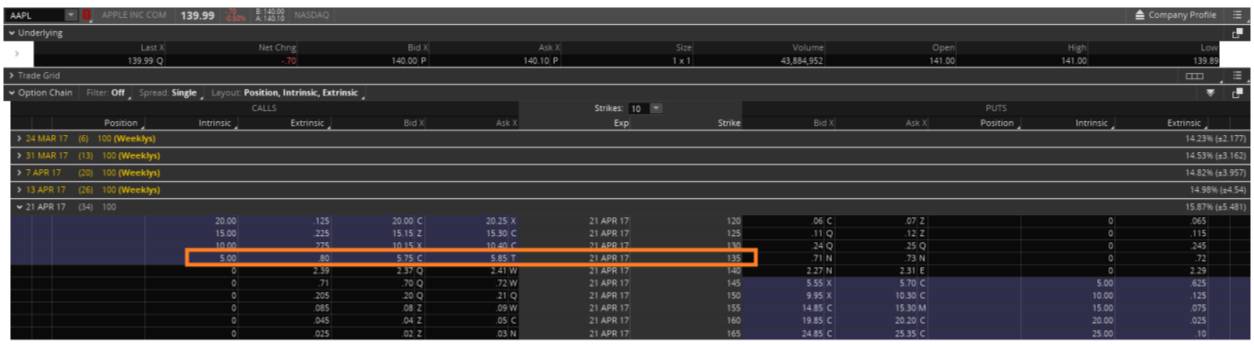
Trading Options and Vertical Spreads

<u>**Buying Vs. Selling options**</u>

Buying call: Buying a straight call option is a long position betting that the security will move higher.

The option buyer will only make money if the stock price moves above the option strike price by more than the extrinsic value.

This is a limited risk trade since the option buyer can only loose the price they paid for this option.



Position	Intrinsic	Extrinsic	Bid X	Ask X	Exp	Strike	Bid X	Ask X	Position	Intrinsic	Extrinsic
	20.00	.125	20.00 C	20.25 X	21 APR 17	120	.06 C	.07 Z		0	.065
	15.00	.225	15.15 Z	15.30 C	21 APR 17	125	.11 Q	.12 Z		0	.115
	10.00	.275	10.15 X	10.40 C	21 APR 17	130	.24 Q	.25 Q		0	.245
	5.00	.80	5.75 C	5.85 T	21 APR 17	135	.71 N	.73 N		0	.72
	0	2.39	2.37 Q	2.41 W	21 APR 17	140	2.27 N	2.31 E		0	2.29
	0	.71	.70 Q	.72 W	21 APR 17	145	5.55 X	5.70 C		5.00	.625
	0	.205	.20 Q	.21 Q	21 APR 17	150	9.95 X	10.30 C		10.00	.125
	0	.085	.08 Z	.09 W	21 APR 17	155	14.85 C	15.30 M		15.00	.075
	0	.045	.04 Z	.05 C	21 APR 17	160	19.85 C	20.20 C		20.00	.025
	0	.025	.02 Z	.03 N	21 APR 17	165	24.85 C	25.35 C		25.00	.10

In the example above you bought AAPL 135 call option for 5.80 which carries an extrinsic value of 80C.

To be profitable AAPL price needs to move higher by more than the extrinsic value.

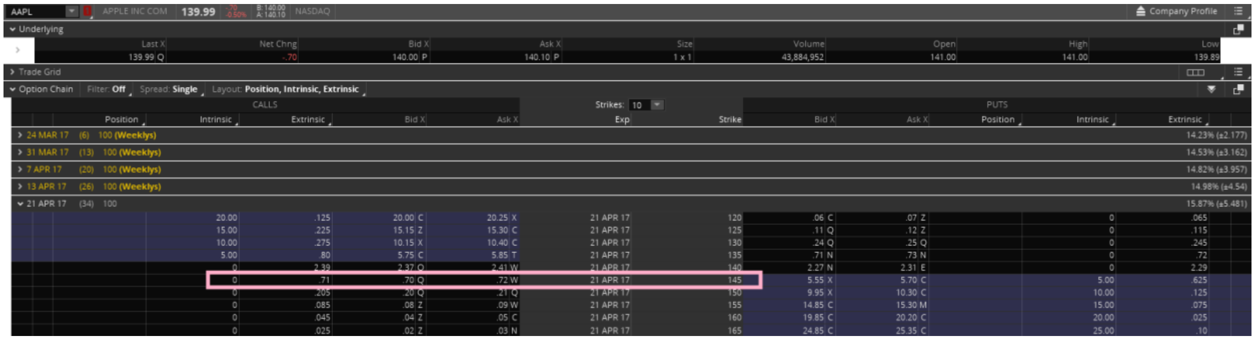
The risk is the 5.80 paid for the option so if AAPL crashes and burn to 100, max lose will be 5.80.

