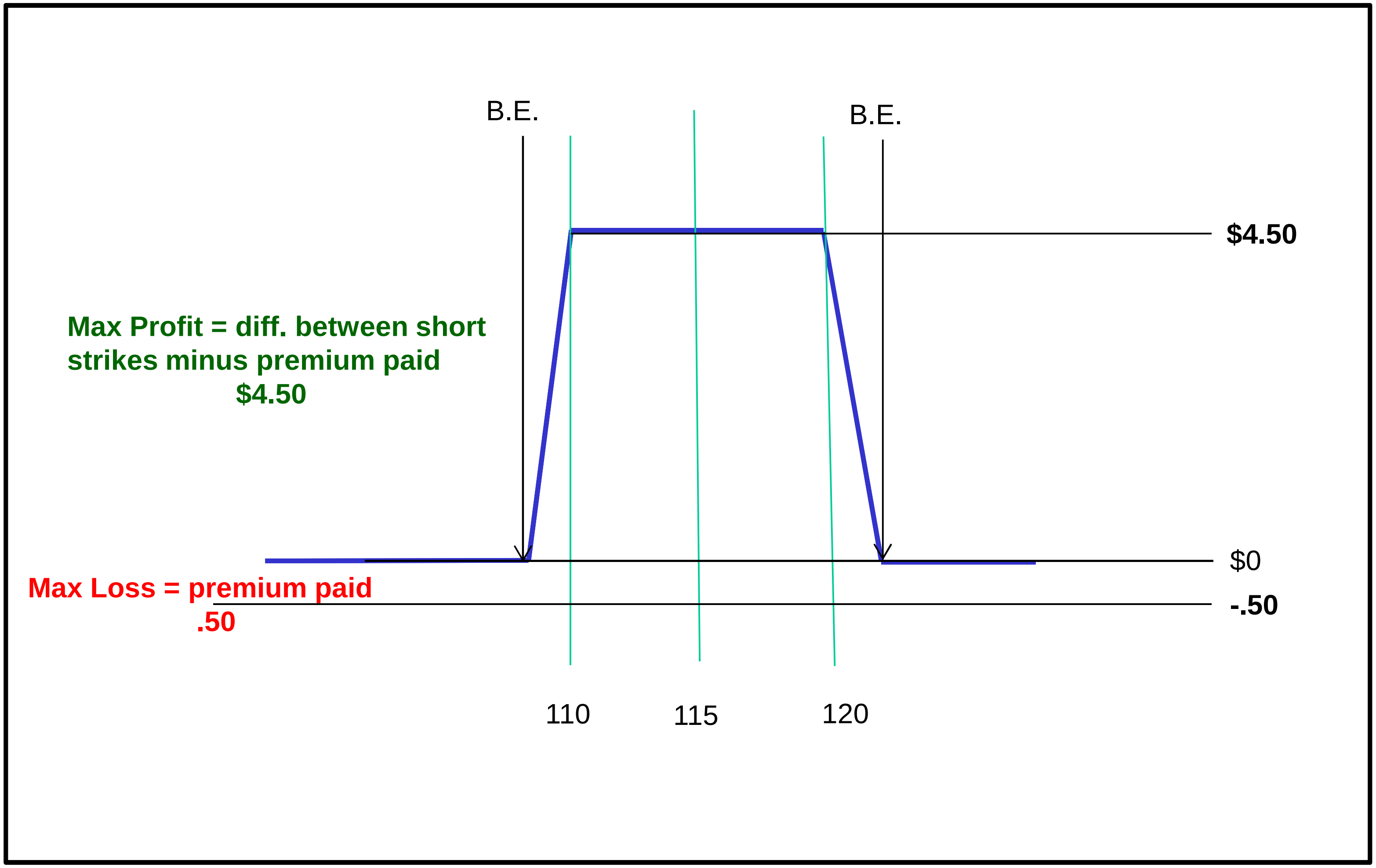
Net debit is $1

BTO 105 C for $2 cost

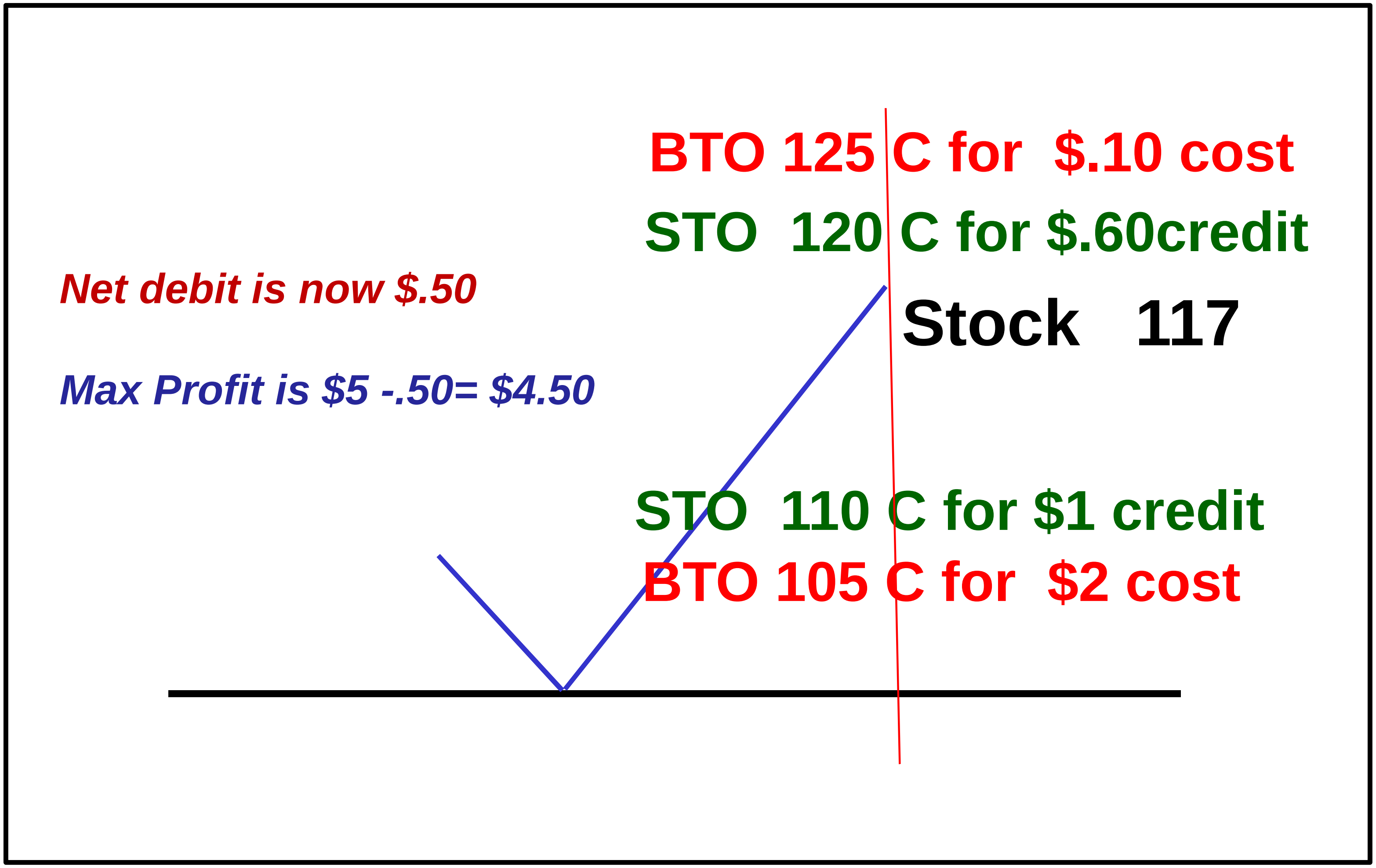
Stock 104



CONDOR Risk/Reward



CONDOR at Expiration



CONDOR Review

- All calls or all puts
- Buy 1 low strike, Sell 1 next strike
- Sell 1 next strike, Buy 1 next strike
- Max Loss = Premium Paid
- Max Profit = Diff. between short strikes minus cost
- Breakeven points (2)
  - short strike + premium
  - short strike - premium

THE BUTTERFLY

Even Closer Together Now!

