

Option Debit Spreads

Lesson 4

Beginner Options Teaching Lessons

Debit Spread Trades

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Topics for this Lesson:

Call Spread Trades

Bullish Call Spread Setup – (Bull Call)

Endpoint Definitions

Strategy and Adjustments

Put Spread Trades

Bearish Put Spread Setup – (Bear Put)

Endpoint Definitions

Strategy and Adjustments

Call Spread Trades

Bullish Call Spread Setup

- Bull Call
- Call Vertical

Long call (primary expectation instrument)
Short call (cost reduction & limiting instrument)

- Expectation is a bullish trend
- Both options in the same expiration series
 - Recommend 45 days minimum time for trade trend to develop
- Short call decreases the capital invested in the trade
- Trade risk = net debit
- Maximum Potential Reward: Difference in strike prices minus the net debit
- Primary exit: Close the trade at a percent Return on Investment (ROI)
- Secondary exit: Close the trade at a percent net loss or adjust to another spread trade

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

BUY 19 JUL 19 200 CALL @4.85 + SELL 19 JUL 19 210 CALL @1.31

Results in our Bull Call Spread

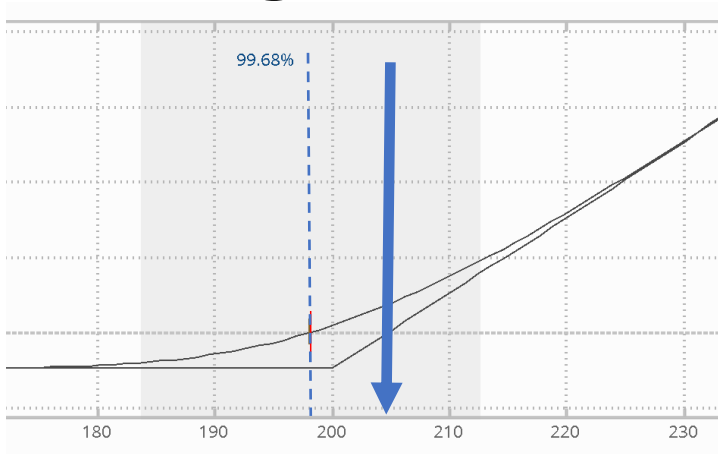
or in a single transaction

BUY VERTICAL AAPL 100 19 JUL 19 200/210 CALL @3.54

- Max Trade risk = net debit
 - \$354
- Max Profit = spread –debit
 - \$1000 - \$354 = \$646
 - For this example that's a 182% ROI

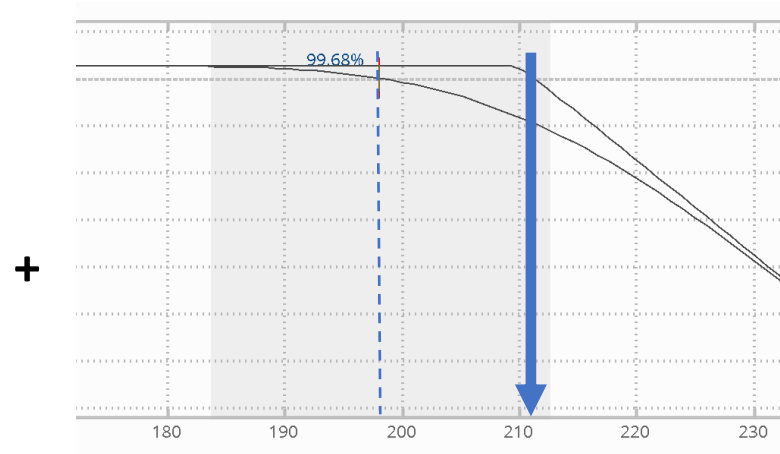
Volume	Open.Int	Bid X	Ask X	Exp	Strike	Bid X	Ask X	Volume	Open.Int
(26) 100									26.81% (
172	6,880	29.20 E	29.70 E	19 JUL 19	170	.32 D	.35 D	1,037	14,748
38	21,181	24.35 N	24.80 E	19 JUL 19	175	.48 N	.50 Q	653	35,426
173	19,381	19.70 X	20.15 W	19 JUL 19	180	.76 P	.80 P	1,297	30,754
224	15,566	15.30 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

