What You Must Know About Option Spread Trading

ETFs

The Lower Risk Strategy Offering Big Potential Gains

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Introduction

Many traders utilize Call and Put purchasing to bank on directional moves in a stock, ETF, index, commodity or currency. Charting, or Technical Analysis, is a great method in which to find the short-term, big, explosive moves and options allow the leverage of a small cash outlay to control hundreds of shares of stock.

However, there is an additional lesser-known strategy that is a complement/replacement for Call and Put buying. In many cases, this can be a more attractive alternative for many investors and traders. We're referring to Debit Spreads (also known as Vertical Spreads, Bull Call Spreads/Bear Put Spreads).

A Debit Spread is known as such because there is a cash outlay for the trade, similar to purchasing a Call or Put. However, you are also selling another option in the same underlying instrument and same expiration (month or week), but with a different strike price. For a bullish spread, you are buying one Call and selling another Call with a higher strike price against it. This is done simultaneously as a spread order and we do this with a limit-price entry. We pay a certain price (or debit) for this trade, just as you would with buying a Call or Put, but with significant differences and advantages to the 'two-legged' trade.

First, let's explore what types of options we like to purchase when we anticipate a big, short-term directional trend move, and what types of options to sell against it to form a debit spread:

In The Money

Most beginner options traders will start with Covered Calls and for speculation will purchase the very "cheap" options that are under $1.00 ($100), for example. These 'lottery ticket' options seem attractive because of the small cash outlay and potential big gains. However, at BigTrends we have many years of combined options trading experience, both from the retail and institutional/market-maker side, and we disagree.

We normally prefer using In-the-Money (ITM) Calls and Puts when we purchase options. Why? There are several factors, most notably that ITM options have a higher Delta and lower time premium. This means that when compared to Out-of-the-Money (OTM) options, they move more for each point that the underlying stock/ETF moves. It also means that the effect of time decay and volatility erosion is less in the pricing.

At the same time we realize that many traders do not want or cannot afford to pay more than $10 ($1000) for options. They want to be able to buy multiple contracts of a trade idea and perhaps close half the contracts when 50% or 100% profit is reached. With a very expensive ITM option, many retail investors aren't able to buy the multiple contracts for a position that they would desire.

As a rule of thumb, we prefer to place trades that cost under $6 ($600) or so – preferably less than that in most instances. Thus, we tend to drift to the ITM options with a high Delta and low time premium (high intrinsic value), but that are also reasonably priced on a real cash basis.

A Sale For Every Buy

We have already determined that we must have a definite strong directional trend signal (using technical analysis and systemized trading rules) and know that an ITM Call or Put is an effective leveraging technique in order to target big gains in short time frames. Here, we add a second layer to the initial trade in the form of making it a debit spread.

Again, this is done as one limit order (we don't recommend market orders for spreads) and can easily be placed with your broker or on your trading platform. Make sure your account is approved for Debit (and Credit) Spread trading, something simple to achieve since these are limited-risk trades.

In a Debit Spread, all you can lose is your cash outlay – exactly the same as straight Call and Put buying. All the broker will require in terms of margin or cash is the initial debit you pay. We are both buying and selling an option at the same time (again the same expiration date but different strike prices) – this offers several advantages to regular Call and Put purchasing that we'll delve into later in this report.

First, we want to mention the importance of incorporating premium selling strategies into your options trading portfolio. It's important to remember that for every option buyer, there is a seller of that exact contract – generally it will be a Market Maker on the other side of the trade. And, just as you don't always want to be Bullish (or Bearish) in your trading, you don't always want to be buying options and paying for time premium.

By selling an option against our purchase to form a limited-risk Debit Spread, we're incorporating option selling into our trading. Just as we prefer deep ITM option buying, we also prefer to sell Out-of-the-Money (OTM) (and sometimes At-the-Money (ATM)) options against that. **Those OTM options are basically made up of time premium which is composed of Vega/volatility and Theta/time decay.**

With a debit spread strategy as we outline, we gain the benefit of selling an option in a limited-risk environment. But what other benefits does this strategy offer and how does it differ from a straight option purchase in terms of risk/reward?

Cash Discount With Healthy Profits

Everybody likes a discount – whether it's real or perceived. For example, how many shoppers buy more because of the 20% off sale in a mall department store? The bottom line is that everyone prefers to have a smaller cash outlay when making a trade.

Our method of Debit Spread trading offers exactly this. Because we are both buying and selling an option at the same time, we lower the cost versus just buying an option outright. But how much cheaper is it?