Selling call is often referred to as selling naked call: this is a short position betting that the price of the security will be below the strike price at expiration.

The seller of the option collects the premium and makes money as long as the security price closes below the strike price.

The option allows the owner to benefit if the security moves down, moves sideways, or move up but does not reach the sold strike price.

This is a risky position because the seller stands to lose the difference between the security price and the strike price minus the premium received if the security price is above the strike price.



In the example above you sold AAPL 145 naked call and collected 71C in premium.

To be profitable AAPL will need to stay below your strike price of 145.

Should AAPL price moves above your strike of 145 + 71C premium received then you stand to lose the difference between the stock price and 145.71.

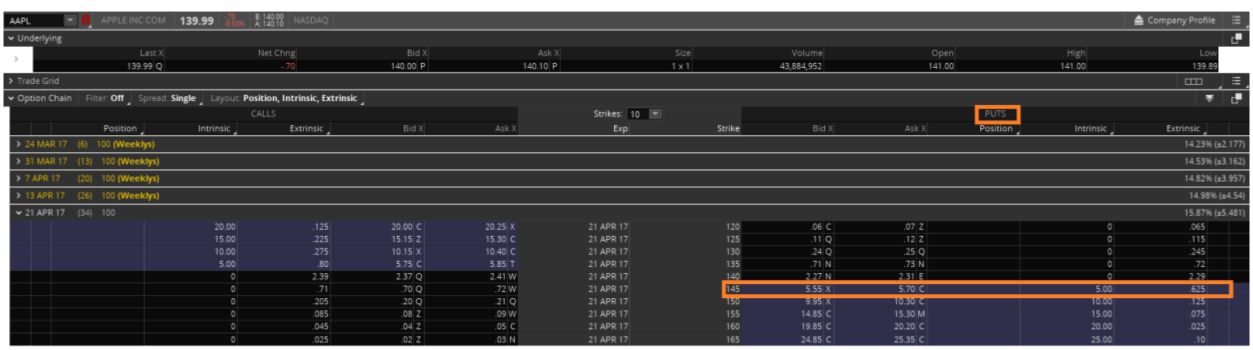
If AAPL moves to 150 then you will lose 150-145.71 or 4.29.

If AAPL moves to 160 then you will lose 160-145.71 or 14.29.

Buying put: Buying a straight put option is a short position betting that the security will move lower.

The option buyer will only make money if the stock price moves below the option strike price by more than the extrinsic value.

This is a limited risk trade since the option buyer can only loose the price they paid for this option.



In the example above you bought AAPL 145 put option for 5.625 which carries an extrinsic value of 62.5C.

To be profitable AAPL price needs to move lower by at more than the extrinsic value.

