My Top 5 Rules for Successful Debit Spread Trading

Trade with Lower Cost and
Create More Consistency in Your Options Portfolio

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How Debit Spreads Give You Growth AND Income Potential

If you've ever bought an option before, you know that one of the challenges of trading a time-limited asset is paying a "time premium" and overcoming the loss of time. And yet as a trader, I still see plenty of opportunities to take advantage of trends on various time frames, from quick moves over a few days to "swing trading" moves over several weeks. So how can you actually place time on your side in the options game? It's not by just selling options, as that can be profitable, but many traders have seen how a small number of trades can cause you lots of trouble in option selling if a stock or market moves sharply against you.

The answer that meets nicely in the middle – profiting from the growth potential of catching a piece of an existing trend, while lowering your total cost per contract and paying no net time in your options – is Debit Spreads. You may have heard them called Vertical Spreads, or Bull Call Spreads or Bear Put Spreads.

A Debit Spread still requires 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 – we do this with a limit entry price. We pay a certain price (or debit) for this trade, just as you would with buying a Call or Put – with significant differences and advantages to the '2-legged' trade.

First, let's explore what types of options I like to purchase when I anticipate a big short-term directional trend move and what types of options to sell against that.

Rule #1. Buy In-The-Money and Sell At or Out-Of-The-Money

You of course want to find a healthy directional trend (I use technical analysis and systemized trading rules in my ***Smart Options*** portfolio, where I do a weekly video explaining various forms of technical analysis to my subscribers) and I want to focus you on the proper principles to construct an effective debit spread, where time is no longer your enemy. Now, we can place time on your side when done correctly with the Debit Spread.

I first want to buy an “In-The-Money” or ITM option as my base, in order to create a “stock substitute” position. For example, say you have XYZ stock trading a $100 per share. If you buy 100 shares of stock, that would cost you $10,000 up front. Instead I can buy a 95 strike call with 1 month before expiration for say, $600. That 1 options contract controls the same 100 shares of stock for just 6% of the stock cost. Of course, if you only bought the ITM option, you are looking at an intrinsic value of $500, and an extrinsic or “time value” remaining of $100. If the stock fails to move, you could be kissing that $100 goodbye in a month in a flat scenario.

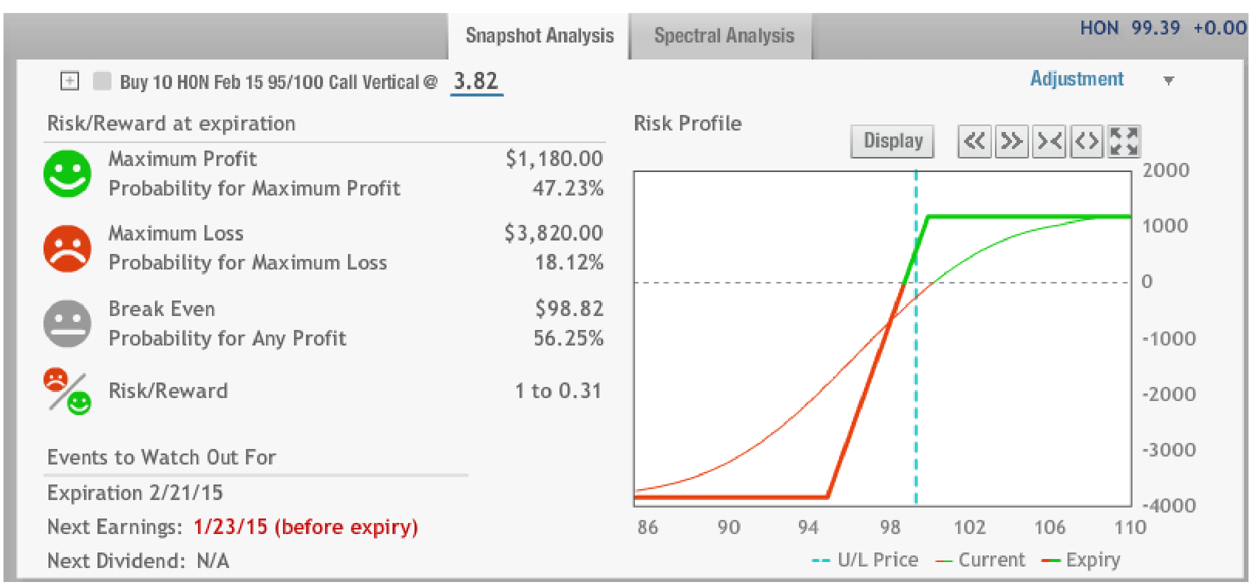
Here’s where I add a second layer to the initial ITM trade to turn it into a Debit Spread. For example, say I think the stock will go to 102 or higher in a month, for a 2% gain the stock. I could be conservative and sell the at-the-money (ATM) 100 call 1 month out for $300, or I could be a bit more aggressive and sell the 1-month 102 call for $200. Let’s look at both scenarios.