An unwritten rule to follow is that generally, our Buy ITM/Sell OTM debit spreads give a 10% or more 'cash discount' – the smaller cash out-of-pocket per spread/contract can be as much as 30% or more in some cases. This allows a trader to either put out less cash/risk for a particular trade or buy more contracts than they normally would.

As an example, in ***BigTrends ETF Tradr*** (which offers real-time option trade recommendations to subscribers) our five most recent debit spread trade recommendations, at the time of this publication, offered cash discounts of 26%, 20%, 40%, 20% and 11% versus if we had just bought a Call or Put. This means less risk/less cash out of your pocket on each trade you make!

Using the 26% cash discount real-life example, in a recent trade, our subscribers bought an ITM Call for 3.40 ($340) and simultaneously sold an OTM Call against it for 0.90 ($90). The net cost, or debit, of this trade was a limit price of 2.50 ($250 per spread.)

Arising from this, what is the maximum profit?

Simply, it's the difference between the strike prices minus the debit paid. In this example it was a 125/130 Call Spread (same expiration month). The maximum this spread can be worth is 5.00 ($500) and we paid 2.50 – thus, the maximum profit potential in this example is 100%, not including commissions. In addition to 'saving' $90 per contract by doing a spread instead of just buying the Call, we also have a gain potential of 100%. Also, we have lessened the overall volatility of the position because we sold an option in addition to buying one. More on this later…

In this example, we bought the 125/130 Call Spread for 2.50. We are basically 'synthetically long' at 127.50 – and guess where the underlying ETF was at the time? Right around 127.50!

What does this mean and what are the repercussions?

Synthetically Speaking

We refer to synthetic long or short positions here – the debit spread trades we recommend are not pure synthetics by the financial dictionary definition of the word. Basically, we're referring to the cost basis entry price. The easy guideline is to use the debit paid and add it to the strike price (for Call Spreads) or subtract it from the strike price (for Put Spreads.)

In the example we cite above, we bought a monthly 125/130 Call Spread for 2.50. Our cost-basis or synthetic long price is 127.50. With the underlying instrument at 127.50, this means ZERO time premium was paid on the spread.

The reason we compare this to a synthetic long is that we are buying a deep ITM option with a high Delta (usually in the 60 to 90 range) and selling an OTM option with a lower Delta (usually in the 10 to 30 range) all comprised of time premium. The net effect is that we are long Delta and short time premium in most cases on a bullish spread. For a bearish Put spread, we're short Delta and again short time premium.

If we do enter around the intrinsic value (or even less in some cases), then if the stock remains flat over time (or even goes slightly against us), we can often still make gains (or avoid losses) because the time decay of the OTM option sold is rapid compared to the smaller amount of premium decay of the ITM option purchased.

This also holds true when a position moves our way quickly. We will reap some gains in the position when this occurs, and actually will gain more over time as the option with more premium in it (the one we have sold) decays as it approaches expiration.

In some cases, if a stock/ETF blows through our key strike price that we've sold (in the case of a bullish spread the higher strike), we may look to 'lock up' profits on that spread and 'roll up' to a higher spread within the same expiration cycle. Other times, if a position is profitable as we approach expiration (we generally will not place new orders within two weeks of an approaching expiration owing to our ETF Tradr Daily Chart based system), then we will 'roll out' the spread by taking profits on the current month and placing a new order for a further-out monthly expiration.

Generally, in addition to the cash discount that we discussed previously, we're looking for our debit spread recommendations to find an optimal price paid versus maximum profit potential ratio. We prefer to pay as close to the pure intrinsic value as possible for the overall spread (near zero time premium), while still having gain potential in the 50% to 200% range.

This maximum gain potential on a spread is another big difference with straight Call or Put buying.

Profits, Profits, Profits

With all the benefits we've described above in Call/Put Debit Spread trading, is there any big difference when compared to straight Call/Put purchasing? The answer is yes. The biggest distinction is that our maximum profit on a spread trade is capped. For a regular Call/Put, this is unlimited.

With option trading, every strategy you undertake has different aspects in terms of risk/reward. In the case of debit spreads, our maximum profit is the difference between the strike prices minus the premium paid.

HOWEVER, as we mentioned, we target gains in the 50% to 200% region on our debit spread recommendations. The trade-off of the benefits received (less cash out of pocket, less volatility due to buying and selling simultaneously, time decay working in your favor and a lowered cost basis) combined with a still strong profit profile makes this strategy very attractive in our view. Remember that we are generally holding trades for one week to one month to achieve these gains – so we're still getting the quick bang and leverage of options trading.

