

VERTICAL SPREADS

An Imaginary Spread Scenario

Let's put together what we've been talking about, develop an imaginary spread scenario and set it in real life events.

In October, let's say that you begin to hear about IJK stock. It looks interesting, so you then use a variety of sources to learn about IJK: news, charts, outside analysts, internet research etc. From your investigations you decide that this stock is poised for a strong upward move and you'd like to take advantage of it.

However, each share is \$50.00 and you question whether you want to put out the capital for enough shares to make the trade worthwhile.

Now is the time to investigate IJK spreads. Since you are bullish on the stock, you investigate the bullish plays of the call spreads and the put spreads. You check the pricing of both since you are aware that implied volatility and time decay will affect both your purchase price and your selling price if you decide to sell out the spread before expiration.

Let's say that you set the spread's maximum potential gain at \$10.00 using our formula. Then you decide you want to buy a call spread, so you buy 10 IJK Nov. 50 calls and sell 10 IJK Nov 60 calls. The spread is called Nov. 50-60. The spread's cost is \$3.50, which means you pay \$3500 for the trade, inexpensive when you consider that to purchase 1000 shares of IJK stock would have cost you \$50,000!

Now, you wait and follow the stock price of IJK. If you hold the position to expiration, you face the following losses or gains.

First, if the stock does not move up as you expected and stays at \$50 or decreases in value, your spread is worthless and you lose the \$3500 that you paid for the spread. Second, if the stock begins to move up, you first recoup your investment and then move into profits. After the stock has moved up \$3.50 you are at the breakeven point. Every money advance after that represents profit.

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The chart below represents the spread's losses and gains and your total profit

<u>STOCK PRICE</u>	<u>50 CALL VALUE</u>	<u>60 CALL VALUE</u>	<u>SPREAD VALUE</u>	<u>SPREAD COST</u>	<u>PROFIT/(LOSS)</u>
64	\$14.00	\$ 4.00	\$10.00	\$3500	\$6500
63	\$13.00	\$ 3.00	\$10.00	\$3500	\$6500
62	\$12.00	\$ 2.00	\$10.00	\$3500	\$6500
61	\$11.00	\$1.00	\$10.00	\$3500	\$6500
60	\$10.00	\$ 0	\$10.00	\$3500	\$6500
59	\$ 9.00	\$ 0	\$ 9.00	\$3500	\$5500
58	\$ 8.00	\$ 0	\$ 8.00	\$3500	\$4500
57	\$ 7.00	\$ 0	\$ 7.00	\$3500	\$3500
56	\$ 6.00	\$ 0	\$ 6.00	\$3500	\$2500
55	\$ 5.00	\$ 0	\$ 5.00	\$3500	\$1500
54	\$ 4.00	\$ 0	\$ 4.00	\$3500	\$ 500
53	\$ 3.00	\$ 0	\$ 3.00	\$3500	(\$ 500)
52	\$ 2.00	\$ 0	\$ 2.00	\$3500	(\$1500)
51	\$ 1.00	\$ 0	\$ 1.00	\$3500	(\$2500)
50	\$ 0	\$ 0	\$ 0	\$3500	(\$3500)
49	\$ 0	\$ 0	\$ 0	\$3500	(\$3500)

This chart is based on stock prices at expiration Friday in November. Until then the spread's value fluctuates between \$0 and its maximum (the difference between strike prices) of \$10.00

At any time until expiration, you can sell out of the spread but what you receive for the price may be influenced by implied volatility and time decay and that will change your profit or loss. If you hold the spread until expiration and your bullish lean proves true, your maximum profit on your \$3500 investment is \$6500.

You paid \$3500 for the spread and received \$10,000 at expiration with the stock at \$60.00. That represents a \$6500 profit which is a 186% return.

If you had invested \$50,000 for 1000 shares of IJK and at expiration sold the stock for \$60,000, your profit is \$10,000 for a 20% return.

For many investors the reward/risk scenario of the spread is attractive because investors can limit the capital at risk and the time of risk/reward exposure. The spread also offers protection if your lean is bullish or bearish. Finally, the spread has the potential of a large percentage return on investment.

For more Information about option trading, please click here:
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