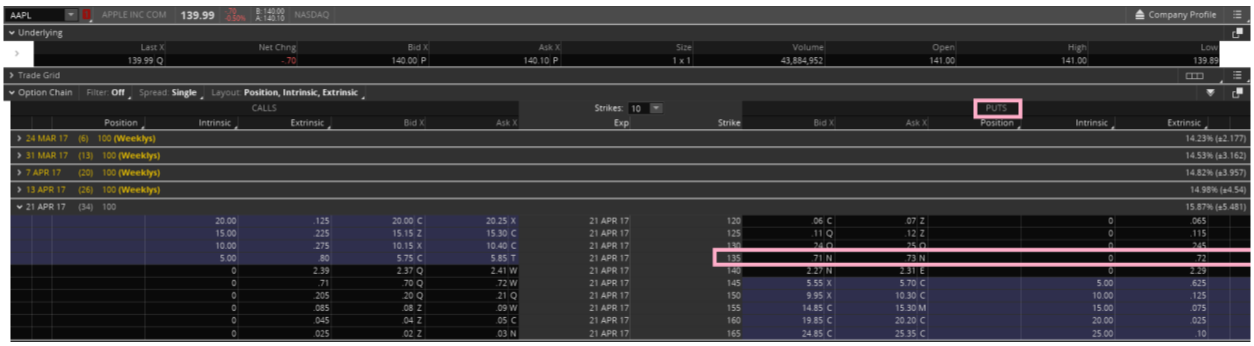
The risk is the 5.625 paid for the option so if AAPL flies to 200 max lose is 5.625.

Selling put is often referred to as selling naked put: this is a long position betting that the price of the security will be above the strike price at expiration.

The seller of the option collects the premium and makes money as long as the security price closes above the strike price.

The option allows the owner to benefit if the security moves up, moves sideways, or move down but does not reach the sold strike price.

This is a risky position because the seller stands to lose the difference between the strike price and the security price minus the premium received if the security price is below the strike price.



In the example above you sold AAPL 135 naked put and collected 72C in premium.

To be profitable AAPL will need to stay above your strike price of 135.

Should AAPL price moves below your strike of 135 - 72C premium received then you stand to lose the difference between the 134.28 and stock price.

If AAPL moves to 130 then you will lose 134.28 - 130 or 4.28.

If AAPL moves to 120 then you will lose 134.28 - 120 or 14.28.

Vertical Spreads

Vertical Spreads involve buying one option and selling another in the same category (+call –call) or (+put –put) with different strike price in the same expiration cycle for the same security.

You will pay for buying an option while receiving credit for selling another.

Vertical spreads are a cheaper alternative to buying a security outright while benefiting from the movement of the security.

Loss and profit from vertical spreads are known immediately upon entering the trade making them a preferred trading method since you know ahead of time your risk and rewards.

Debit Spread

Call Debit Spread (CDS): is a bullish play involves buying a call at a certain strike while selling a call at a higher strike.

Max Risk = the debit you paid for the spread

Max Reward = the difference between the width of the spread and the debit paid for the spread.

Spread	Side	Qty	Symbol	Exp	Strike	Type	Link	Price	Order	TIF	Exchange
VERTICAL	BUY	+1	AAPL	21 APR 17	140	CALL		1.68 LMT	LIMIT	DAY	BEST
	SELL	-1	AAPL	21 APR 17	145	CALL		DEBIT			

In the above example we are buying +140/-145 CDS on AAPL for 21 Apr, 2017 expiration cycle for a debit of 1.68.

This is a $5 wide call debit spread.

Max Risk = Debit Paid = 1.68

Max Reward = 5-1.68 = 3.32

This is a directional play betting that AAPL will move higher.

AAPL will have to be above 141.68 at option expiration for this trade to make money but we don’t usually wait for expiration and will take profit at target.

Put Debit Spread (PDS): is a bearish play involves buying a put at a certain strike while selling a put at a lower strike.

Max Risk = the debit you paid for the spread

Max Reward = the difference between the width of the spread and the debit paid for the spread.

In the above example we are buying +140/-135 PDS on AAPL for 21 Apr, 2017 expiration cycle for a debit of 1.57.

This is a $5 wide put debit spread.

Max Risk = Debit Paid = 1.57

Max Reward = 5-1.57 = 3.43

This is a directional play betting that AAPL will move lower.

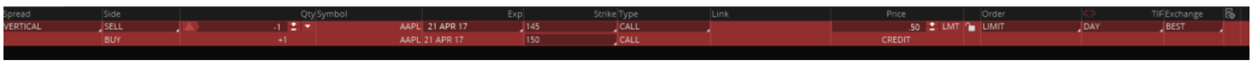
AAPL will have to be below 138.43 at option expiration for this trade to make money but we don’t usually wait for expiration and will take profit at target.