The conservative income-only trader is looking to maximize the time premium collected, in this case lowering the cost on the 95 call down from $600 to a net outlay of $300, cutting the total cost by 50%. That reduction in the net price per contract is the primary advantage of debit spreads. The main downside of the Debit Spread is that you cap your upside, in this case at a $200 maximum gain (100 strike sold – 95 strike bought = $500 max gain minus $300 cost per spread contract). So for a percentage return, your maximum profit would be +67% ($500 max/$300 cost … and of course you should factor in your commissions. Here in this report we are not counting commissions for easier understanding).

On the more aggressive alternative, you could sell the 102 call to give yourself more growth potential on the upside. The trade-off is you collect less time premium up front, lowering your net cost to $400 vs. the original $600, a 33% reduction in your risk per contract. But now your maximum gain potential at 102 or higher at the options' expiration is $700 (102 strike sold – 95 strike purchased). So your maximum gain percentage at 102 or higher in this case is +75% (700/400).

The entry and exit for the Debit Spread is done as one limit order (we don't recommend market orders for spreads) and can be easily placed with your broker or on your trading platform. Check with your broker to make sure your account is approved for Debit Spread trading, which is typically simple to achieve because these are limited-risk trades.

Here's an example of a 95/100 call debit spread on Honeywell (HON), courtesy of OptionsHouse.com:



Note that this HON example, and for Debit Spreads in general, you don't want to just "hold and hope" as you can lose your full cash outlay – exactly the same as straight Call and Put buying. The odds of a maximum profit over 100 are much higher than the risk of a full loss, but we still want to control risk effectively. We'll cover rules for exits shortly.

All the broker will require in terms of margin or cash is the initial debit you pay. Since we are both buying and selling an option at the same time (with the same expiration date but different strike prices), this can offer several advantages to regular call and put buying that we'll delve into later in this report.

There are other advantages to adding a premium-selling element 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 also don't always just want to be buying options and paying for time premium.

So by selling an option against the purchase to form a limited-risk Debit Spread, you incorporate option selling into your trading. And just as I prefer deep ITM option buying, I also prefer to sell Out-Of-The-Money (OTM) and sometimes At-The-Money (ATM) options against the ITM buy side. Both ATM and OTM options are made up of 100% time premium, priced based on the volatility of the underlying stock (or "Vega") and the time remaining (also called "Theta").

So with a Debit Spread strategy, you gain the benefit of selling an option against the in-the-money option you purchase, in a limited-risk environment. What other benefits does this strategy offer, and how does it differ from a straight option purchase in terms of risk/reward?

Rule #2. Sell More Time Premium Than You Buy

Everybody likes a discount – whether it is real or perceived. For example, how many shoppers buy more because of the 25%-off sale in a mall department store? But the bottom line is everyone prefers to have a smaller cash outlay when making a trade.

My method of Debit Spread trading offers this. Because you are both buying and selling an option at the same time, you lower the cost versus just buying an option outright. But by how much?

A rule of thumb is that generally our Buy ITM/Sell OTM debit spreads give a 10% or more 'cash discount' – but the smaller cash out-of-pocket per spread/contract can be 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 Smart Options*** (which offers real-time option trade recommendations to subscribers), 5 recent debit spread trade recommendations offered cash discounts of 26%, 18%, 22%, 15% and 12% versus if we just bought a Call or Put. This means less risk and less cash out of your pocket on each trade you make.

Using the 26% cash discount real-life example, you could have 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). And what is maximum profit?

Well simply, it is the difference between the strike prices minus the debit paid. In this example it was a 125/130 Call Spread (same expiration month). So 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.
So 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%. And we have lessened the overall volatility of the position because we sold an option in addition to buying one (more on this later).

Also in this example where we bought the 125/130 Call Spread for 2.50, we are basically ‘synthetically long’ at 127.50 – and guess where the underlying was at the time…right around 127.50! In this case, you take back all the time premium you paid for the 125 call with the time premium you sold in the 130 call. And often you can sell even more total time premium in the out-of-the-money option than you have to buy with the in-the-money choice. That way it’s like buying the stock at a discount, and truly putting time on your side.

Rule #3. Profit Taking in Pieces Increases Win Percentage

Too many traders take an “all or nothing” approach to trading. I’d rather take some money off the table as the market makes it available to me, while still shooting for a bigger gain on the rest of my position. So this has led to my “Half and Half” strategy to generally book a first profit at approximately half of my maximum potential gain. So if I have potential capped at +60%, I expect to book a profit on the first half of my position at +30%.

This also has ramifications for where I want to set my stop on the Debit Spread, as well as how I manage my trailing stop to protect my profits and make sure the position can result in an overall winner, even if the second half of the position hits its trailing stop.

For starters, if I expect a 60% gain on the final half of the position, there’s no way my stop should be any looser than -30% initially. This keeps me with an initial profit target of 2 times my risk, with the actual reward-to-risk closer to 1.5 times risk, since a 30% gain on half and 60% on the rest is an average gain of +45%.

