



THE VALUE LINE

Daily Options Survey

The Weekly Option Strategist, April 29, 2010

Option Spreads I: Basic Bull and Bear Spreads

This report is part of an ongoing series on option spreads. Spreads are combinations of different option positions on the same stock. Spreads are really not that complicated once you understand a few basic principals. The spreads that we will cover in this series will all have limited risk. Some of them can offer investors very efficient use of their capital.

Bull vs. Bear

You create basic bull and bear spreads by simultaneously buying and writing calls or puts (not both) on the same stock with the same expiration but with different strike prices. The risk/reward characteristics of the spread will depend on the price and the strike prices of the options you buy and the options you write.

You have all heard “buy low, sell high if you are bullish.” This adage can help you remember how to structure your spreads.

Bullish: Buy Low and Sell High. In a bull spread, the investor simultaneously buys the lower strike call (or put), and sells the higher strike call (or put).

Bearish: Buy High and Sell Low. In a bear spread, the investor simultaneously buys the higher strike call (or put) and sells the lower strike call (or put).

Debit vs. Credit Spreads

Debit Spreads: Bull spreads constructed with calls (bull call spreads) and bear spreads constructed with puts (bear put spreads) require that you pay a net payment of premium, since you are buying the higher premium option and selling the lower premium one. We call these spreads “debit spreads,” because your broker debits your account for the net premium amount. With a debit spread, the most you can lose is this net premium you paid, while your potential gains are limited by the option you wrote. The Exchanges do not require a margin on debit spreads.

Credit Spreads: Bear spreads constructed with calls (bear call spreads) and bull spreads constructed with puts (bull put spreads) always involve selling the higher premium option and buying the lower premium one. We call these spreads “credit spreads” because your broker credits your account with the net premium. With these spreads, the Exchanges require that you post a margin equal to the difference between the two strike prices. This margin covers your maximum possible loss on the spread. With a credit spread, you are allowed to apply your net credit of premium toward this margin requirement.

Time Value Is the Key

Investors often wrongly assume that because you take in premium and post margin with a credit spread, your position is always comparable to option writing. In fact, what really

determines if a spread is like an option sale or purchase is whether the investor is selling or buying time premium on a net basis. Remember that at-the-money or close-to-the-money options always have more time value than options that are further out-of-the-money or deeper in-the-money. For options with the same expiration date, if you are buying the option that is closer to the money than the one you are writing, then on a net basis, you are a buyer of time premium. If you are writing an option that is closer to the money than the one you are buying, then on a net basis, you are a seller of time premium. In both examples below, you are a net seller of time premium even though with the debit spread, we actually pay a premium.

Examples - Bull Call vs. Bull Put Spreads

Somewhat surprisingly, credit spreads usually require approximately the same amount of capital to establish as do debit spreads involving the same strikes. (The examples below will help illustrate this point).

In Figure 1, we compare two spreads on Amazon (AMZN), a bull call spread and a bull put spread. In each one we buy the \$120 strike option and sell the \$140 strike option (with AMZN at \$140).

In the bull call spread, we pay \$22.75 for the \$120 call and we receive \$9.30 for the \$140 call with a net debit of \$13.65 per share or \$1,365 on a spread involving one option on each side. This spread is a little like a covered call in which you use the long \$120 strike call as a substitute for the stock and where you write the \$140 call against it. Notice that the \$120 call has only \$2.75 in time premium and that you are taking in \$9.30 worth of time premium with the call that you wrote. Your net credit of time premium is \$6.55 per share - or \$655 for the spread. If the stock ends up at \$140 or above, you get to keep this \$655 net time premium, net of transaction costs.

In the bull put spread, we write the \$140 put at \$9.25 and buy the \$120 put at \$2.75 as a hedge against losses below \$120. This spread is similar to a “naked” put write; the difference, however, is that we have covered the downside by buying the lower strike put. In this example, the net premium received is \$6.50 or \$650 on a spread with one option on each side. With the credit of premium applied to the margin, the capital requirement is \$1,350 on the spread. If the stock ends up at \$140 or above, you get to keep the entire \$650 credit of premium on the position.

