

The Backspread

A directional strategy that costs nothing if you are wrong

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I'm a great believer in using the right tool for the job. The backspread is an amazing little strategy when you expect a potentially big price move, but at the same time you realize that there is a chance you could be wrong and no move whatsoever develops.

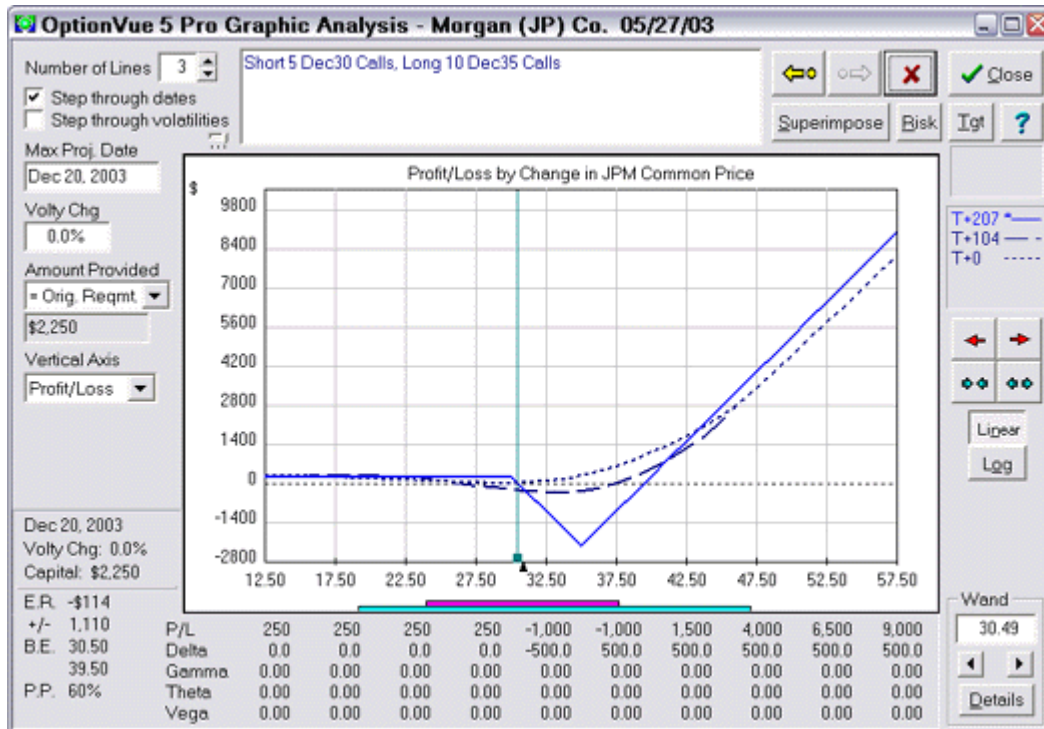
One example when it would be appropriate to use a backspread might be when a drug company is approaching a deadline for FDA approval of a new product. Another good time to use a backspread is when you are bottom fishing because you think is the end of a market sell-off.

A backspread is constructed by shorting a near-the-money option and buying a larger quantity of options of the same type (calls or puts) at a farther out-of-the-money strike. A 2x1 ratio is most common. Normally you try to select the options in such a way that the options you're shorting bring in a sufficient credit to cover the cost of the options you're buying, resulting in a net cash flow of nearly zero, or even a net credit to your account.

Since in a backspread you are net long options, the profit potential is unlimited. At the same time, the sale of a smaller number of more expensive options effectively "pays for" the options purchased, with the result that if both legs of the backspread expire worthless, it costs you nothing. The short leg of the backspread also effectively eliminates time decay as a worry.

If all that sounds too good to be true, I'll tell you what the catch is. There is a price zone where the backspread loses money. It occurs when the underlying moves in the desired direction by only a small amount.

Let's illustrate using a call backspread in JP Morgan (Symbol: JPM) options. While the stock has declined in recent weeks, I expect that large-cap banks will outperform the rest of the U.S. market over the next 12 months as the business environment improves and interest rates remain low. But while many others also expect an economic recovery; we just can't be sure when. So we are looking at either a strong stock performance or a drop in price if the recovery fails to materialize. If you go along with this, a call backspread might be a perfect way to play it:



This particular 2x1 backspread costs \$2,250 to put on. (The cost of a backspread arises from the collateral requirement for a 1x1 credit spread plus the cost of the extra calls purchased.) Note that this position loses money when JP Morgan is in a range from \$30.50 to \$39.50 – the "dead zone". However, it is very difficult to lose all your money, as the stock would have to finish precisely at \$35.00 (the long leg's strike price) on expiration day. Contrast this with simple option buying – where it is very easy to lose all your money!

Big profits can be made if JP Morgan moves above 35. Even better, if you are wrong and the stock price drops below \$30, you still gain \$250 no matter how far the stock falls in price.

Noteworthy is the outstanding risk/reward characteristic of the T+104 line (the dashed line), representing the halfway point in the life of this position. If the expected rally happens within this time frame, you're golden. If not, you may consider closing the position at this time for just a small loss. Assuming that implied volatility (IV) does not drop (and JP Morgan's IV is fairly low right now relative to its past history), the most you could lose in 104 days is \$300.

Note that if you are bearish, backspreads can be constructed in puts just as well as in calls. Put backspreads behave in a mirror image fashion to call backspreads:

