

Vertical Spreads

Russell Rhoads, CFA

Instructor – The Options Institute

Options involve risks and are not suitable for all investors. Prior to buying or selling options, an investor must receive a copy of *Characteristics and Risks of Standardized Options*. Copies may be obtained by contacting your broker, by calling 1-888-OPTIONS, or from The Options Clearing Corporation, One North Wacker Drive, Suite 500, Chicago, Illinois 60606. In order to simplify the computations, commissions, fees, margin interest and taxes have not been included in the examples used in this presentation. These costs will impact the outcome of all transactions and must be considered prior to entering into any transactions. Multiple leg strategies involve multiple commission charges. Investors should consult their tax advisor about any potential tax consequences. The information in this presentation, including any strategies discussed, is strictly for illustrative and educational purposes only and is not to be construed as an endorsement, recommendation, or solicitation to buy or sell securities. Supporting documentation for any claims, statistics or other technical data in this presentation is available by calling 1-888-OPTIONS, or contacting CBOE at www.cboe.com/Contact. Past performance is not a guarantee of future results. CBOE®, Chicago Board Options Exchange® and The Options Institute Logo are registered trademarks of CBOE.

CBOE is not affiliated with Interactive Brokers.

Copyright © 2010 Chicago Board Options Exchange, Incorporated. All rights reserved.

- Vertical Spread Introduction
- Bullish vs. Long Call
- Bullish vs. Long Put
- Dollar Strikes
- Summary / Q&A

- Vertical spread involves two options
 - Same Type (Put or Call)
 - Same Expiration
 - Same Underlying
 - Different Strikes
- Bullish
 - Long Low Strike Call / Short High Strike Call
 - Long Low Strike Put / Short High Strike Put
- Bearish –
 - Short Low Strike Call / Long High Strike Call
 - Short Low Strike Put / Long High Strike Put

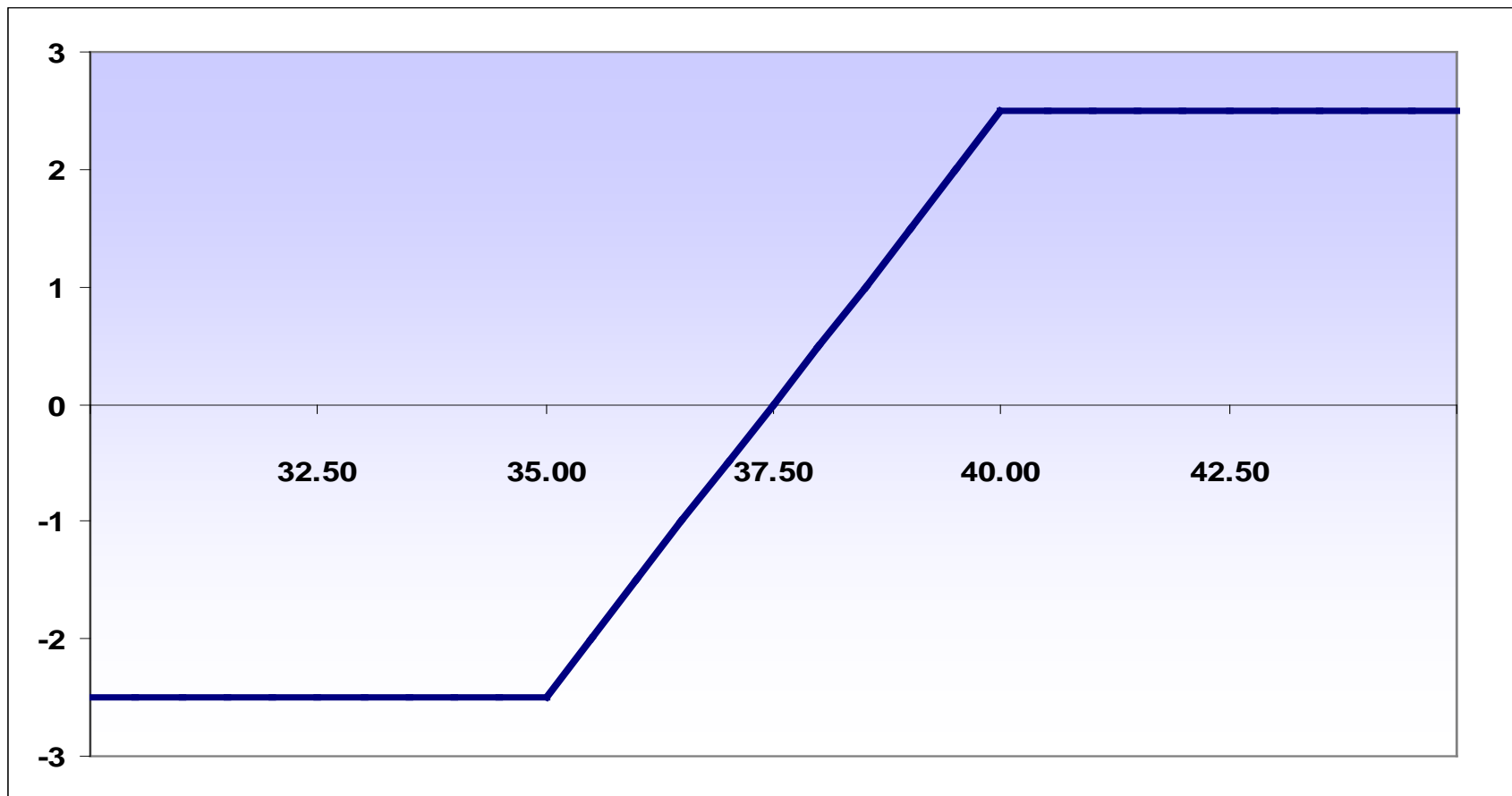
Bullish Vertical Spread Examples –

With Puts – Long 1 35 Put @ 2.50
Short 1 40 Put @ 5.00
Goal - Stock Over 40

With Calls – Long 1 35 Call @ 5.00
Short 1 40 Call @ 2.50
Goal - Stock Over 40

Goal is the same for both spreads.