- By Doing the Credit Spread and Debit Spread at the same time on the same stock we can create a BUTTERFLY.

- The expirations are all the same.

- The option type is the same.

- This creates a limited risk (smaller) and limited reward (typically larger).

Buy the Butterfly

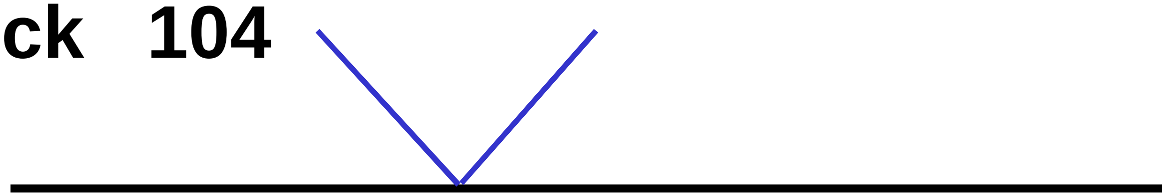
BTO 115 C for $.60 x 1

Net debit is $.60

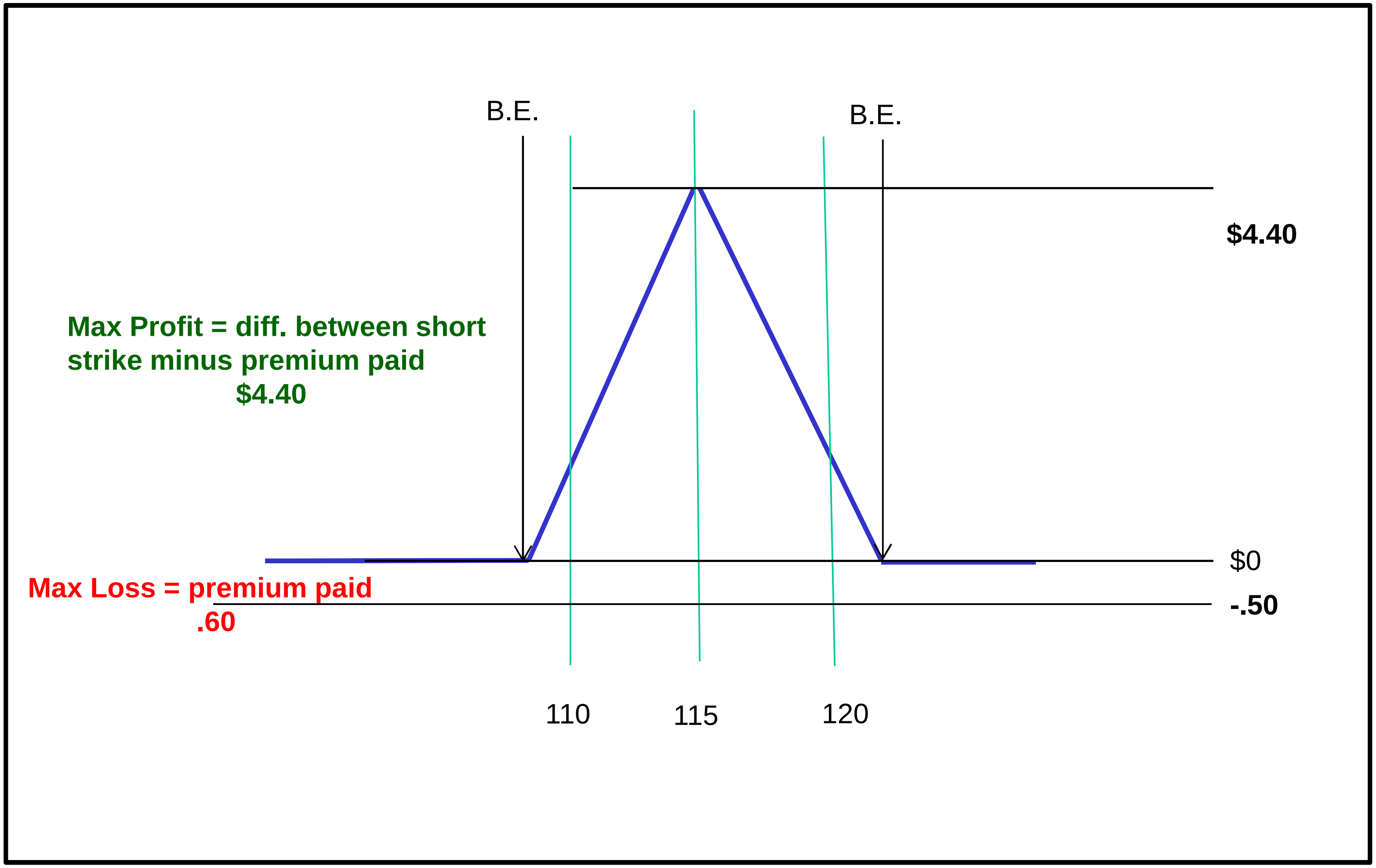
STO 110 C for $1   x 2

BTO 105 C for $2   x 1

Stock   104



BUTTERFLY Risk/Reward



The BUTTERFLY at Expiration