Which Spread Is Best?

Not only do these two spreads, constructed by buying the \$120 strike option and selling the \$140 strike one, require similar amounts of capital and have similar maximum losses (\$1,345 for the bull call spread versus \$1,350 for the bull put spread), they have similar maximum gains as well.

The maximum gain on the bull call spread is \$655 if the stock ends up at or above \$140. However, at any level above \$140.75 beyond the strike is the trigger for automatic); the investor will have to close out both the long call and the short call. This will incur both commissions and possible losses on the bid and ask spreads.

The maximum gain on the bull put spread in this example is \$650, which is \$5 lower than with the bull call spread. However, if the stock ends up at or above \$140, there are no further transactions required. The investor simply keeps the net premium. Another

attractive feature of the bull put spread is that if you have a margin account, your broker usually will allow you to use other assets instead of cash to establish and maintain your spread.

In general, a simple way to figure out which spread would be the best (credit or debit) is to ask yourself where you expect the stock to end up. If it is a bull spread and you expect the stock to end up above both strike prices, then the bull put spread has the edge.

Searching For Spreads

At present, we do not specifically rank spreads, but we do provide a template (Spreadsearch2.Xls), with which you can find spreads that our model finds to be favorably priced. See “Searching for Spreads with Spreadsearch2.Xls,” Ot080526.Pdf. In Figure 2, we show an example of a search for favorably priced bull put spreads, expiring in July, with common and technical ranks of 1 or 2.

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Figure 1 - Bull Call and Bull Put Spread Comparisons - Amazon (AMZN)						
	Trade Date			28-Apr-10		
	Expiration			17-Jul-10		
	Stock Price			\$ 140.00		
	Bull Call (Debit) Spread			Bull Put (Credit) Spread		
	Call Premium	Time Premium	Call Delta	Put Premium	Time Premium	Put Delta
Buy \$120	\$ 22.75	\$ 2.75	82	\$ 2.75	\$ 2.75	(17)
Write \$140	\$ 9.30	\$ 9.30	(53)	\$ 9.25	\$ 9.25	46
Debit (Credit)	\$ 13.45			\$ (6.50)		
Margin Requirement	\$ -			\$ 13.50		
Capital Requirement	\$ 13.45			\$ 13.50		
Time Premium (Credit)		\$ (6.55)			\$ (6.50)	
Net Delta			29			29