Bullish Vertical Spread Payout Diagram –



Bullish 35/40 Spread –

Goal – stock over 40.00

Bull Put Spread –

Both options out of the money

Bull Call Spread –

Long Call value higher than Short Call

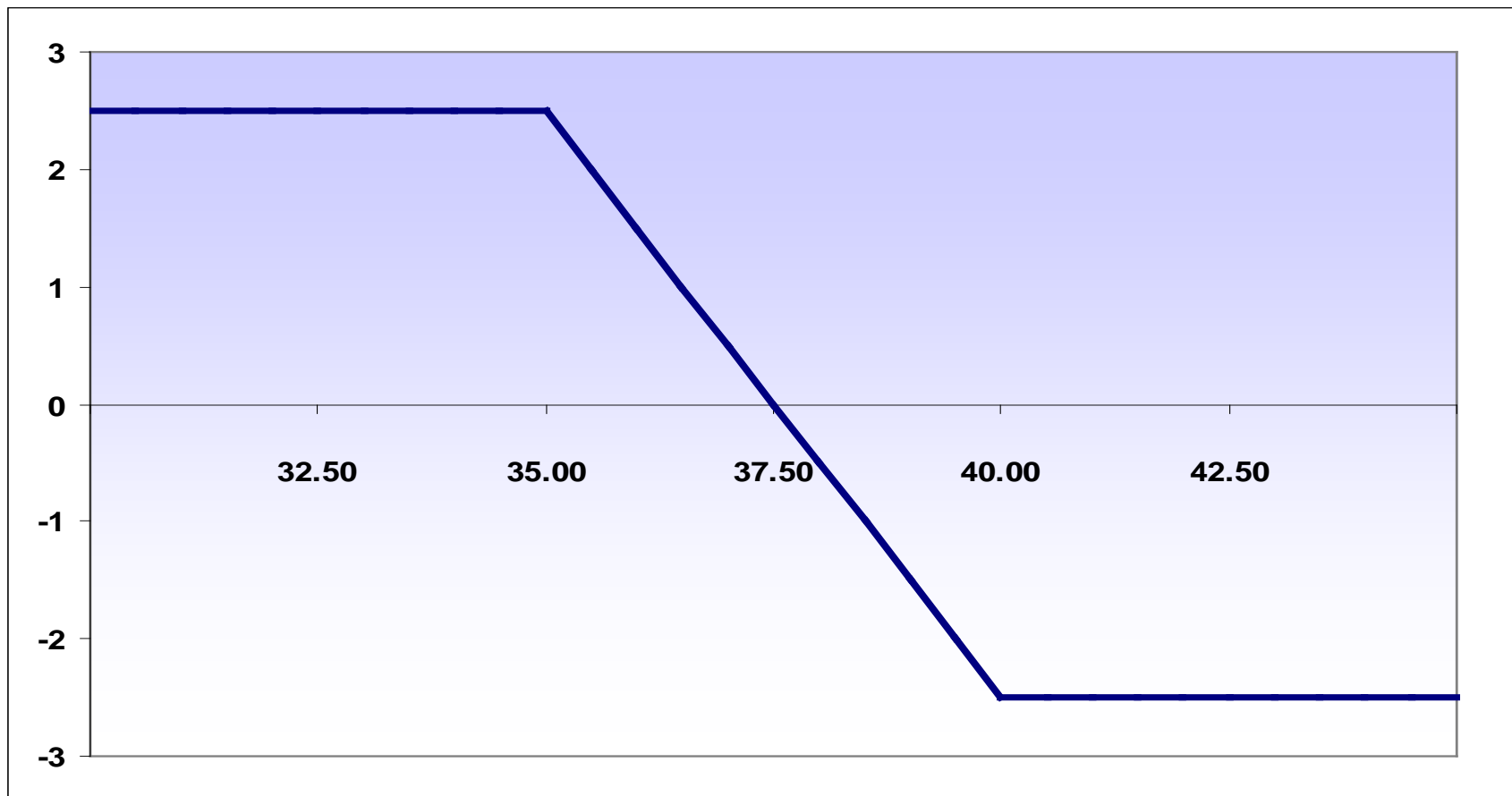
Bearish Vertical Spread Examples –

With Puts – Short 1 35 Put @ 2.50
 Long 1 40 Put @ 5.00
 Goal - Stock Under 35

With Calls – Short 1 35 Call @ 5.00
 Long 1 40 Call @ 2.50
 Goal - Stock Under 35

Goal is the same for both spreads.