Below are the numbers to back this up. These are actual profits from ETF Tradr positions closed in 2011. Each is based on the reported fill price data provided by brokers auto-trading our services and do include a base commission structure:

RKH Straight Call	40% gain
EWZ Put Spread	72% gain
IWM Call Spread	42% gain
SLV Call Spread	70% gain
GLD Call Spread	61% gain

FXI Call Spread	1% gain
XRT Straight Call	34% gain
GLD Call Spread	44% gain
XLE Call Spread	11% gain
XLI Straight Put	39% gain
RKH Put Spread	81% gain
FXE Call Spread	4% gain
GLD Call Spread	74% gain
XLI Straight Put	71% gain
SLV Call Spread	54% gain
EFA Put Spread	89% gain
SMH Put Spread	6% gain

Note that we do, at times, give Straight Call/Put recommendations when a spread trade is not as attractive, or our expectation for the underlying move is limited. However, the profits achieved on Spreads have been roughly the same as Straight option trades. When you consider the other benefits of debit spreads, you can see for yourself why we love this strategy.

Also note that we have successfully traded the same underlying security throughout the year multiple times – Gold ETF (GLD) for example. This is the technique of 'rolling up' or 'rolling out' that we discussed earlier and is due to the fact that our ETF Tradr system signals can remain in a bullish/bearish mode for some time (in some cases one to two months or potentially longer).

Real-Life Case Study

There are many examples to show how our ETF Tradr system finds the ETFs poised for big directional moves and how we apply our Debit Spread trading strategy to target big potential gains with a cash discount.

Here is one in-depth example we analyzed for our clients on the BigTrends.com website:

"We recently had a bearish Put Debit Spread (some of you may know this as a Vertical Put Spread) trade recommendation in ETF Tradr that I wanted to do a little post-mortem on today. On the first half of the trade we took 43% profits in 1 day, and we closed the remainder of the trade for 100% profits on Thursday.

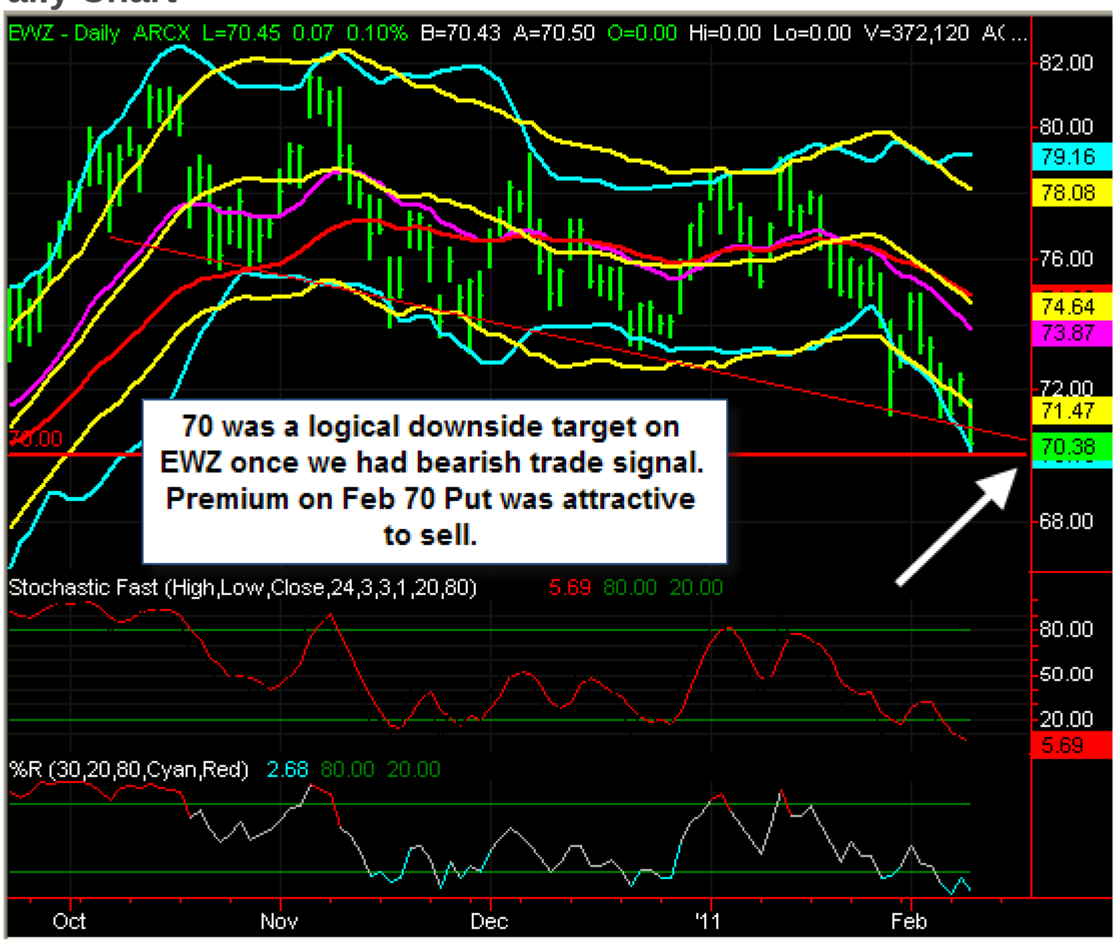
Actual EWZ Trade on ETF Tradr Position Table

