Vertical Debit Spreads

Creating a less stressful options trading position

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Most traders are first attracted to options for high-leverage directional trading. Directional trading is whena trader opens an option position to take advantage of an expected price move in a stock, index, or futures contract. New options traders often start out simply buying options. However, buying calls and puts is high-octane trading.

Traders, especially beginning options traders, should consider the benefits of spreads. A spread is constructed by buying an option and selling another option of the same type (call or put) on the same underlying. Usually the two options are of the same expiration month. Such a spread is said to be a "vertical" spread because the options differ only by strike, and in a matrix of options you typically picture the strikes running vertically.

When the option bought is more expensive than the option sold, the spread is said to be a "debit" spread because opening it results in a net debit to your trading account. When the option sold is more expensive than the option bought, the spread is a "credit" spread. We will say more about credit spreads later. For now, let's just talk about debit spreads.

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How does a vertical debit spread work, and why should you use it?

When you buy a debit spread, you are essentially buying the difference, or spread, between the prices of two options. You enter the trade expecting that with the right price move, the price difference will widen, resulting in a profit.

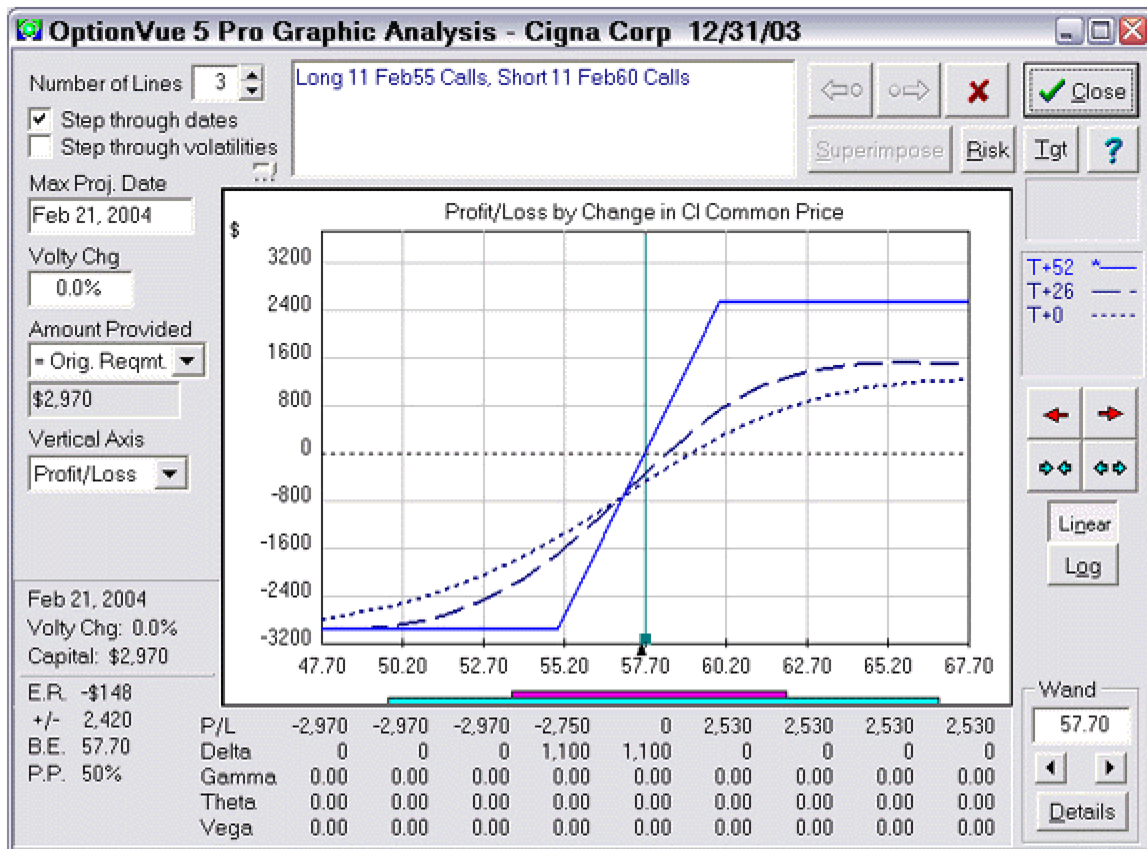
A trader who buys a vertical debit spread in calls (often called a bull call spread) expects the underlying to go up in price. As the underlying price goes up, both legs (options) of his spread increase in price, but the higher-priced leg increases faster, thus widening the spread. In contrast, a trader who buys a debit spread in puts expects the underlying to go down in price.