Long Call



$$b/e = 200 \text{ strike} + 4.85 \text{ db} = 204.85$$

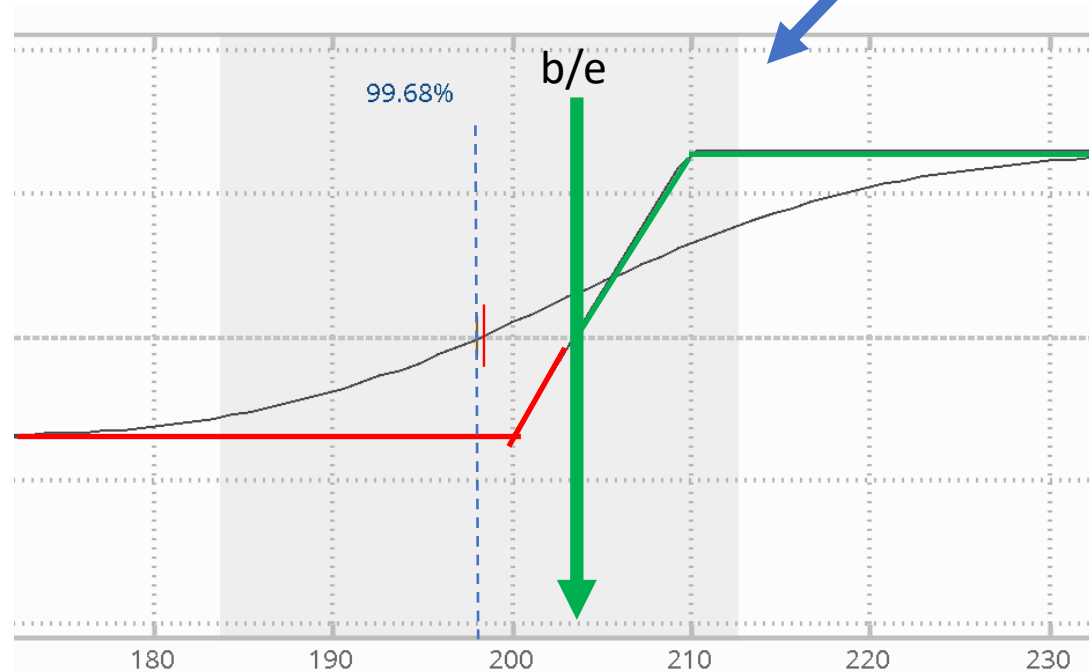
+ Short Call =



+

$$b/e = 210 \text{ strike} + 1.31 \text{ cr} = 211.31$$

Bull Call



How can we achieve max reward in this trade? There are two ways:

1. Wait for options expiration with BOTH options in the money or;
2. Have the short call assigned early. When this happens you are obligated to sell the equity

If you do not own the equity, the broker will loan it to you and you will have a “short equity” position in your portfolio

The broker will want you to cover this short position quickly

You now have a couple of different actions that you could take to cover the short equity position:

1. Exercise your long call and buy the equity

Scenario 1: Equity is at \$220.00. We had a 200/210 bull call for a debit of \$3.40 max profit of \$6.60

