HC SECURITIES

DEBIT SPREADS

OPTIONS STRATEGY, DIRECTIONAL TRADING

STRATEGY OVERVIEW

Strategy Name	Debit Spreads
Risk Level	Medium / High Risk
Objectives	Short Term Trading Profits
Market Outlook	Bullish or Bearish
Break-Even Level	Put Spreads: Bought option strike – net premium paid Call Spreads: Bought option strike + premium paid

What is a Debit Spread?

Debit Spreads are an options trade that is entered into for a debit to the investors account; essentially you are buying a higher priced option and selling a lower priced option and paying the difference between the prices. The Debit Spread can be created using either calls or puts and have either a bullish or bearish outlook on the market. A Debit Spread trade will buy time value and deteriorate with the passage of time.

Parts that make up a Credit Spread

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

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

Similarly there are 2 parts that make up a Debit Call Spread:

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

Examples

Debit 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 come under pressure leading into the results. The investor would trade a debit put spread strategy over ABC if they believe that the share price is likely to depreciate prior to expiry. With the share price trading at $40.30, we enter the following position.

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

The investor will pay a debit of $0.20 per share multiplied by 1,000 (the usual number of shares covered by an options contract) and then by the 10 contracts traded for each option leg. This will result in a $2,000 debit to the investors account. The risk of this strategy is that if the share price rises to above $40.00 at expiry your spread will expire worthless. The loss in this scenario would be $2,000 i.e. ($0.50 - $0.30) x 10 x 1,000. Should the share price move below the $39.50 level at expiry as anticipated, the investor will close the position and make a profit of $3,000.

Debit Call Spread Example

The Australian share market appears to be rallying to breach the psychologically important 5,000 point level. The investor believes that the market will be able to push through this level prior to the end of the year and ABC would then appear to be moving higher with this in mind. The investor would trade this strategy if they believe that the share price is likely to appreciate prior to expiry. With the share price trading at $40.00, we enter the following position.

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

The investor will pay a debit 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 debit to the investors account. The risk of this strategy is that if the share price is below the $40.00 level at expiry, you will lose the premium you have paid to open the position. The loss in this scenario would be $0.35 x multiplied by 1,000 and then by the 10 contracts. Should the share price move above the $41.00 level at expiry as anticipated, the investor will make a profit of $6,500 i.e. (($41.00 - $40.00) - $0.35) x 10 x 1000.

What are the uses of Debit Spreads?

Debit Spreads allow investors to trade either a bullish or bearish strategy on a stock without tying up large amounts of capital. The risks and rewards of this strategy are limited and are ideal for investors that are moderately bullish or bearish.

Risk / Reward

An investor who opens a Debit Spread has limited upside potential with risk limited to the amount paid.

The Specifics

Debit Put Spread

Market Outlook	Mildly Bearish
Breakeven	Exercise price of the bought put option, minus the net premium paid for opening the position.
Maximum Profit	Maximum profit can be calculated as the difference between the strike prices, times the number of contracts, times the number of shares per contract, less the net premium paid to open the position.
Maximum Loss	Limited to the premium paid to open the position.
Time Decay	Works against the investor
Margins to be paid	No

Debit Call Spread

Market Outlook	Mildly Bullish
Breakeven	Exercise price of the bought call option, plus the net premium paid for opening the position.
Maximum Profit	Maximum profit can be calculated as the difference between the strike prices, times the number of contracts, times the number of shares per contract, less the net premium paid to open the position.
Maximum Loss	Limited to the premium paid to open the position.
Time Decay	Works against the investor
Margins to be paid	No

Considerations

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

1. Bought 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 be made from the position.
2. Net Debit Amount – The net debit amount should always be compared to the potential profit that is in the position. As a general rule, we look for a return on risk of 50% 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. In order to close a Debit Spread for a maximum profit, all of the time value will need to have eroded from the position.
4. Dividends – Dividends will make call options look cheaper than normal because the stock is expected to drop once the stock goes ex-dividend.

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.

Strategy

1. Open a Debit Spread trade in a stock that is expected to trade in a slight bullish / bearish direction.
2. Monitor the position for any opportunities to eliminate risk early by closing all / part of the position early.