Bearish Vertical Spread Payout Diagram –



Bearish 35/40 Spread –

Goal – stock under 35.00

Bear Call Spread –

Both options out of the money

Bear Put Spread –

Long Put value higher than Short Put

Summary –

- Vertical spreads can be initiated with a neutral to directional bias
- The risk / reward / break even levels are known when held to expiration
- In certain situations, a vertical spread may be a superior choice to a long call or long put position

Bullish Trade Scenario –

Today is October 1, 2010

ABC Group (ABC) is trading at 52.00

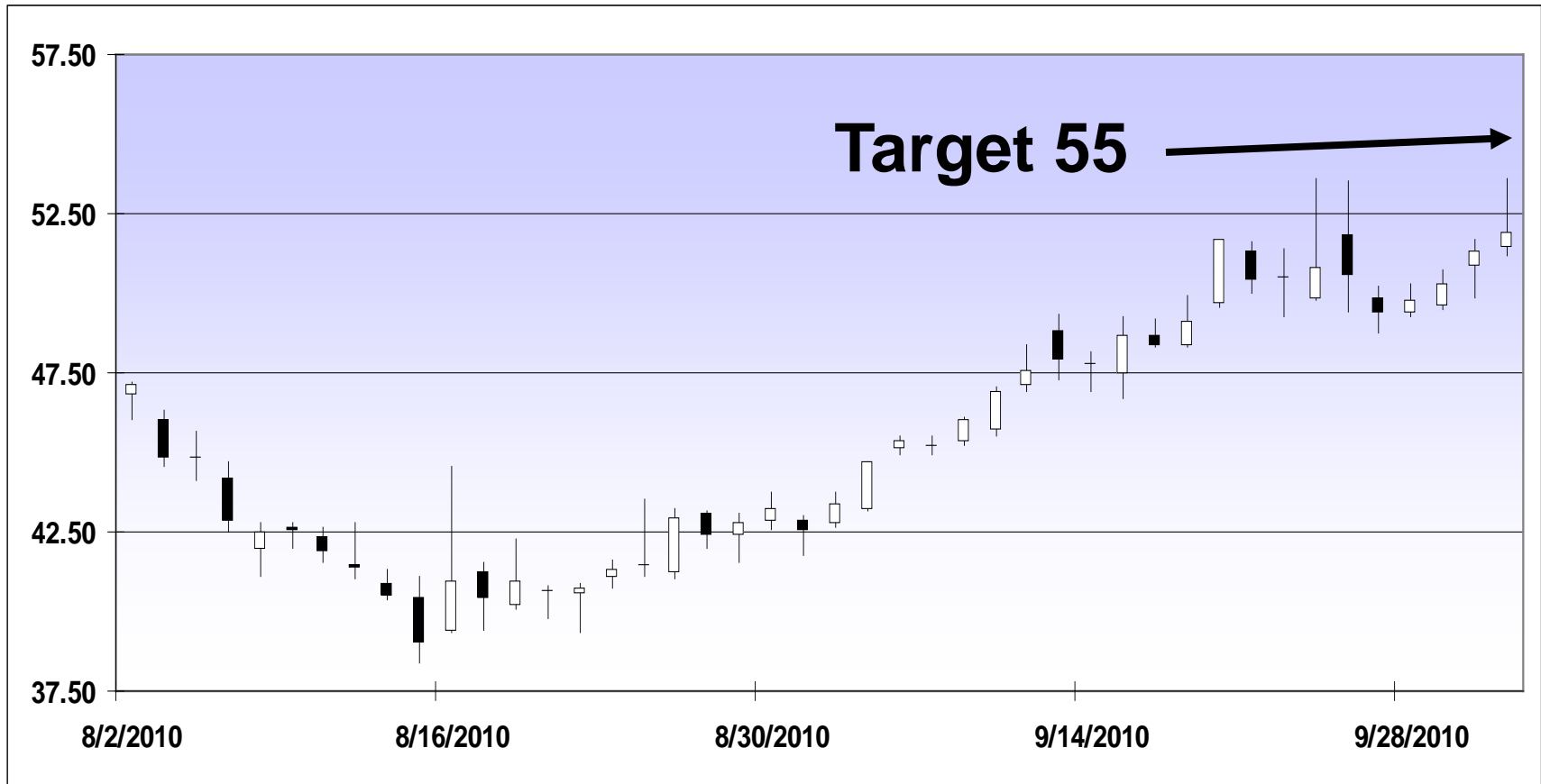
Earnings out 10/13, expect stock to trade higher

Would like to put on a trade now to benefit

October Expiration is Friday 10/15

Bull Spread

ABC – 8/2/2010 – 10/1/2010



Bull Spread

ABC – 52.00

Strike	Call Bid	Call Ask		Put Bid	Put Ask
45	7.20	7.65		0.35	0.40
50	3.25	3.40		1.35	1.45
55	1.00	1.10		4.05	4.20

Buy 1 ABC Oct 50 Call at 3.40
Sell 1 ABC Oct 55 Call at 1.00
Net Debit (Cost) = 2.40