Just as when you buy an option, you can lose the amount paid for a spread and no more. However, while the value of an option can theoretically increase without limit, the value of a spread can increase only to the difference in the strikes.

One reason the vertical debit spread is attractive relative to a simple purchase is the size of the position you can afford to own. Let's look at an example using Cigna, a position that OptionVue Research currently has outstanding (at least for those following the recommendations, or that are in the auto-execute program). When the trade was placed on 12/31/03, the stock was trading at $56.99. Below are the values for the February 55 and 60 calls used in the trade:

Strike Price	Option Premium
55	4.00
60	1.30

With $3,000, you could only afford to buy 7 of the February 55 calls. However, we were able to enter an 11-lot for the debit spread, wince the the spread (difference) was 2.70. A vertical debit spread using the above options can only go to a maximum value of 5 (60-55). Once you buy it for 2.70, it could then go to 0 (both options out-of-the-money), 5 (both options in-the-money), or any price in between (the 55 option in-the-money and the 60 option out-of-the-money). These possibilities are illustrated in the risk graph of this vertical debit spread below:

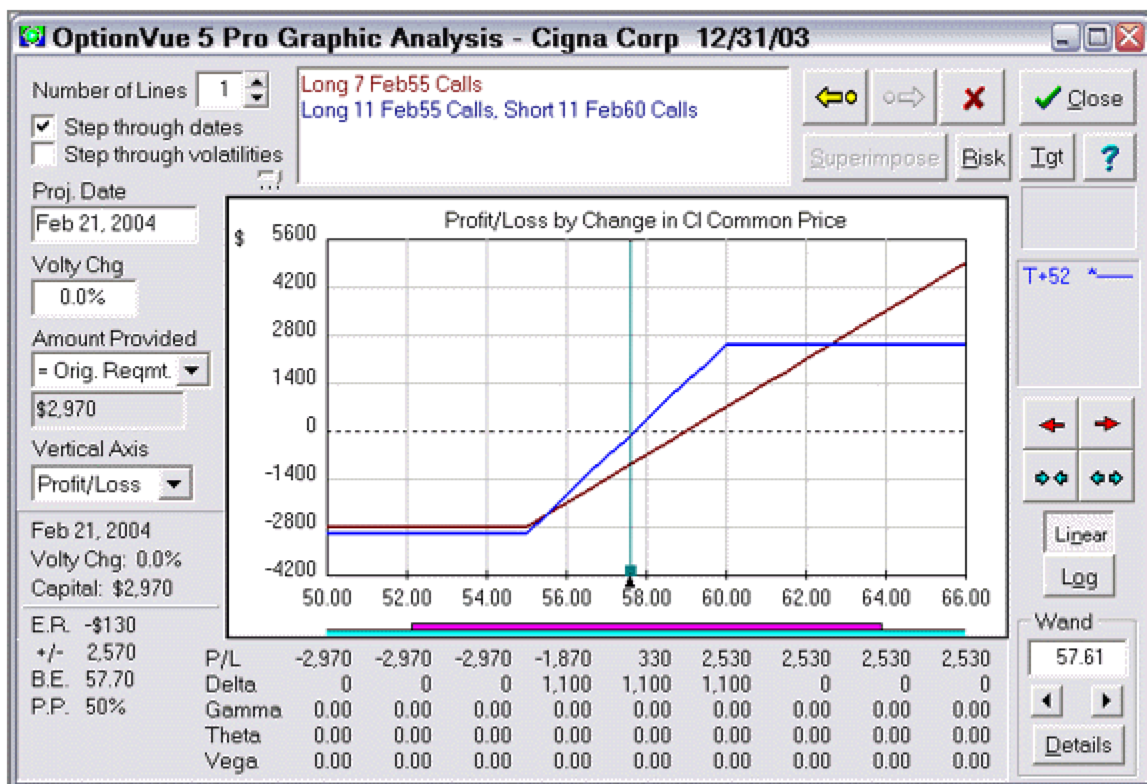


A vertical debit spread behaves very differently than a simple option purchase. Because of that, the trader must decide if it is an appropriate type of trade for their psyche. The price of the spread changes very gradually as the price of the underlying moves. Thus it is more sedate than straight option purchases, and requires less attention.

The angst of picking a selling price, so important with simple option buying, is abated. Simple option buying requires greater strength of discipline. A simple call or put position is like raw energy. It responds dramatically to every move in the underlying. Thus the trader must add his own discipline -- objectives, stops, and perhaps trailing stops.

