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STRADDLES AND STRANGLES
LONG TRADES ONLY

STRATEGY OVERVIEW

Strategy Name	Straddles and Strangles
Risk Level	Medium / High Risk
Objectives	Short Term Trading Profits
Market Outlook	Bullish or Bearish, Volatility to Increase
Break-Even Level	Call strike plus total premium paid or put strike minus total premium paid

What are Straddles and Strangles?

Straddles and Strangles are option trading strategies that will benefit when volatility is on the rise or when the underlying price moves strongly higher or lower. These strategies are typically entered when the investor is not sure of which direction the underlying will move, however they are of the opinion that any movement will be substantial. Straddles & Strangles are similar trades however the difference between them is that a Straddle will use at the money calls and puts (the same strike price), and a Strangle will use out of the money calls and puts (different strike prices).

Parts that make up a Straddle or Strangle

There are two parts that make up a Straddle or a Strangle:

1. The purchase of a Call Option
2. The purchase of a Put Option

Examples

Strangle Example

Due to the potential for a move in either direction as a result of XYZ's upcoming production numbers and low volatility, the investor would open up the following strangle position with the share price currently trading at $3.15:

Purchase XYZ March $3.25 calls for $0.25
Purchase XYZ March $3.00 puts for $0.20

One day after entering the position, the company reports its production numbers and the share price has fallen $0.50 to $2.65. With the fall in share price, the put option has now increased in value to $0.43 and the call option has now decreased in value to $0.12. Depending on the investors' thoughts of where the share price will move from here, they have the following alternatives to chose from:

- Close the entire position for $0.55 ($0.43 + $0.12) giving a $0.10 profit.
- Close out the puts for $0.43 and continue holding the call options.
- Take no action because the investor is of the opinion the share price will decline further and therefore the put will increase further in value.

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For the purposes of our example, our investor will chose the second alternative and dispose of the put options for $0.43. The investor would do this if they are of the opinion the share price will not decrease any further. This will then leave the investor holding onto the call option. For the purposes of the example, the share price increases over the next week to $2.95. As a result of this the value of the call option increases to $0.15 and the investor decides to close the position. The end result is that the investor has received a total of $0.58 ($0.43 + $0.15) and therefore makes a profit of $0.13 ($0.58 - $0.45) or 28.8% return on funds invested.

Straddle Example

In the same scenario as outlined above, an investor would do the following for a Straddle:

Purchase XYZ March $3.15 calls for $0.30
Purchase XYZ March $3.15 puts for $0.28

What are the uses of Straddles and Strangles?

The main use of Straddles and Strangles is that they are intended to profit from a sharp move in the underlying price in either direction.

Risk / Reward

The owner of a Strangle or Straddle has unlimited upside potential, with downside limited to the amount paid to open the position.

The Specifics

Market Outlook	Bullish or Bearish, Volatility to Increase
Breakeven	Call strike plus total premium paid or put strike minus total premium paid
Maximum Profit	Unlimited
Maximum Loss	Occurs if the position is held until expiry and there is no intrinsic value left in the options
Time Decay	Works against this trade
Margins to be paid	No

Considerations

If you are thinking about opening a Strangle or Straddle position, the main variables to consider are:

1. Strike Price – The further away your strike price is, the further the share price will be required to move.
2. Time Decay – Is the share price going to move fast enough to compensate for time decay?
3. Volatility – The higher the current volatility level, the higher the cost to open the position and therefore the more the share price needs to move in order to profit.

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 or letting it run through to its natural conclusion. In almost all cases, it would always be the intention to sell both the calls and puts prior to expiry. This would then ensure that at least some time-value is recouped.

Strategy

1. Purchase both calls and puts in a stock that is expected to be volatile or where volatility is to increase.
2. Set points where you would look to sell out of the calls/puts.
3. Set a point in time where you would close the position early should volatility not occur.

GPO Box 5392 Sydney NSW 2001 | P: +61 2 8917 2900 | www.hcsecurities.com.au | info@hcsecurities.com.au