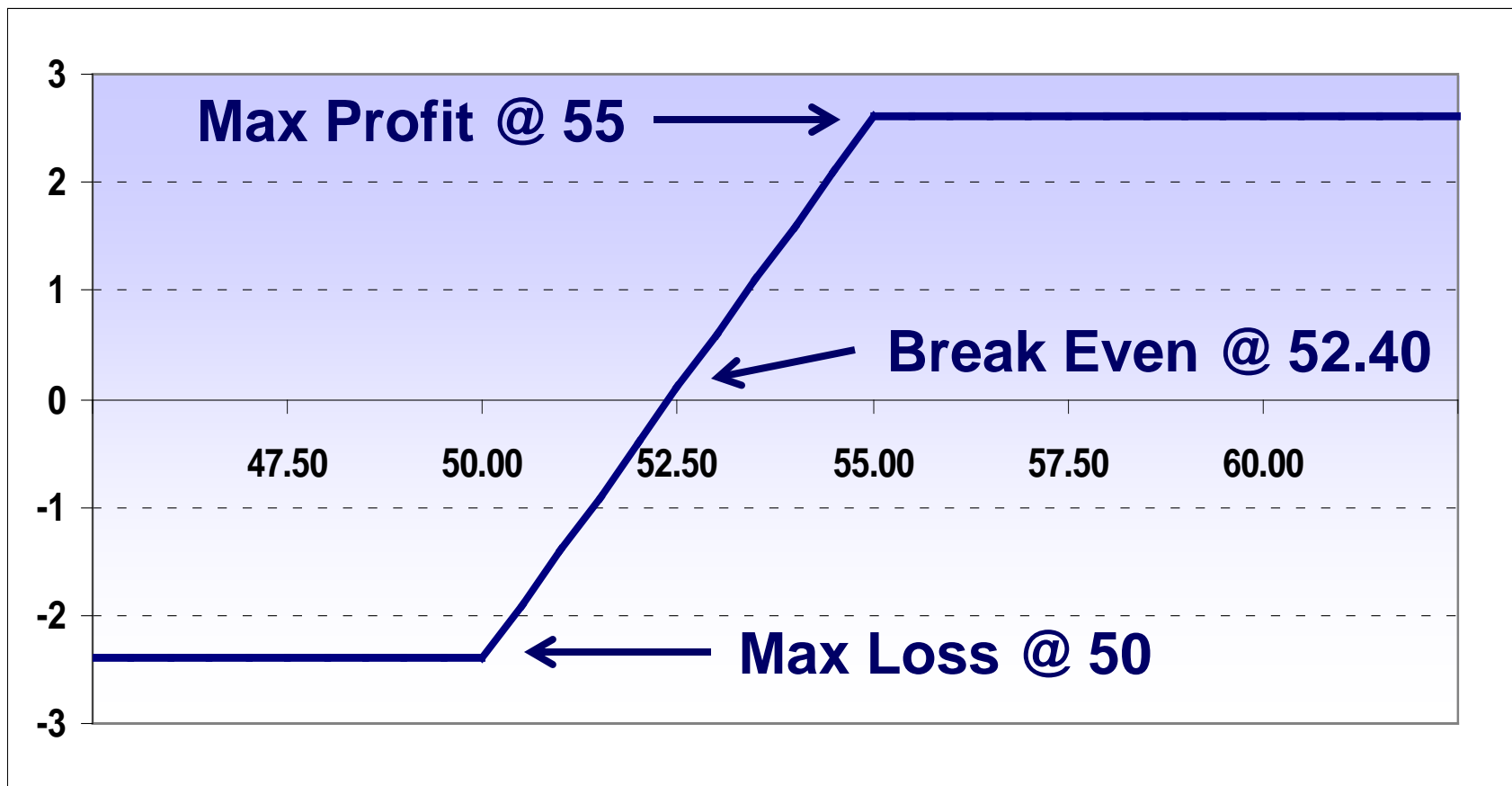
Bull Spread

ABC 50/55 Bull Call Spread Payout –

ABC	50 Call	55 Call	Spread Cost	Profit / Loss
45	0.00	0.00	(2.40)	(2.40)
50	0.00	0.00	(2.40)	(2.40)
55	5.00	0.00	(2.40)	2.60
60	10.00	(5.00)	(2.40)	2.60
65	15.00	(10.00)	(2.40)	2.60