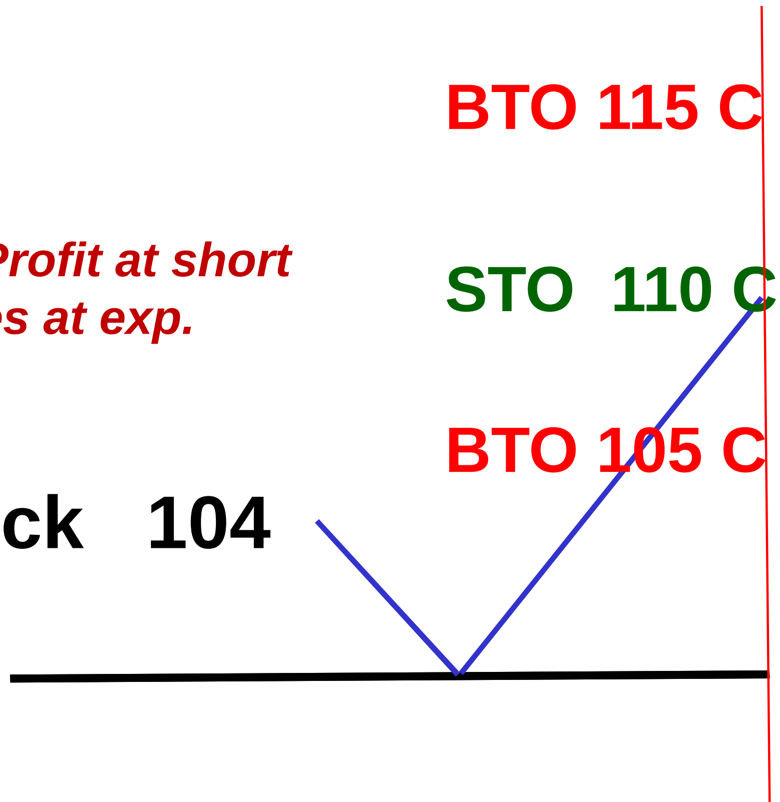
BTO 115 C for $.0 x 1 (-.60)

Max Profit at short Strikes at exp.

STO 110 C for $0   x2 +$2

BTO 105 C for $5   x1 +$3

Stock   104



= $4.40

BUTTERFLY Review

- All calls or all puts
- Buy 1 low strike
- Sell 2 next strike
- Buy 1 next strike
- Max Loss = Premium Paid, if stock above/below
- Max Profit = Diff. between short strikes minus cost
- Breakeven points (2)
  - short strike + premium
  - short strike - premium

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