<u>**Credit Spreads**</u>

Call Credit Spread (CCS): is a bearish play involves selling a call at a certain strike while buying a call at a higher strike for protection.

Max Risk = the difference between the width of the spread and the credit received from the spread.

Max Reward = the credit received from the spread



In the above example we are selling -145/+150 CCS on AAPL for 21 Apr, 2017 expiration cycle while receiving a credit of 50C.

This is a $5 wide call credit spread.

Max Risk = 5-.50 = 4.5

Max Reward = credit received = 0.50

There are 3 ways for this trade to be profitable:

1) AAPL moves down.
2) AAPL moves sideways.
3) AAPL moves up but remains under $145 short strike price.

Put Credit Spread (PCS): is a bullish play involves selling a put at a certain strike while buying a put at a lower strike for protection.

Max Risk = the difference between the width of the spread and the credit received from the spread.

Max Reward = the credit received from the spread

In the above example we are selling -135/+130 PCS on AAPL for 21 Apr, 2017 expiration cycle while receiving a credit of 47C.

This is a $5 wide put credit spread.

Max Risk = 5-.47 = 4.53

Max Reward = credit received = 0.47

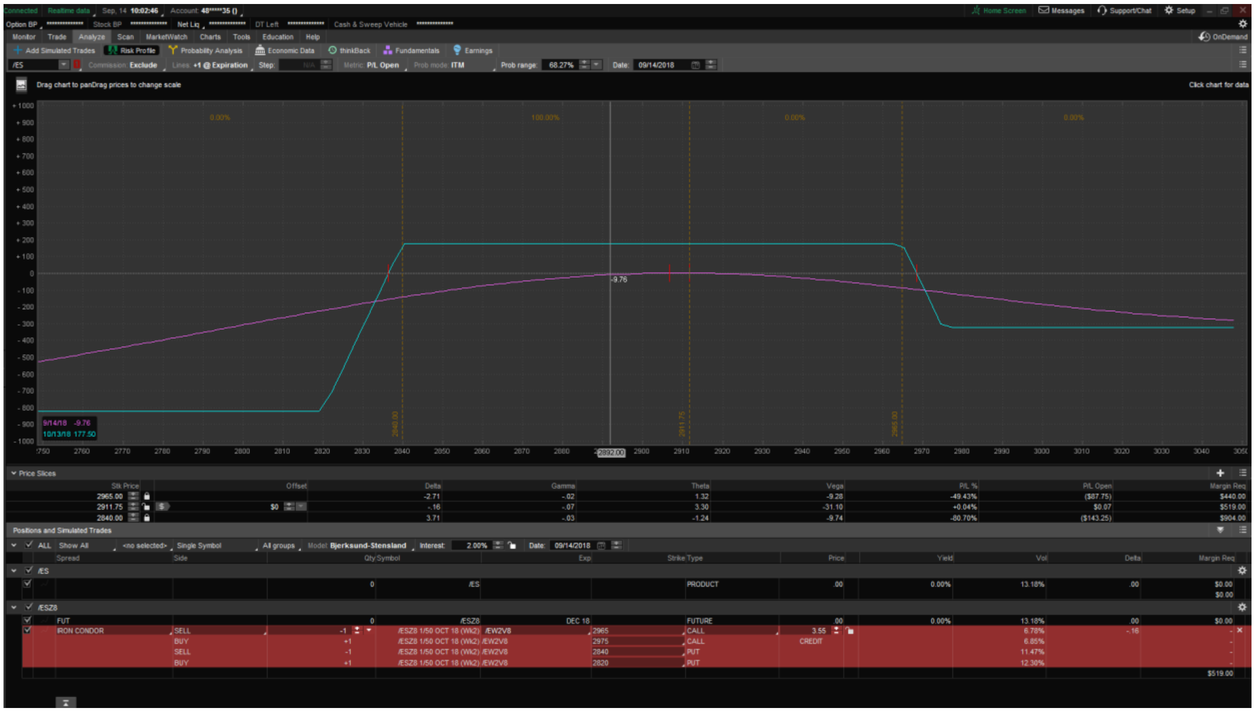
There are 3 ways for this trade to be profitable:

1) AAPL moves up.
2) AAPL moves sideways.
3) AAPL moves down but remains above 135 short strike price.