we will achieve the reward as calculated

Short call: Sold the equity (exercised) for a credit of \$210.00

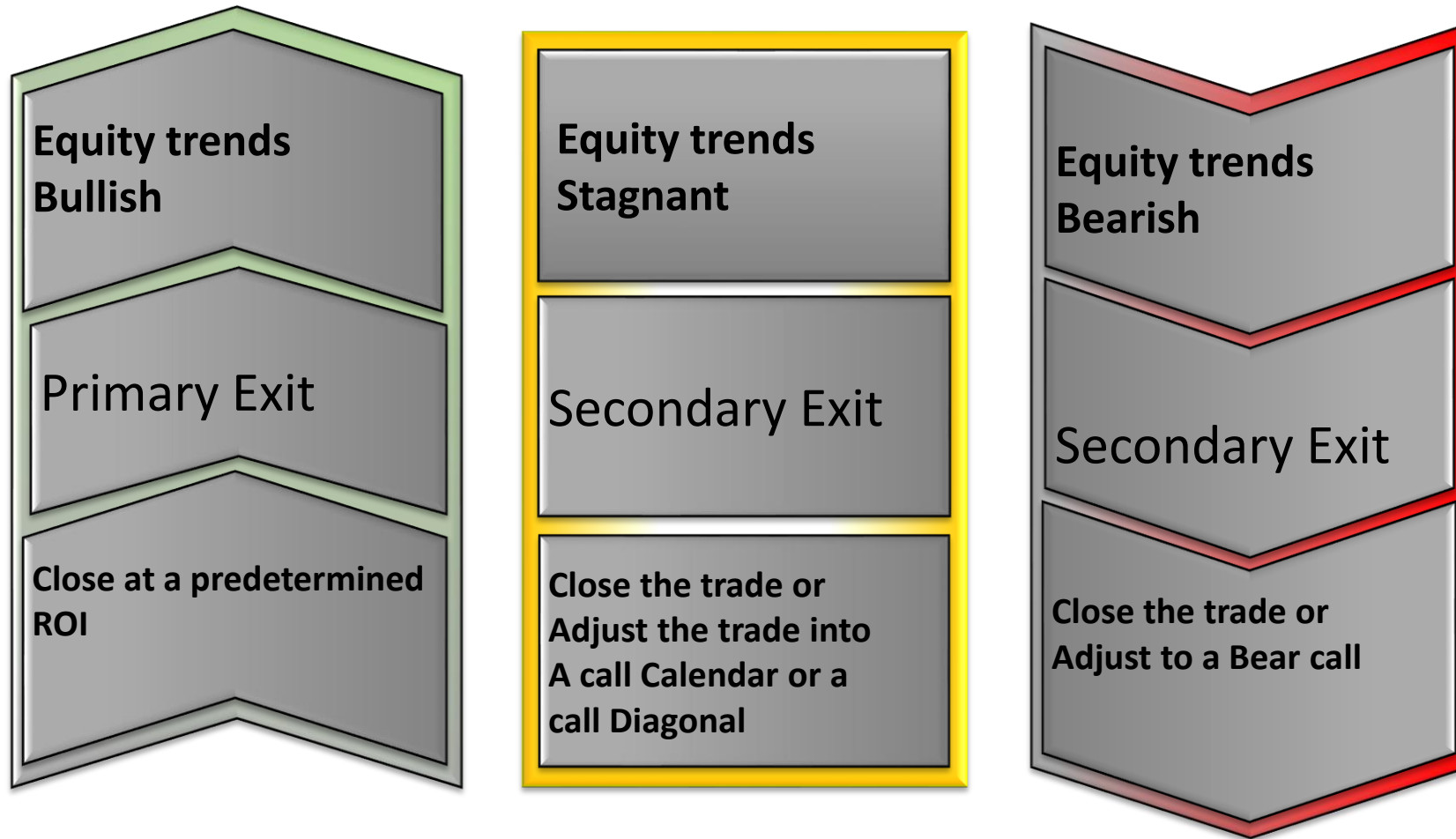
Long call: exercise and purchased the equity for a debit of \$200.00

Initial debit of the trade: \$3.40

$$\$210.00 - 200.00 - 3.40 = \$6.60 \text{ profit}$$

- 2. Evaluate the net result of RESELLING the long option to the market and then buying the equity to satisfy the short call. If this produces a greater return than simply exercising your option, then it is the logical course
 - Scenario 2: Equity is at 220.00, same trade, however, the long call has a bid price of 22.50 (strike 200 long call, equity @ 220.00, \$20.00 of intrinsic value and 2.50 of extrinsic value)
 - Buy the equity to cover the short at \$220.00
 - Short call: Sold (exercised) the equity for \$210.00
 - Long call: sold back to the market for a credit of \$22.50
 - Initial debit of the trade: \$3.40
 - $\$210.00 - 220.00 + 22.50 - 3.40 = \9.10 net profit instead of \$6.60 profit!
 - The difference between the two scenarios is that you CAPTURED the remaining extrinsic value of the long call!

The bull call – Trade Plan



Put Spread Trades

Bearish Put Spread Setup

- Bear Put
- Put Vertical

Long put (primary expectation instrument)
Short put (cost reduction & limiting instrument)

- Expectation is a bearish trend
- Both options in the same expiration series
 - Recommend 45 days minimum time for trade trend to develop
- Short call decreases the capital invested in the trade
- Trade risk = net debit
- Maximum Potential Reward: Difference in strike prices minus the net debit
- Primary exit: Close the trade at a percent Return on Investment (ROI)
- Secondary exit: Close the trade at a percent net loss or adjust to another spread trade

