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? Many would say that options selling is the best way to do this but despite how profitable collecting premium can be, selling options can occasionally cause lots of trouble 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, 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 'two-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 them.

Rule #1: Buy In-The-Money, Sell Slightly Out-Of-The-Money

You of course want to find a healthy directional trend (I use technical analysis and systemized trading rules in my ***Debit Spread Trader*** 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 at $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 single 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.

But this is 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.

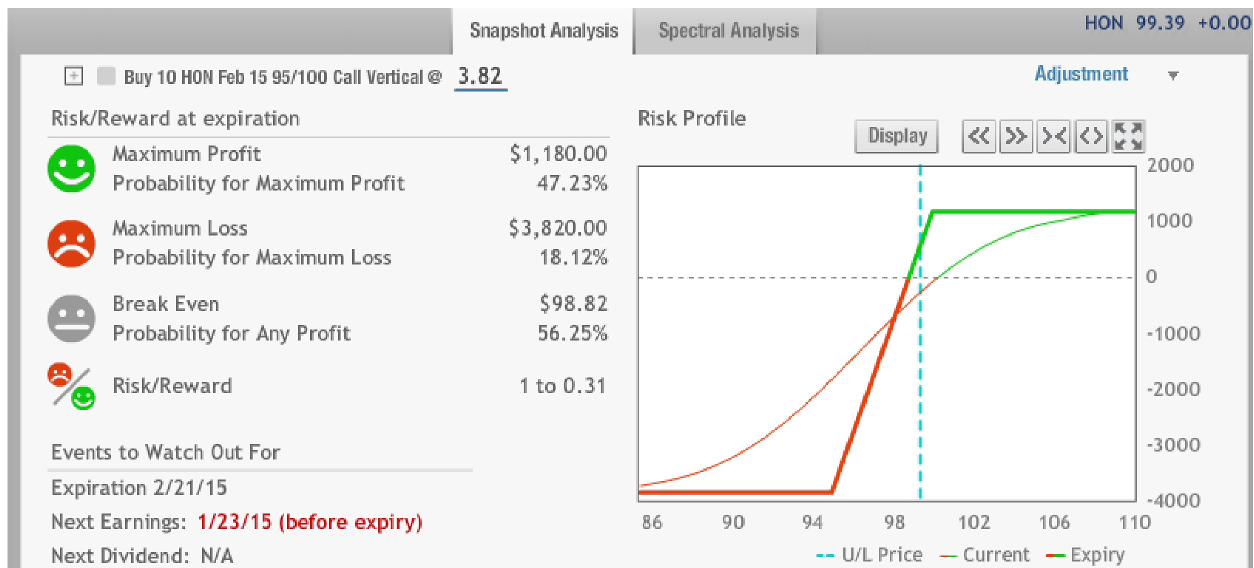
The conservative income-only trader is looking to maximize the time premium collected, in this case lowering the cost on the 95 call down from $600 to a net outlay of $300, cutting the total cost by 50%. That reduction in the net price per contract is the primary advantage of debit spreads. The main 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, something which I am excluding from this report 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 slightly Out-Of-The-Money (OTM) options against the ITM buy side. Usually I will choose the next strike price just above the current stock price. With many of the blue chip stocks I trade, if they’re trading near 100, I’ll buy the 97 call and sell the 101 call. This gives you some upside growth potential from 100 to 101 while also covering the cost of the time premium you paid for on the options leg you purchased. The 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. But 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 the ***BigTrends Debit Spread Trader*** (which offers real-time option trade recommendations to subscribers), five recent Debit Spread trade recommendations offered cash discounts of 26%, 18%, 22%, 15% and 30% 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 the 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, 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 of the time premium you paid on 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 Quickly Increases Win Percentage

Too many traders take an "all or nothing" approach to trading. I'd rather take money off the table as the market makes it available to me, if my trading system has a positive edge and keeps my losing trades reasonably small. 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.

For starters, if I expect a minimum 20% gain or a bigger gain of up to 30%, I cannot let the stop on the downside be any larger than my target. This keeps me with an initial profit target equal to my risk. Some traders feel their reward should be twice or more what they are risking but the problem with the bigger upside target is it doesn't get achieved as often. So a 2-to-1 reward to risk in my testing likely leads to a winning percentage around 40%. Meanwhile, the 1-to-1 reward to risk leads to a win percentage around 67% in my system.

I find most subscribers would sacrifice some occasional bigger upside for the greater probability of winning trades. The saying "a bird in the hand is better than two in the bush" comes to mind. You're certainly giving up on home runs but you can't go broke taking a profit, as the popular trading motto says.

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 20% or 30% gain on the trade. I wish we always had this problem! 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 remembering and I must admit to thinking I could squeeze more out of a ***Debit Spread Trader*** recommendation in the past and regretting it later. 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:

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 16th, the Tuesday of the expiration week. I thought I would surely be able to get filled near maximum value, with the stock a full 12 points under my short strike of 185. I even 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 GS and put with WYNN was a successful "Pair Trade," 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 Weekly Options for More Bang for Your Buck

“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 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 being right for a short period of time was easier than being right for a much longer holding period.

As I translated this concept to options, I realized that I could take a leading stock with good momentum and not just buy a call but also sell another lower-probability Out-Of-The-Money call to someone else to reduce my cost. And the strategy only become truly optimized when weekly options came around, as then I would not have to buy more time than I needed. If you buy a 1-month Debit Spread, for example, you’ll often have to sit around for most of that month before you realize your maximum profit.

With weekly options, every Friday becomes an expiration day. I’ve found that going out to the next week’s expiration gives us 5-10 trading days to let our view play out and still not have to wait around for too long. I can hit my profit target more quickly, and if the stock flatlines, I still get paid while I wait as the time erosion is faster in weekly options as the Out-Of-The-Money options will decay relatively quickly in the final days of the options’ life.

I’ve included two charts on Disney (DIS), one bullish and one bearish, to show you how I trade quickly in and out of weekly options Debit Spreads using overbought and oversold indicators.

Disney (DIS) Bullish Case Study

My trading system looks to buy the dips in DIS shares with the stock in a longer-term uptrend. When these stocks come out of their short-term oversold condition, the pop back up can be quick. In fact, I exited this one the next trading day for a +20.6% gain in December 2017.

Disney (DIS) Bearish Case Study

On the bearish trades, I need to see the long-term trend headed down and then find a short-term overbought condition that leads to a selling phase soon to follow. In this case of DIS in October 2017, I spotted a likely short-term peak and then captured a +21.9% gain in 4 trading days.

You may want to learn more about my ***BigTrends Debit Spread Trader*** portfolio, where I focus exclusively on Debit Spreads, typically making 1-2 new recommendations per week. 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.

For more details on how you can start taking advantage of the many benefits of Debit Spreads with ***Debit Spread Trader***, just email us at clientcare@bigtrends.com or **call toll-free at 1-800-BIGTRENDS** (800-244-8736).