Figure 3 – Search for Bull Put Spreads

Common Rank 1 or 2, Technical Rank 1 or 2, July 2010 Expiration, Option Written Overpriced by 10% or more and Close-to-the-Money																
Basic Information				Option Purchased					Option Written					Spread Summary		
Company	C/	Cm	Cm	Exp'	Strike	Price	% In- or	Under/	Strike	Price	Norm	% In- or	Under/	Net	Net	Diff
	P	Tkr	Price				Out of	Over				Out of	Over	Prem	Est	
Amazon.com	P	AMZN	141.23	Jul-10	125.00	3.65	-11.0%	4.0%	140	8.85	7.72	-1.0%	13.0%	(5.20)	(4.37)	(0.83)
Assured Guaranty	P	AGO	22.04	Jul-10	19.00	1.25	-13.0%	54.0%	22.5	2.55	1.81	2.0%	47.0%	(1.30)	(1.28)	(0.02)
Darden Restaurants	P	DRI	46.11	Jul-10	40.00	0.70	-13.0%	11.0%	45	1.9	1.55	-2.0%	18.0%	(1.20)	(1.03)	(0.17)
Disney (Walt)	P	DIS	36.92	Jul-10	33.00	0.51	-10.0%	14.0%	36	1.2	0.98	-2.0%	16.0%	(0.69)	(0.63)	(0.06)
Energy Transfer Equity	P	ETE	34.72	Jul-10	22.50	0.10	-35.0%	4.0%	35	1.65	1.29	1.0%	31.0%	(1.55)	(1.22)	(0.33)
Gen'l Mills	P	GIS	70.96	Jul-10	60.00	0.20	-15.0%	-13.0%	70	1.85	1.16	-1.0%	48.0%	(1.65)	(0.81)	(0.84)
Gen'l Mills	P	GIS	70.96	Jul-10	65.00	0.55	-8.0%	13.0%	72.5	3.2	2.67	2.0%	37.0%	(2.65)	(2.29)	(0.36)
IDEXX Labs.	P	IDXX	66.11	Jul-10	50.00	0.25	-24.0%	-24.0%	65	2.25	1.98	-1.0%	11.0%	(2.00)	(1.22)	(0.78)
ITT Educational	P	ESI	104.91	Jul-10	90.00	3.80	-14.0%	37.0%	105	8.9	5.55	0.0%	60.0%	(5.10)	(3.68)	(1.42)
Lauder (Estee)	P	EL	66.32	Jul-10	50.00	0.30	-24.0%	-11.0%	65	2.7	2.27	-1.0%	15.0%	(2.40)	(1.78)	(0.62)
Lexmark Int'l 'A'	P	LXK	39.16	Jul-10	35.00	1.10	-10.0%	22.0%	38	2.05	1.37	-2.0%	36.0%	(0.95)	(0.65)	(0.30)
Lexmark Int'l 'A'	P	LXK	39.16	Jul-10	36.00	1.40	-8.0%	31.0%	39	2.5	1.81	0.0%	36.0%	(1.10)	(0.96)	(0.14)
Life Partners Holdings	P	LPHI	24	Jul-10	17.50	0.50	-27.0%	17.0%	25	3.1	2.58	4.0%	27.0%	(2.60)	(2.28)	(0.32)
NIKE Inc. 'B'	P	NKE	77.04	Jul-10	67.50	0.85	-12.0%	9.0%	75	2.55	1.99	-2.0%	20.0%	(1.70)	(1.34)	(0.36)
Penn National Gaming	P	PENN	31.21	Jul-10	20.00	0.10	-35.0%	-20.0%	30	1.4	1.07	-3.0%	21.0%	(1.30)	(0.78)	(0.52)
Procter & Gamble	P	PG	61.17	Jul-10	52.50	0.35	-14.0%	11.0%	60	1.49	1.07	-1.0%	29.0%	(1.14)	(0.84)	(0.30)
RadioShack Corp.	P	RSH	22.91	Jul-10	15.00	0.15	-34.0%	-20.0%	22.5	1.35	1.12	-1.0%	18.0%	(1.20)	(0.77)	(0.43)
Reinsurance Group	P	RGA	51.87	Jul-10	35.00	0.20	-32.0%	2.0%	50	1.45	1.11	-3.0%	19.0%	(1.25)	(0.93)	(0.32)
S & T Bancorp	P	STBA	24.39	Jul-10	17.50	0.15	-28.0%	-12.0%	25	1.65	1.51	2.0%	13.0%	(1.50)	(1.27)	(0.23)
Smithfield Foods	P	SFD	19.02	Jul-10	15.00	0.35	-21.0%	16.0%	19	1.4	0.99	0.0%	40.0%	(1.05)	(0.78)	(0.27)
Thoratec Corp.	P	THOR	35.66	Jul-10	27.50	0.30	-22.0%	-20.0%	35	1.75	1.49	-1.0%	14.0%	(1.45)	(0.87)	(0.58)
Tyson Foods 'A'	P	TSN	19.88	Jul-10	15.00	0.15	-24.0%	5.0%	21	1.75	1.51	5.0%	31.0%	(1.60)	(1.39)	(0.21)
VistaPrint NV	P	VPRT	58.36	Jul-10	47.50	1.10	-18.0%	17.0%	57.5	3.8	2.69	-1.0%	36.0%	(2.70)	(2.00)	(0.70)