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VETICAL SPREADS

Getting Out or Rolling the Position

The selection and management of a vertical spread are only two-thirds of the game. Closing out, rolling or morphing the position has to be analyzed and executed with the same due diligence as was used in the selection and management processes.

Looking at the closing out of a vertical call spread, we find there are three possible outcomes that must be addressed. The spread can finish out-of-the-money and valueless. For a call spread, this scenario occurs when the stock closes at or below the lower strike of the spread. In this scenario, in order to close out the spread, one would just let it expire. Both options finish out of the money so no residual position will be left over.

If the spread finishes fully in the money, (at maximum value) that is with both options in-the-money, then both options will be exercised. You will exercise your long call and your short call will be assigned. They will cancel each other out and you will be left with no residual position. This scenario occurs when the stock price closes lower than the lower strike call involved in the spread.

The difficult scenario is when the stock closes in between the two strikes of the spread. This scenario, the closing of the stock between the two strikes creates a situation where one strike winds up being in-the-money while the other ends up out-of-the-money.

When both options expire in-the-money, they are both exercised-one creating a long stock option, the other creating a short position thus canceling each other out. This is not the case here. Here, one option, the one that is in-the-money will leave a residual stock position and since the other option is out-of-the-money, it will not be able to be used to offset the residual stock position created by the expiring in-the-money option.

There are two actions that could be taken. Choice number one involves trading out of the spread on expiration Friday just before the close. Because of the bid/ask spread of the two options, you will probably have to give away some of your profits in order to close out the position.
Giving up a portion of the profits may be the best thing to do in order to avoid naked, unlimited risk.

If you only trade out of the in-the-money option, you run the risk (albeit short-lived because you are doing this late on expiration day of the expiring month) that the stock moves adversely and the out-of-the-money option suddenly becomes in-

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the-money. If that happens, you will now be naked the residual stock position. Of course, if there is still time, you could always trade out of the option then but that is very risky. However, if the stock is at a relatively safe distance from the out-of-the-money you may want to just close out the in-the-money option and let the out-of-the money option expire worthless.

The two factors that must be considered are: the combination of the distance of the strike from the stock price in relation to the short amount of time for the stock to get there, and the amount of money saved by not buying back the out-of-the-money option. Remember, this is being done at the very end of the day on expiration day. These options only have minutes of life left. So, knowing this, the risk is somewhat mitigated, but still there none the less.

The catch is the proximity of the stock to the out-of-the-money option. If the stock is close to the out-of-the-money option, you would be best advised to trade out of the spread entirely.

Again, as stated before, if the stock closes either with the spread fully in-the-money, or fully out-of-the-money, the position will adjust itself through the exercise process leaving no residual position. If the stock price finishes between the two strikes, there will be a residual position. We discussed above how to trade out of this position. Your second choice is not to trade out and allow yourself to go through the expiration process. You must remember that if you are going to accept a residual stock position, you must be able to afford it.

Then, if you have 10 July 50 calls and you exercise them you will be receiving 1000 shares of stock at $50.00 per share. Thus, you must have $50,000.00 of cash and/or margin in your account to receive the stock. If you do not have enough cash and/or margin to accept delivery of the stock, then you must trade out of the position before it expires.

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