<u>Complex Strategies</u>

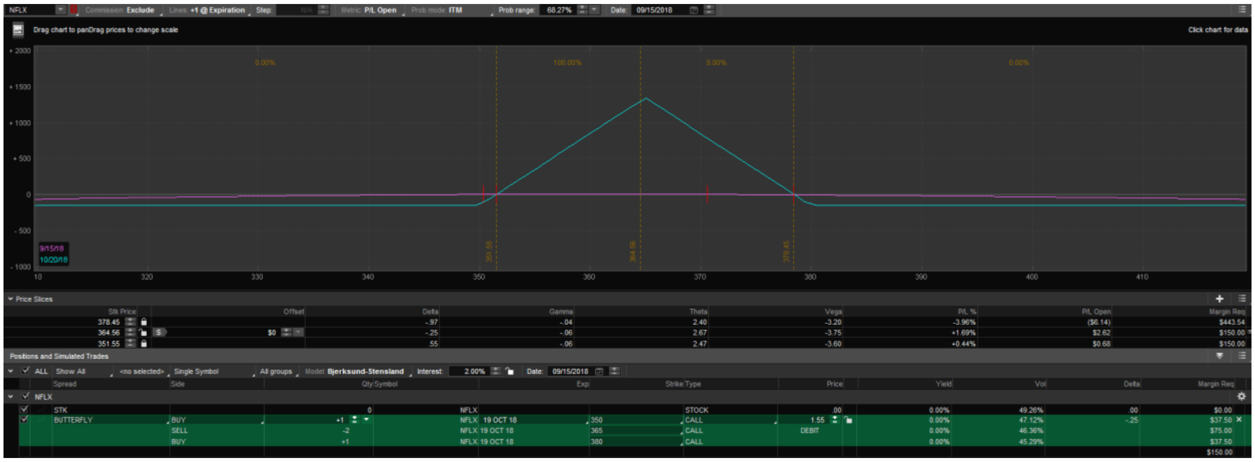
Most complex strategies are combination of vertical spreads.

Iron Condor (IC): Iron Condor is a combination of CCS and PCS creating a strategy that will benefit from premium decay when the underline is trading within a range.

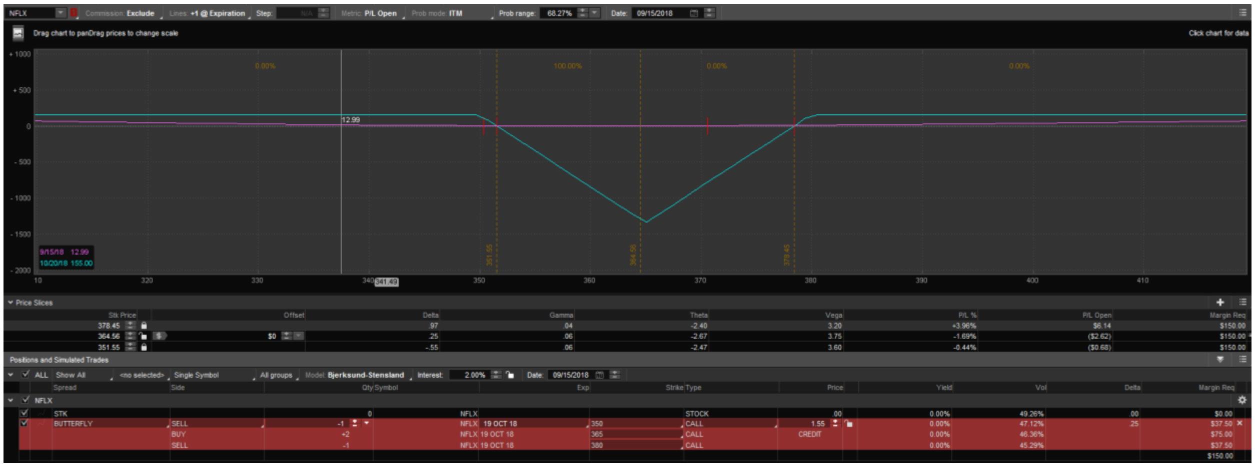


Butterfly:

Buying a butterfly is a low risk/high reward strategy with very low probably of success betting that the underline will expire within the wings of the butterfly. It consist of either 2 CCS or 2 PCS (+1call -2 call +1call) or (+1put -2put +1put).