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

BUY 19 JUL 19 195 PUT @3.60 + SELL 19 JUL 19 185 PUT @1.25

Results in our Bear Put Spread

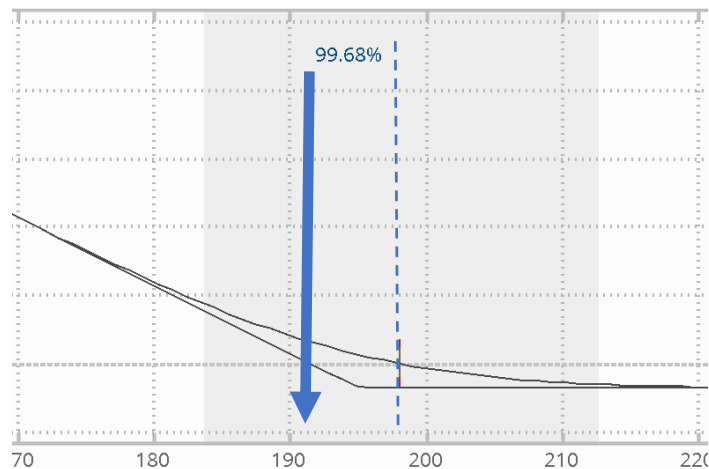
or in a single transaction

BUY VERTICAL AAPL 100 19 JUL 19 195/185 PUT @2.35

- Max Trade risk = net debit
 - \$235
- Max Profit = spread –debit
 - \$1000 - \$235 = \$765

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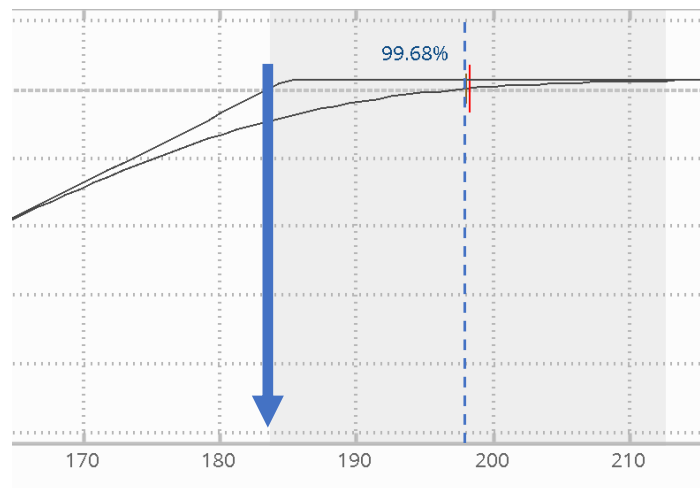
Long Put



b/e = 195 strike - 3.60 db = 192.40

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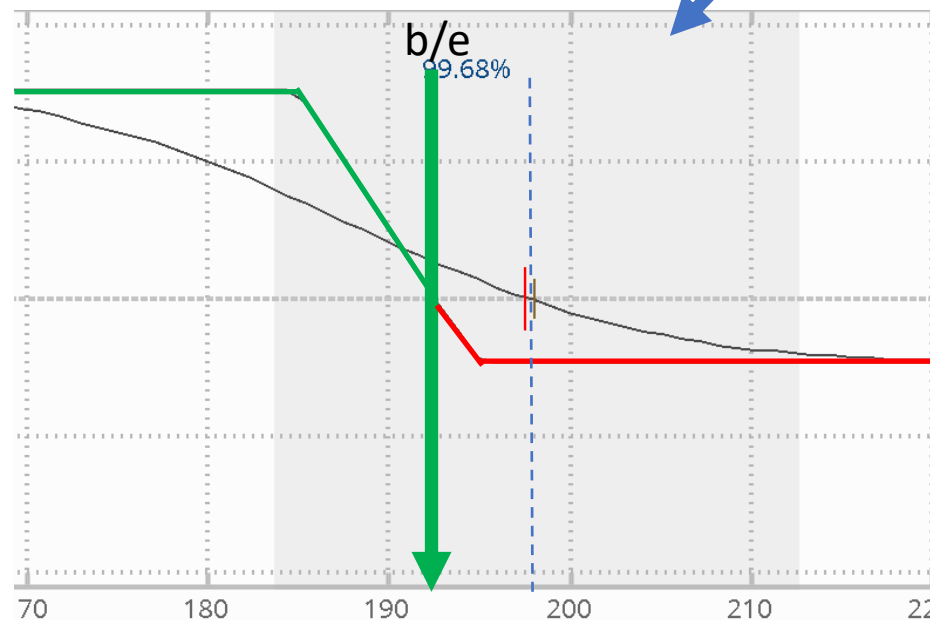
Short Put =



b/e = 185 strike - 1.25 cr = 183.75

+

Bear Put



The bear put – Trade Plan