Bull Spread

ABC 50/55 Bull Call Spread Payout –



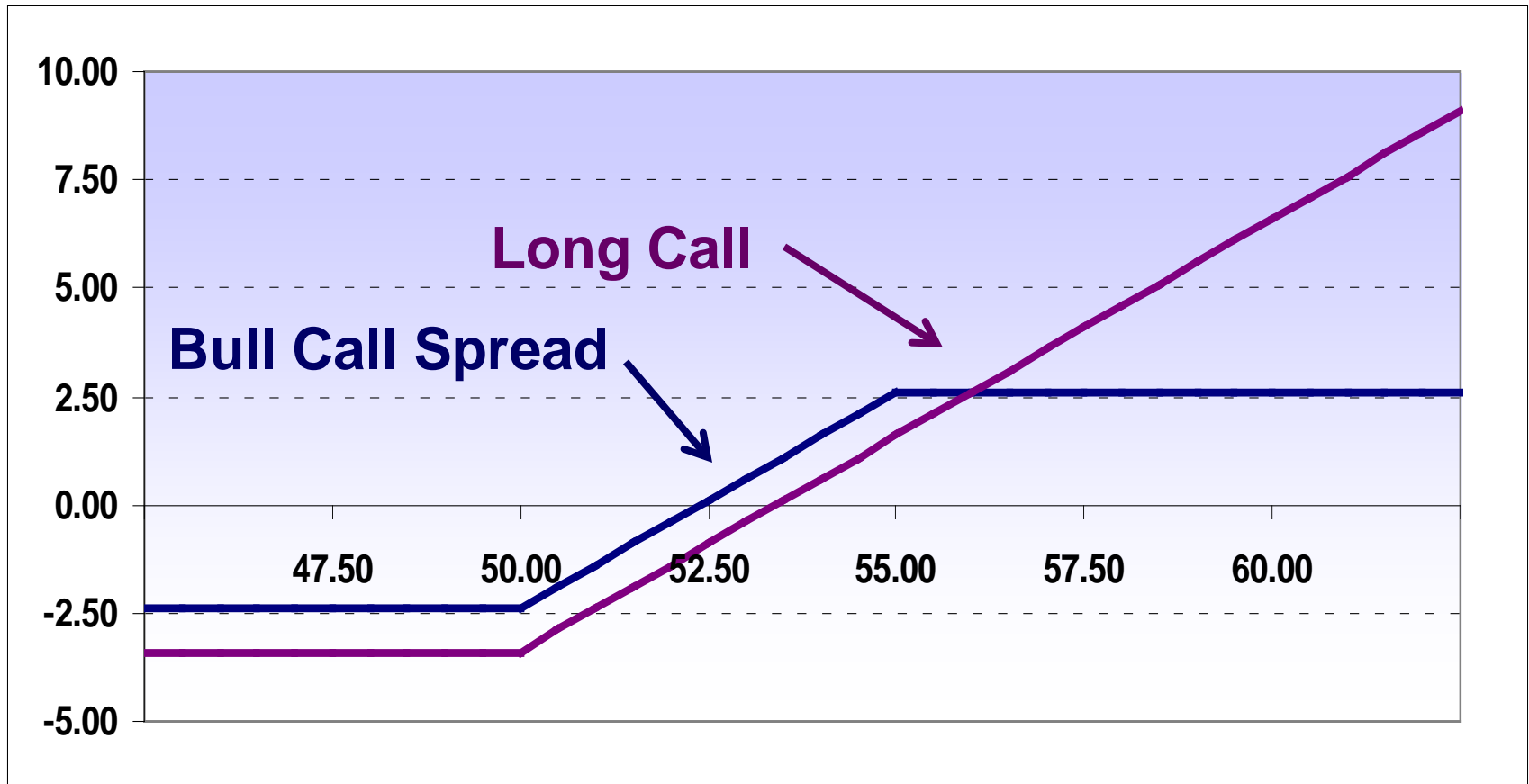
But what about buying a call?

Position	Cost	Profit at 55.00	% Profit
Long 45 Call	7.65	3.35	44%
Long 50 Call	3.40	1.60	47%
Long 55 Call	1.10	(1.10)	-100%