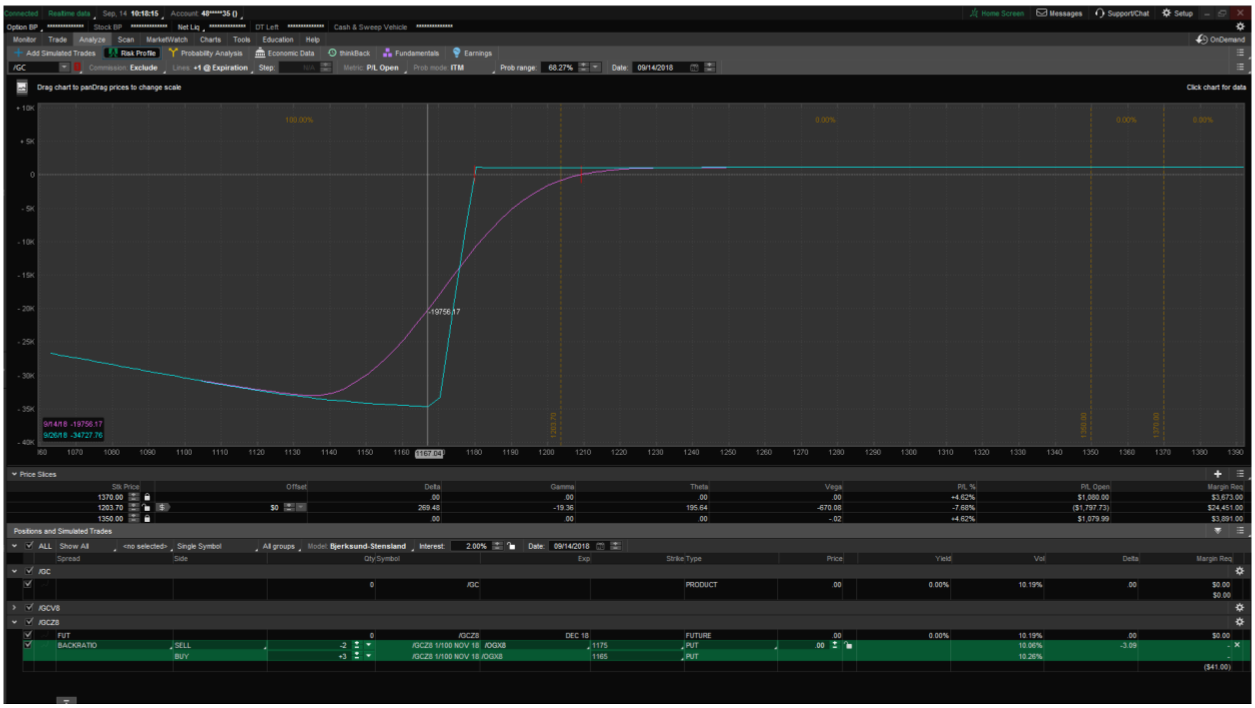


Selling a butterfly is a high risk/low reward strategy with very low probably of success betting that the underline will expire outside the body of the butterfly. It consist of either 2 CDS or 2 PDS (-1call +2 call -1call) or (-1put +2put -1put).



<u>Ratio Spread (RS)</u>: Is unbalanced (-call +call) or (-Put + Put) in the same option expiration where the number of long options is not the same as the numbers of short options.

The following is -2/+3 put ratio spread in Gold.



There many other types of complex spreads but I will only be using the above types in this class.

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