The Perfect Spread for Beginners

Consider spreads rather than outright option purchases

Len Yates

07/10/2004

Every occupation has its own "lingo" and the options trading world has more than its share of confusing terminology. A newcomer wades through words like "long", "short", "underlying", "at-the-money", etc. and attempts to find real-world associations. It can be frustrating to say the least.

What is "long" in the trading world? It is when you buy something. If you buy a call option, you are long a call. The opposite is true for "short". (No, it doesn't mean you buy a put option.) If you sell a call option you are short a call. Long and short also apply to the buying and selling of puts and the underlying. Which bring us to the "underlying" — what is this?

The *underlying* is the **asset** that underlies the option. This can be a stock, future, currency, index, bond, etc.

Finally, this ***at-the-money business***. This means the option closest to where the underlying is trading. If the underlying is trading at 34, the closest strike is 35, so the 35 strike is considered the at-the-money strike. The 40 is out-of-the-money and the 30 strike is the in-the-money for calls (vice versa in puts).

So what is a vertical debit spread?

If you've read this far, you're probably fairly new to options trading and are interested in the next step. The leap from just being *long* an option to spreading. Let's start by dissecting the term "*Vertical Debit Spread*".

Spread: When you buy one option and sell another option of the same type (calls or puts) on the same underlying.

Vertical: The options are in the same month, only different strikes. (Think of the Matrix, where each month's calls and puts are in vertical columns)

Debit: This trade will result in a net debit. (Money leaves your account.)

Because this is a **debit** spread, the option that we buy *HAS* to be more expensive than the one we sell otherwise it wouldn't be a debit. If the option is more expensive, and it is in the same month as the one we sell (remember it's vertical), it *HAS* to be a strike that is closer-to-the-money.

So, for example, if we are buying a call and selling a call to make this a spread, and the one we are buying is closer-to-the-money, the one we sell has to be further-out-of-the-money (it doesn't matter how many strikes away, as long as it's in the same month). Pretty easy, isn't it?

Q: Why use a vertical debit spread?

A: A vertical debit spread in calls is a bullish position. It makes money as the underlying goes up. A vertical debit spread in puts is a bearish position. Use it when the underlying is going down.

Q: Why use a spread instead of just buying a call or buying a put?

A: A spread almost always makes more money, at less risk, than a simple purchase, when the time horizon of your price forecast is two weeks or more. Why? Because selling the further out-of-the-money option helps pay for the more expensive option, therefore making your breakeven lower.

Q: What's the worst that can happen if I put this spread on?

A: Exactly the same as when you go long. The very worst that can happen to you is you lose the debit - the amount of money you put up to buy the spread. Yes, it's true, even with futures options.

Q: Why is it true? If I'm selling an option, aren't I vulnerable?

A: The one you are selling is further out-of-the-money than the one you are buying, the short option is protected by the long option. In other words, it's covered.

Q: How much margin do I need for this kind of strategy?

A: None, nada, zippo, zilch. It is the same as going long an option. You just have to pay the net debit of the premium of the two strikes.

Q: Sounds too good to be true, what's the down side?

A: It generates more commissions than just going long, so if you expect a quick move in the underlying it's probably better not to spread, unless you find a spread that's extremely cheap.