Remember
50/55 Bull Call Spread
Cost 2.40 / Profit 2.60
Percent Profit – 108%

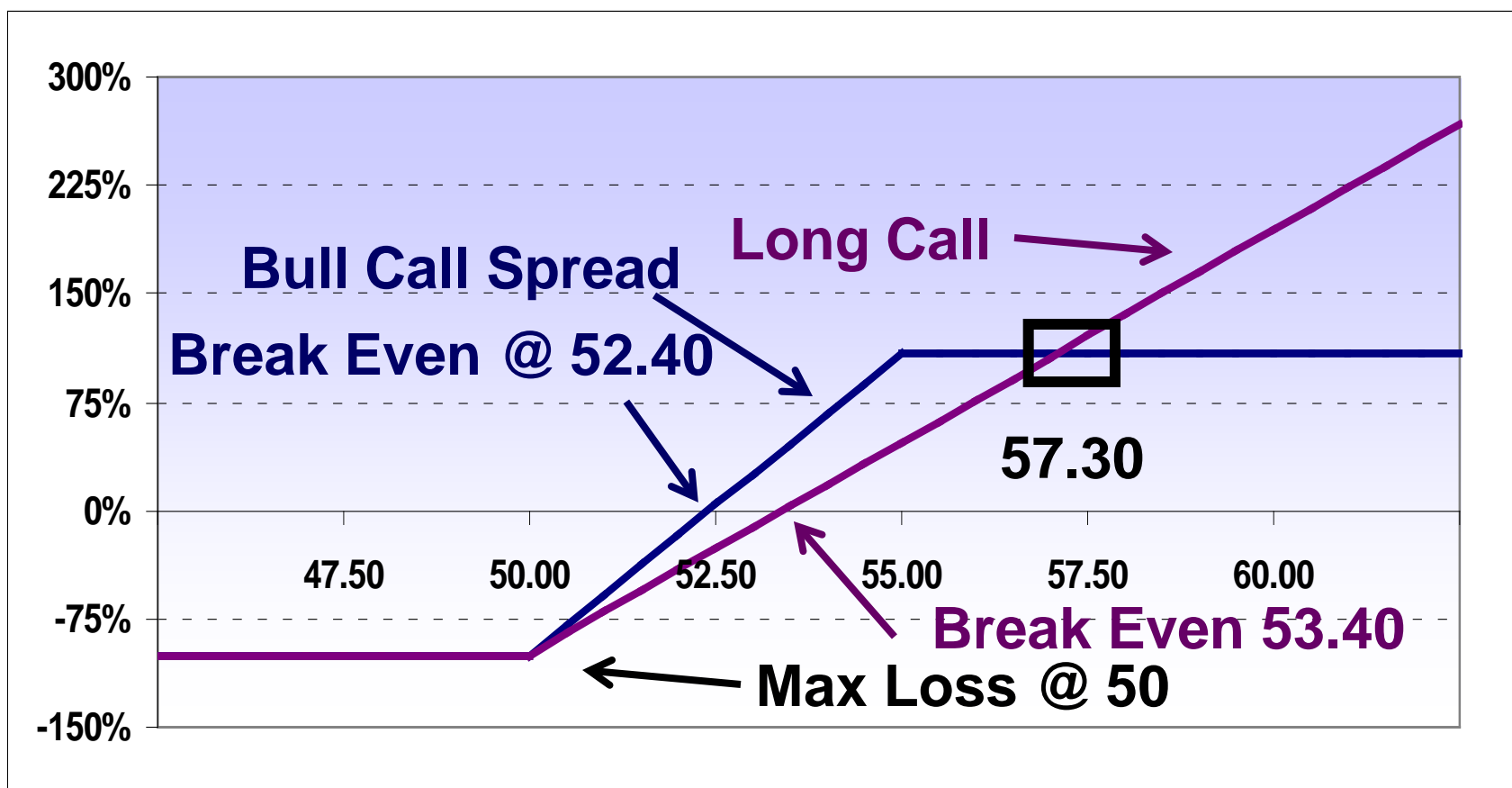
Bull Spread

Long 50 Call vs. 50/55 Bull Call Spread



Bull Spread

Long 50 Call vs. 50/55 Bull Call Spread



Bearish Trade Scenario –

Today is October 1, 2010

XYZ Co. (XYZ) is trading at 525.00

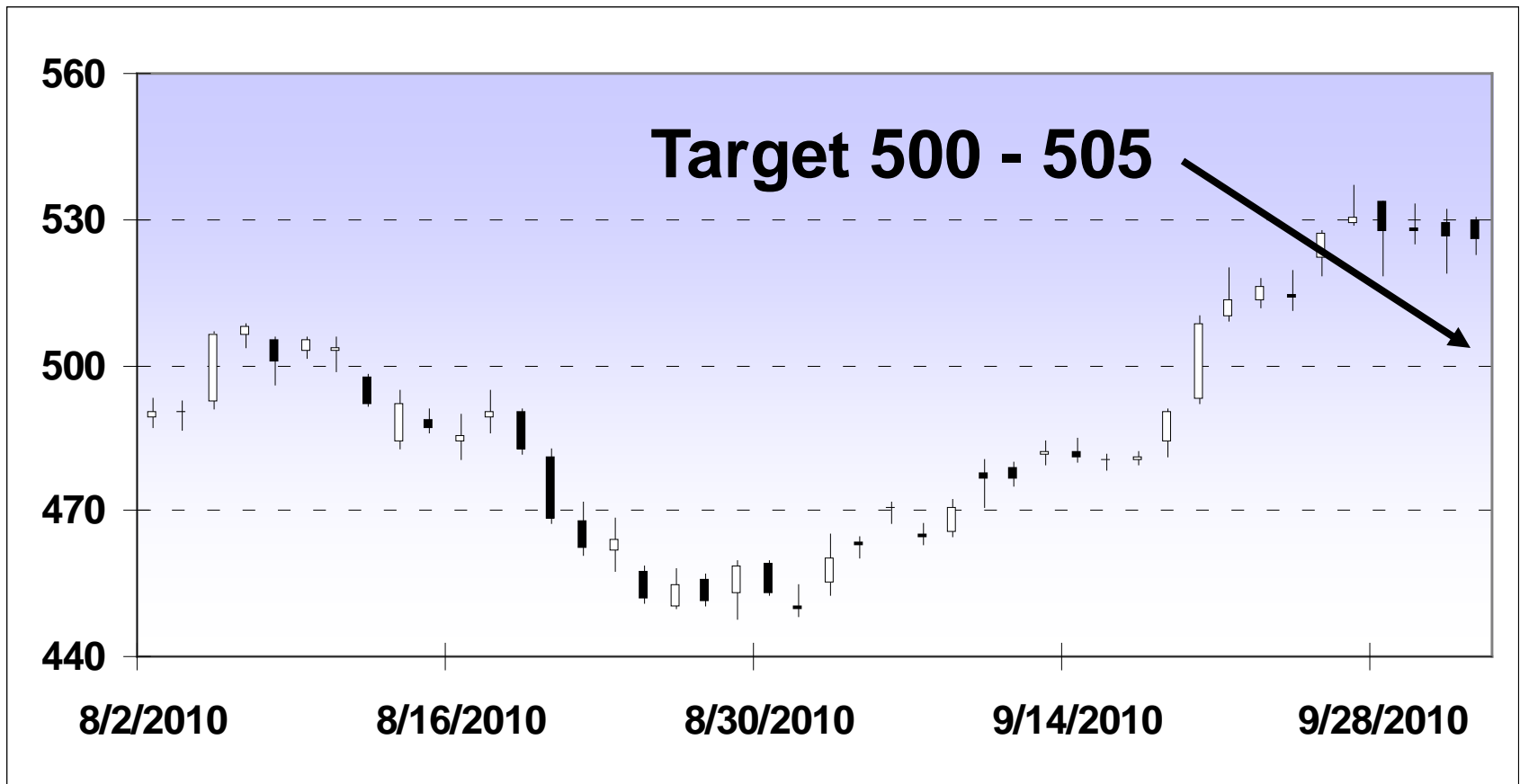
Earnings out 10/14, expect stock to trade lower