ETFTRADR SPREADS						
Entry Date	Options Traded	Entry	Current	Key Level	% Δ	Exit Date
02/02/11	Bought EWZ Feb 78/70 Put Spread 1/4 Position	3.20	4.60	72.79	43.75%	02/03/11
02/02/11	Bought EWZ Feb 78/70 Put Spread 1/4 Position	3.20	6.40	72.79	100.00%	02/09/11

The trade signal was based on our Daily ETF Tradr system, which incorporates a smoothed optimized Stochastics (similar, but a bit different than Percent R), Exponential Moving Averages and Negative Volume Index. We focus on a key group of less than 30 liquid ETFs in a variety of manners — with special attention paid to having ETFs in the screen list that differ in terms of trading performance (aka don't all move in tandem).

Anyway, our bearish EWZ signal was confirmed for February 2nd. We decided to go for a February Debit Spread on EWZ, rather than just a straight Put Purchase, due to the higher price/higher volatility of the ETF and its options. Selling a lower Put against the one we purchased lowers the overall out-of-pocket cost and also effectively gives us a synthetic entry point below the intrinsic value of the higher Put.

EWZ Daily Chart



We received an excellent question from a subscriber on the day of the trade about why we chose to do this Debit Spread instead of a straight Put purchase — here is some of the response that went to all the ETF Tradr subscribers in the Daily Portfolio Update.

For more information on our ETFTradr Advisory Service, click here.

From the February 2, 2011 ETF Tradr Portfolio Update:

"We had a great subscriber question today about why we chose to do a Debit Spread on EWZ rather than just buying the Feb 78 Put and other aspects of the trade — here is some of the trade choice rationale for all of our ETF Tradr clients. First, if you are unable or do not desire to trade the spreads, you are welcome on your own to purchase a single option outright when those recommendations come in (but for auto-traders it will be executed as listed on the alert).

In this case, with a higher-priced and more volatile ETF as we mentioned, we first lower the cost out-of-pocket by simultaneously buying one Put and selling another against it in one spread trade. In today's trade, we lowered the cost of the trade by over 10% by doing the Spread versus the straight Put. Therefore, we have limited our maximum profit on the trade by doing this … the most this spread can be worth is $8 (78 minus 70 spread). However, with only paying $3.20 for the spread, our maximum profit is still a very healthy 150% or $4.80 (8 minus 3.2).

Additionally, we lowered the "synthetic" cost of our bearish entry level on this position to about 74.8 (based on the average price our auto-traders were filled of 3.2), while EWZ was at the time at 74.83 or so. Basically, the spread allowed us to the do the trade for no time premium in the options – and we like that. As for closing out the trade … these spreads should be done as 1 single trade. When we close it out, we close out both legs also as a single trade.

This one moved quickly in our favor and is already over 20% + profitable as of today's prices. If EWZ moves right down to the 70 level, a spread could potentially get a bit trickier than a normal Put, depending on how far we are from Expiration … but the premium on the 70 Put that we sold will eventually erode, and there is very little premium on the 78 Put that we purchased.

Just a few educational notes on our perspective of why spreads are very attractive at times and are a part of the current ETF Tradr portfolio."

With Debit Spreads (our preferred method is to buy a deep in-the-money ITM option and sell an at-the-money ATM or out-of-the-money OTM option), you can make a strong profit (but the maximum gain is less than outright Call/Put purchase), lower your out-of-pocket cost and get into a position for little or no time premium. There is risk on virtually every options trade, of course, no matter what strategy you employ."

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Please visit www.BigTrends.com for up-to-date market information, trader education and trade advisory services to suit every active trader. Please address any questions to ClientCare@BigTrends.com or call 800 244 8736. We're here to assist you in reaching your trading goals.

Trade well!
Price Headley and the BigTrends Staff