The other key is that once my first profit target is achieved, I raise my trailing stop on the rest of my Debit Spread position to breakeven. This means that even if I get taken out of the second half at 0% give or take, I'm still ahead of the game on average by +15% in this case (+30% on half and 0% on half = +15% on average). Certainly not a home run, but you can't go broke taking a profit, as the old saying goes.

Some worry about the stock surging past the upside strike price on the call sold. If the stock does not look back, then you have to live with only making a 60% gain on the final piece rather than a bigger gain. This leads me to an important philosophy that you should seek to embody in your trading….

Rule #4. Don't Be Greedy – Favor Early Profit Taking

"Bulls make money, Bears makes money, Pigs get slaughtered."

That old Wall Street maxim is always worth remembered, and I must admit succumbing to thinking I could squeeze more out of a ***Smart Options*** Debit Spread in the past and it ended up costing me. Casino operator Wynn Reports (WYNN) gave me a clear breakdown signal based on my BigTrends indicators, and the trade recommendation was part of the email sent to subscribers via email and text and our debit spread instructions looked like this:

September 5, 2014

BTO the Goldman Sachs (GS) September 175 Call (GS 140920C175)
and SIMULTANEOUSLY
STO the Goldman Sachs (GS) September 180 calls (GS 140920C180)
for a net Debit of 3.00 or better for this debit spread.

BTO the Wynn Resorts (WYNN) September 190 puts (WYNN 140920P190)
and SIMULTANEOUSLY
STO the Wynn Resorts (WYNN) September 185 puts (WYNN 140920P185)
for a net Debit of 3.00 or better for this debit spread.

We were filled on WYNN that day at 3.00 (and Goldman at 3.00 too which was a nice +63% winner, but I'm teaching about a trade I missed on with WYNN), for a cost of $300 per contract plus commissions. We started making money on WYNN quickly, as the stock dropped from the initial level of 187.00 to under 173 on

September 16, the Tuesday of the expiration week. I thought surely I should be able to get filled near maximum value, with the stock a full 12 points under my short strike of 185. So I figured I was giving the market a gift by trying to exit at 4.90 rather than the full 5.00. But I could not get filled.

And then faster than anyone could really expect, WYNN shares shot up that same day to close around 179, then the next day near 183. I figured we're still safe under 185, then bam! The next morning the stock gapped up again and tested near 190, forcing me to scramble to place an exit at 2.40 which was filled for a -20% loss. This mistake of figuring I was safe to hold on forced me to tighten my first initial profit target and also implement tighter trailing stop rules ever since.

The lesson: just because you're in a less volatile Debit Spread, the stock can still force you to exit early or potentially risk a total loss if you hold on amid adverse volatility. If I had taken a bit less I could have still had a near 50% gain on that side too. While the combined call with Goldman and put with WYNN was a successful "Pair trade" (more on that next), I still had to re-examine my rules to not leave profits on the table.

Wynn Resorts (WYNN) Daily Chart (area of September trade in dotted box)

Rule #5. Trade in Pairs

"The market can remain irrational longer than you can remain solvent."

I'll admit that when I first started trading more than 25 years ago, I was a "plunger." I'd do my analysis and make a big bet on my #1 favorite play, hoping to strike it rich quick. And too often, some adverse market move would happen that would make my "home run" option idea suddenly at risk of a strikeout. I quickly realized that in order to stay in the game for the long haul, I needed to diversify, and risk a smaller amount of my stake on a variety of plays.

As my analysis improved and I found patterns that allowed some stocks to stay bullish and others to be bearish in the same market, I realized that the concept of "pairs trading" was indeed very viable. Originally pair trades were the foundation of the hedge fund industry, where a hedge fund would buy a leading stock in a sector and short a laggard in the same sector, to benefit from the performance differential while remaining hedged from sector and market risk. If the market rose, the leader should gain more than the laggard, and if the market fell, the laggard should lose more than the leader gave back.

As I translated this concept to options, I realized that I could take a leading stock as a call and a relative dog as a put, and it did not have to be in the same sector as long as the ideas are not correlated (for example, you would not want to be a stock call and a bond put, as when stocks go down, the bonds should rise in a flight to safety, potentially placing you on both wrong sides). While there's always the possibility that both a call and a put could lose, there's also the opportunity to make money on both sides of two different plays and offset the effects of a potentially volatile market environment.

So now I prefer most every week to have both a Call Debit Spread and a Put Debit Spread to balance out the effects of our manic depressive markets. As in life, timing is everything in trading. So trend methods are very important. And it's also nice to smooth out the ride in getting to your desired destination, so the pairs trading approach tends to promote greater consistency and reduces the concern about market gyrations.

You may want to learn more about my ***BigTrends Smart Options*** portfolio, where I focus exclusively on Debit Spreads, typically making 2 new recommendations per week, or about 100 new trade ideas per year. And of course, I always send follow-ups to my subscribers via email and also via text message with updates on where to take profits or close down all open positions, along with weekly video updates to help you learn while you earn.