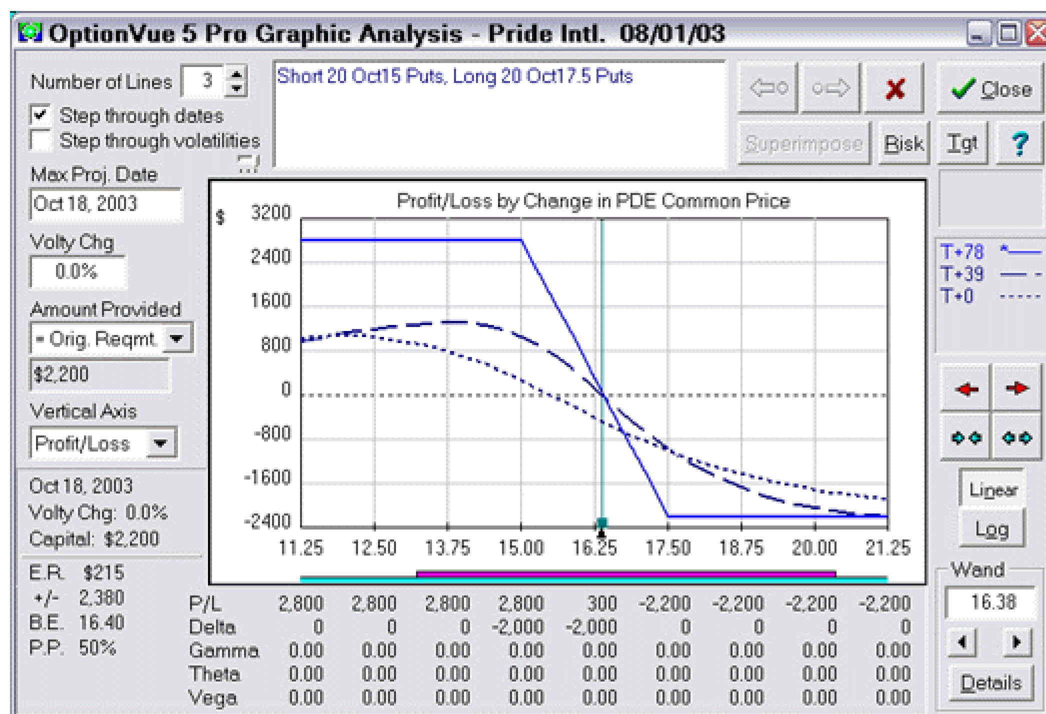
In contrast, spreads allow the trader more time to make an exit decision. Spreads may even be held all the way to expiration without concern over rapid time decay. In fact, if the underlying has already made the price move you expected, your now in-the-money spread will make money as time passes.

In times of exceptional volatility, when options are more expensive, the option buyer is at a disadvantage. However, the option spreader gets to neutralize this effect by selling an overpriced option at the same time he buys an overpriced option. The illustration below displays the performance at expiration of the vertical debit spread using call options versus a simple call purchase with the same amount of capital:



As you can see, if the stock closes below $55 on expiration day, it really doesn't matter which strategy you picked. You would lose all your money. If Cigna ends between $55 and $62.68, your profit is greater with the vertical debit spread. However, if the price rose anywhere beyond $62.68, you would have been better off with the call purchase. The call option continues to rise in value, while the profit for the spread is capped at $2,530.

The relative risks of an option purchase vs. the vertical debit spread holds just as true when using put options. Those with bearish price expectations can simply buy a put option, or create a vertical debit spread with puts (often called a bear put spread). The risk graph of this strategy is a mirror image of the bull call spread. Below is a risk graph of a vertical debit spread using puts:



One caveat with spreads: if the underlying quickly makes the move in the direction you expected, you may be disappointed to see that your spread has not gained much. In order for the spread to achieve its full potential, much of your gain will only come through the passage of time. Not only could this be too boring for your trading psyche, it also risks giving the stock time to slip back.

Also note that since spread trading involves trading more option contracts with the same amount of capital, it incurs larger commission charges.

Bottom line: For directional trading, use a strategy that best matches your trading psyche. A lot depends on how involved you want to be, or can afford to be, in watching the markets. Your trades need to be interesting but not anxiety producing. If you find that buying calls and puts makes you too emotionally involved, you may need to consider switching to less stressful vertical debit spreads. Successful traders are unemotional, unstressed traders.