Double Calendar Spread - Rules

How the Double Calendar Strategy Works

- Determine the Expected Move by looking at the Straddle Pricing
  - Add the “at-the-money” Call and Put together to find this amount
  - For example; if the stock is trading at 50.00 and the 50 Call and 50 Put are trading at 2.50 each then that means the expected move is 5.00 (10%)

- Sell the “out-of-the-money” Call and Put corresponding with the expected move, in the nearest expiration (usually weekly options)

- Buy the “out-of-the-money” Call and Put corresponding with the expected move, in a further out expiration (usually a month later)

- The Short Term Weekly options that you are selling are usually “juiced up” in anticipation of the earnings. This means the Implied Volatility will be much higher on the weeklies than the monthlies you are buying (typically we look for a 2-to-1 ratio on IV, weeklies twice as much as the monthlies)
This is what an entry order will look like.

This order was placed when GOOGL was trading near 510.00 on the stock. The price of the straddle indicated an expected move of 20.00, so that is how the strikes for the double calendar spread were chosen.
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This is what the trade analysis shows, the “Probability for Any Profit” percentage is inflated because the software is not factoring in the earnings announcement.

Ultimately, you want the earnings reaction to end near one of the strikes without going past by expiration. This allows you to make money on your long options while most of the time value gets drained from the short options. The spread can be profitable at a variety of price levels but the max profit occurs when price is right at one of the strikes upon expiration.
Other Considerations

- We often take profit on one side of the trade immediately following the earnings gap.
  - If price moves strongly in one direction while still within the strikes then we sometimes are able to buy back the short leg and sell the long leg to lock in a profit on the entire trade. We are then left with a “free” long option on the other side, and the short option on that side will likely expire worthless as expected.

- When a move goes beyond one of the strikes it is prudent to look for an exit. We occasionally “leg out” of the trades if the technical landscape presents the opportunity to do so.

- As the situation changes so do the expectations. This strategy has large profit potential but it also has the ability to provide consistent smaller gains. After the earnings reaction we are able to get a more precise reading on the true potential for each trade. Sometimes we anticipate an 80-100% profit but we will gladly take a 50% profit if that is what the market gives us.
Conclusion

- Compute the expected move for a stock by using the straddle price

- Look at the Implied Volatility of short term options versus long term options to find a ratio of 2-to-1 (short term IV twice the long term IV)

- Sell Short Term Calls and Puts while buying Long Term Calls and Puts, the strikes should be out of the money and they should encompass the expected move.

- Manage your risk accordingly, we recommend committing no more than 10% of your account to any one trade.

- Wait for the earnings reaction and exit the trade accordingly. You may exit the call side, the put side or the entire spread. Legging out can be used but note that it increases both the profit potential and the risk.