HC SECURITIES

CREDIT SPREADS

INCOME GENERATING OPTIONS STRATEGY

STRATEGY OVERVIEW

Strategy Name	Credit Spreads
Risk Level	Medium / High Risk
Objectives	Short-Term Trading Profits
Market Outlook	Bullish or Bearish, Volatility to Decrease
Break-Even Level	Call Spreads: Sold option strike + net credit Put Spreads: Sold option strike – net credit

What is a Credit Spread?

A Credit Spread is an options trade that is entered into for a credit to the investors account, essentially you are buying a lower priced option and selling a higher priced option and taking the difference between the prices. The Credit Spread can be created using either calls or puts and have either a bullish or bearish outlook on the market. A Credit Spread trade will sell time value and benefit with the passage of time.

Parts that make up a Credit Spread

There are two parts that make up a Credit Put Spread:

1. Purchase Lower Strike Put
2. Writing (sell) Higher Strike Put

Similarly, there are two parts that make up a Credit Call Spread:

1. Purchase Higher Strike Call
2. Write (sell) Lower Strike

Examples

Credit Put Spread Example

ABC is due to release their financial results in early January and the investor is of the opinion that the share price will remain well supported until this time. The investor would trade a Credit Put Spread over ABC if they believe that the share price is likely to appreciate prior to expiry, or not move at all. With the share price of ABC trading at $40.00, we enter the following position.

Sell 10 ABC $40.00 Dec10 Put – Receive $0.50
Buy 10 ABC $39.50 Dec10 Put – Pay $0.30

The investor will receive a credit of $0.20 per share multiplied by 1,000 (the usual number of shares covered by an options contract) and then buy the 10 contracts traded for each option leg. This will result in a $2,000 credit to the investors account. The risk in this example is that if the share price drops to below $39.50 you be required to pay $5,000. The loss in this scenario would be $3,000 i.e. ($0.50 – ($0.50 – $0.30)) x 10 x 1,000 = $3,000.

Should the share price remain above the $40.00 level at expiry as anticipated, the investor will keep the full $2,000 credit as a profit.

Credit Call Spread Example

The Australian share market appears to be struggling to breach the psychologically important 5,000 point level. The investor does not believe that the market will be able to push through this level prior to the end of the year and ABC would then appear to have trouble moving higher with this in mind. The investor would trade this strategy if they believe that the share price is likely to depreciate prior to expiry, or not move at all. With ABC shares trading at $39.50, we enter the following position.

Sell 10 ABC $40.00 Dec10 Call – Receive $1.00
Buy 10 ABC $41.00 Dec10 Call – Pay $0.65

The investor will receive a credit of $0.35 per share multiplied by 1,000 and then by the 10 contracts traded for each option leg. This will result in a $3,500 credit to the investors account. The risk of this strategy is that if the share price rises above the $41.00 level at expiry, you will be required to pay $10,000. The loss in this scenario would be $6,500 (($1.00 – ($1.00 - $0.65)) x 10 x 1000). Should the share price remain below the $40.00 level at expiry as anticipated, the investor will keep the full $3,500 credit as a profit.

What are the uses of Credit Spreads?

Credit Spreads allow investors to trade either a bullish, bearish or neutral strategy on a stock without tying up large amounts of capital. The risk and rewards of this strategy are limited and are ideal for investors that are not either strongly bullish or bearish.

Risk / Reward

An investor who opens a Credit Spread has limited upside potential with limited risk.

The Specifics

Credit Put Spread

Market Outlook	Neutral/Mildly Bullish
Breakeven	Exercise price of the sold put option, less the net premium received for opening the position.
Maximum Profit	Limited to the credit received for the sale of the put less the cost of the bought put.
Maximum Loss	Occurs if the share price finishes below the bought put strike. Maximum loss can be calculated as the difference between the strike prices, times the number of contracts, times the number of shares per contract, less the premium received for opening the trade.
Time Decay	Helps
Margins to be paid	Yes

Credit Call Spread

Market Outlook	Neutral/Mildly Bearish
Breakeven	Exercise price of the sold call option, plus the net premium received for opening the position.
Maximum Profit	Limited to the credit received for the sale of the put less the cost of the bought put.
Maximum Loss	Occurs if the share price finished above the bought call strike. Maximum loss can be calculated as the difference between the strike prices, times the number of contracts, times the number of shares per contract, less the premium received for opening the trade.

Time Decay	Helps
Margins to be paid	Yes

Considerations

If you are thinking about opening a Credit Spread position, the main variables to consider are:

1. Sold Option Strike Price – This will determine how far the share price will need to move prior to expiry before any potential profit will start to erode from the position.
2. Net credit amount – The net credit amount should always be compared to the risk that is being taken on for the position. As a general rule, we look for a return on risk of 30% or greater.
3. Time decay – the longer you choose to have the spread open for, the longer amount of time your money is at risk.
4. Dividends – Dividends can sometimes cause the early exercise of call options meaning that this should be taken into account. When a dividend is to be paid it can also inflate the Put Option premium above what the normal fair value would be.

Follow Up Action

When a position has been opened, it must be monitored to see if there is any advantage of closing the trade early to minimise risk. Should the position move strongly against the anticipated direction, the risk of early exercise should be taken into account.

Strategy

1. Open a Credit Spread trade in a stock that is not expected to have a strong market direction or a stock that is expected to trade in a sideward's direction.
2. Monitor the position for any opportunities to eliminate risk early by closing all / part of the position.