Would like to put on a trade now to benefit

October Expiration is Friday 10/15

Bear Spread

XYZ – 8/2/2010 – 10/1/2010



Bear Spread

XYZ – 525.00

Strike	Call Bid	Call Ask		Put Bid	Put Ask
500	30.20	30.70		4.50	4.70
510	22.90	23.20		7.20	7.40
520	16.70	17.00		10.90	11.20
530	11.70	12.00		15.90	16.20
540	7.80	8.10		22.00	22.30
550	5.10	5.30		29.20	29.60
560	3.20	3.40		37.30	37.70

Bear Spread

Long Put at Target Prices –

Long	Cost	505	% P/L	500	% P/L
510 Put	7.40	(2.40)	-32%	2.60	35%
520 Put	11.20	3.80	34%	8.80	79%
530 Put	16.20	8.80	54%	13.80	85%
540 Put	22.30	12.70	57%	17.70	79%
550 Put	29.60	15.40	52%	20.40	69%
560 Put	37.70	17.30	46%	22.30	59%

Bear Put Spreads at Targets

Bear Put Spread	Cost	505	% P/L	500	% P/L
500 - 510	2.90	2.10	72%	7.10	245%
510 - 520	4.00	6.00	150%	6.00	150%
520 - 530	5.30	4.70	89%	4.70	89%
510 - 530	9.00	11.00	122%	11.00	122%
520 - 540	11.40	8.60	75%	8.60	75%

Remember - Long 530 Put +85% @ 500

Decide on Oct 510 / 520 Bear Put Spread –

Buy 1 XYZ Oct 520 Put at 11.20

Sell 1 XYZ Oct 510 Put at 7.20

Net Debit (Cost) = 4.00

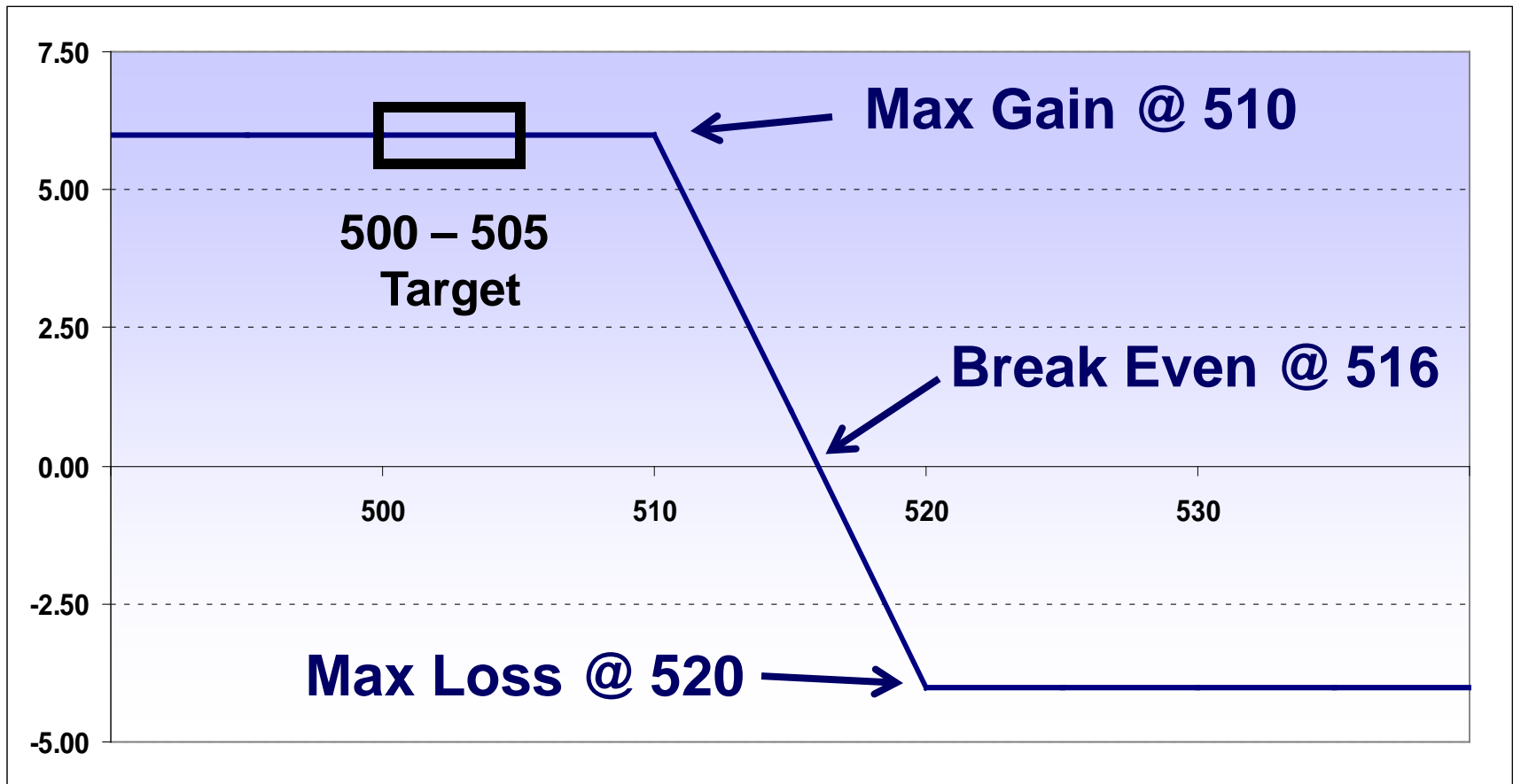
Bear Spread

XYZ 510/520 Bear Put Spread Payout –

XYZ	510 Put	520 Put	Spread Cost	Profit / Loss
490	(20.00)	30.00	(4.00)	6.00
500	(10.00)	20.00	(4.00)	6.00
510	0.00	10.00	(4.00)	6.00
520	0.00	0.00	(4.00)	(4.00)
530	0.00	0.00	(4.00)	(4.00)
540	0.00	0.00	(4.00)	(4.00)

Bear Spreads

XYZ 510 / 520 Bear Put Spread -



But what about just buying a put?

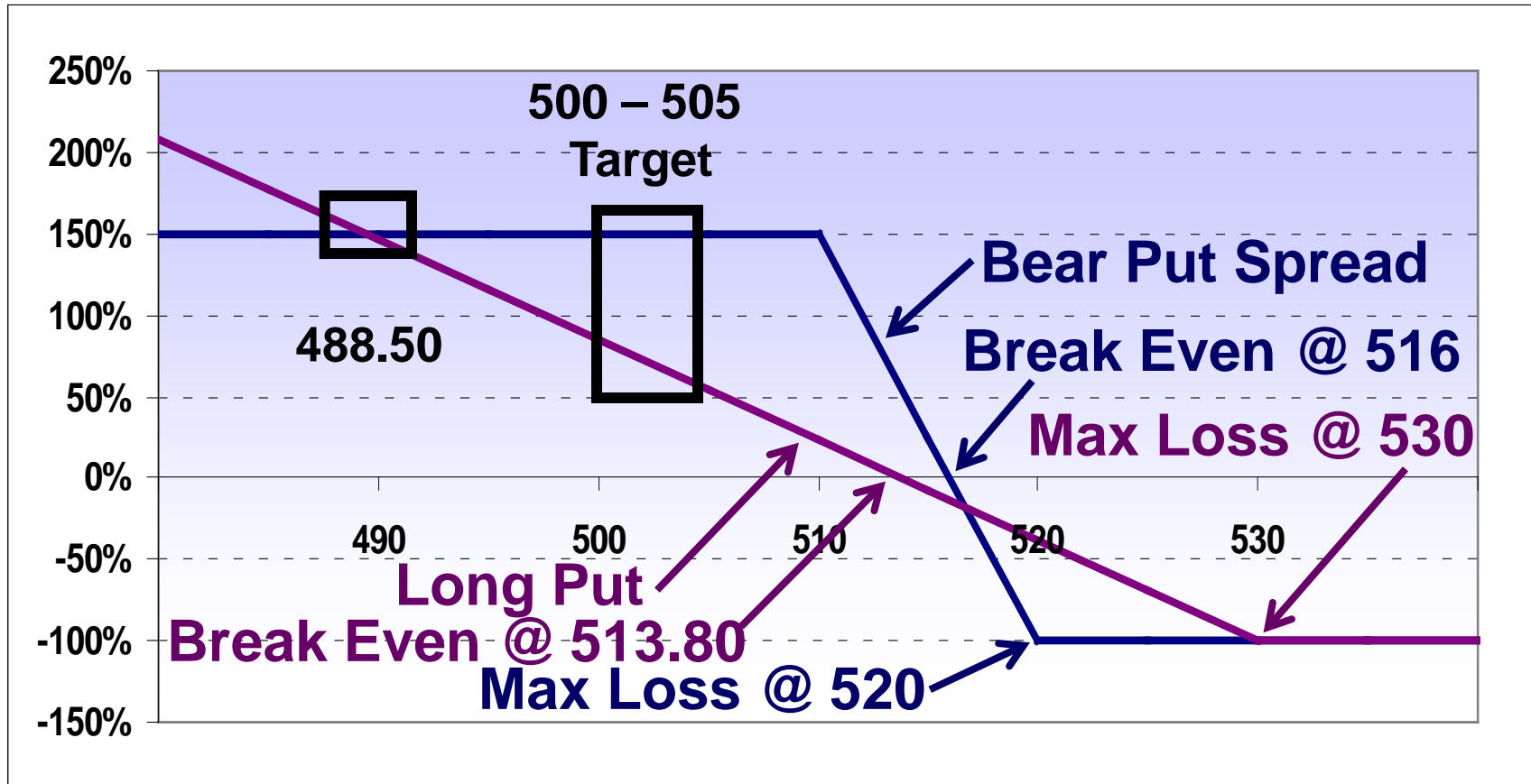
Long XYZ Oct 530 Put @ 16.20

At Target Range
Return 54% to 85%

Potential Return is Substantial

Bear Spreads

Long Put vs. Bear Put Spread –



- Vertical spreads may be bullish or bearish
- Both may be created with call or put options
- Depending on structure – may be at a debit or a credit
- When held to expiration – key levels are known
- Possible alternative to long option

Questions / Comments?

rhoads@cboe.com

www.cboe.com/learncenter