THE VALUE LINE

Daily Options Survey

The Weekly Option Strategist, May 6, 2010

Option Spreads II: Credit Spreads As "Naked" Write Alternatives

Writing "naked" options can be highly profitable, but it also can be very risky, since losses can easily exceed the margin that you originally posted. In this report, we show you how, in many cases, you can substitute a credit spread for an uncovered (or "naked") write. Because credit spreads have limited losses, their margins are often a lot lower than the margins on naked writes. At the same time, these spreads can still offer very substantial returns on capital.

Bull and Bear Spreads: A (Very Brief) Review

In last week's report ("Option Spreads I: Basic Bull and Bear Spreads," in our Option Strategy Reprints), we showed how you create bull and bear spreads by buying and selling calls (or puts, but not both in the same spread) on the same stock with the same expiration date but with different strike prices.

When you buy the lower strike call or put and sell the higher strike call or put (a bull call spread or a bull put spread), your spread is bullish - hence a bull spread. When you buy the higher strike call or put and sell the lower strike call or put (a bear call or a bear put spread), your spread is bearish - hence a bear spread.

Bull put spreads and bear call spreads are called credit spreads since the option you write has a higher premium than the one you buy; thus, your account is credited the net premium. Credit spreads are often thought to be analogous to option writing because you take in premium; however, this is only part of the story. More accurately, you need to be a net seller of time premium (i.e., total premium net of intrinsic value) for your spread to have the characteristics of an option write. Only then, will time decay be in your favor (i.e., you will make money if the stock stands still). To be a net seller of time premium, you need to make sure that the option you write has a strike price that is closer to the stock price than the one you buy.

Spread Margin Requirements

The required margin on a credit spread is equal to the difference between the two strike prices times the number of underlying shares. This amount represents the most the investor can lose on these positions (e.g., $1,000 for an option on 100 shares with the strike prices $10 apart). However, your actual capital requirement is reduced by the fact that you are allowed to apply the net credit of premium to this margin.

In contrast, margin requirements on "naked" option writes can be hefty. Here, you are required to post the entire premium taken in plus a percentage of the underlying value (20%, less the amount out-of-the-money, or 10%, whichever is greater).

A Bull Put Spread from a "Naked" Put Write Recommendation

When you create a bull put spread that is based on one of our "naked" put writing recommendations, you need to select a put that is reasonably close-to-the-money. You then need to find a put of the same expiration with a strike price that is lower than than the recommended short put.

Here Is an Example

On May 5, 2010, we recommended writing (rank 5) the Cree Inc. (CREE) June 70 put at $4.25 with the stock at $71.72. If you write this "naked" put, you are required to have $1,262 in your account (20% of the underlying value, $1,434, minus the amount that the option is out-of-the-money, $172). You also need to keep the premium of $425 in your account (you can get called for a higher margin if the stock falls and the value of the put rises).

Alternatively, you might create a bull put spread starting from the same recommendation. Here, in addition to writing the June $70 put for $4.25, you buy the June $55 strike put for $0.68. In this spread, you take in $357 net premium. The margin required to establish the spread is $1,500. This is the difference between the two strikes prices times the number of underlying shares. It represents the maximum potential loss of the position. However, with a credit spread, the premium taken in can be applied to this margin. Thus, the capital required to open the spread is $1,075 ($1,500 minus the $425 premium).

In this bull put spread example, you get to keep the entire $357 net premium (less opening commissions) if the stock ends up above the $70 strike price. The maximum percentage return on capital (before commissions) comes to 33.2%, based on earning $357 from the $1,075 capital required to establish the spread.

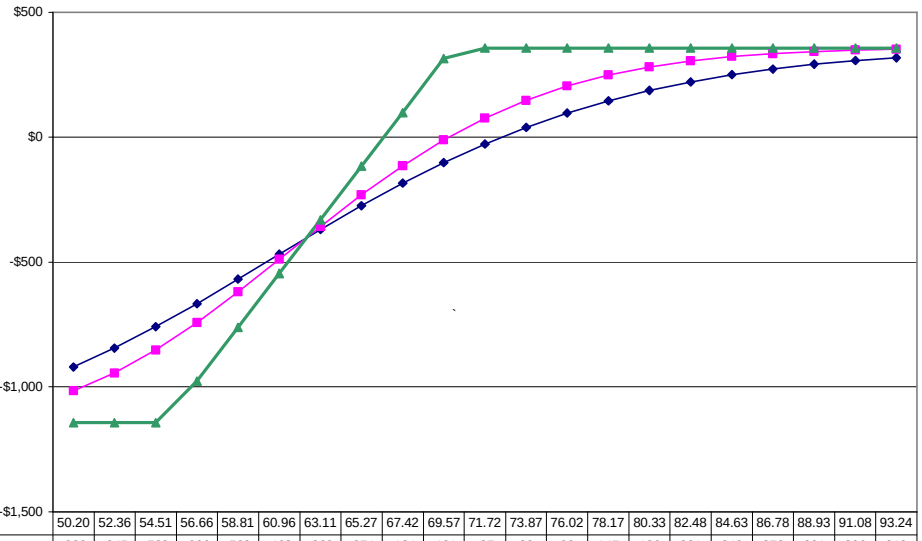
By comparison, if we had written the "naked" short put, the maximum return on capital would have been almost exactly the same (i.e., 33.7% based on earning $425 on a capital requirement of $1,262). With the "naked" put write, you can lose $6,747 if the stock drops to zero, while with the put spread the most you can loses is $1,075. In comparing the two strategies, you need to be aware that the "naked" option's breakeven price is lower ($67.47 versus $68.15 for the spread); however, the spread gives you more protection if the stock declines sharply before the June expiration.

In Graph 1, we show the potential profit or loss of the position for a 30% price move in either direction on the date the spread is established, 23 days later (i.e. on May 27, 2010), and on the June 19, 2010 expiration. In Graph 2, we show the outcomes for writing the "naked" December $70 put over this same price range.

Using Our Templates

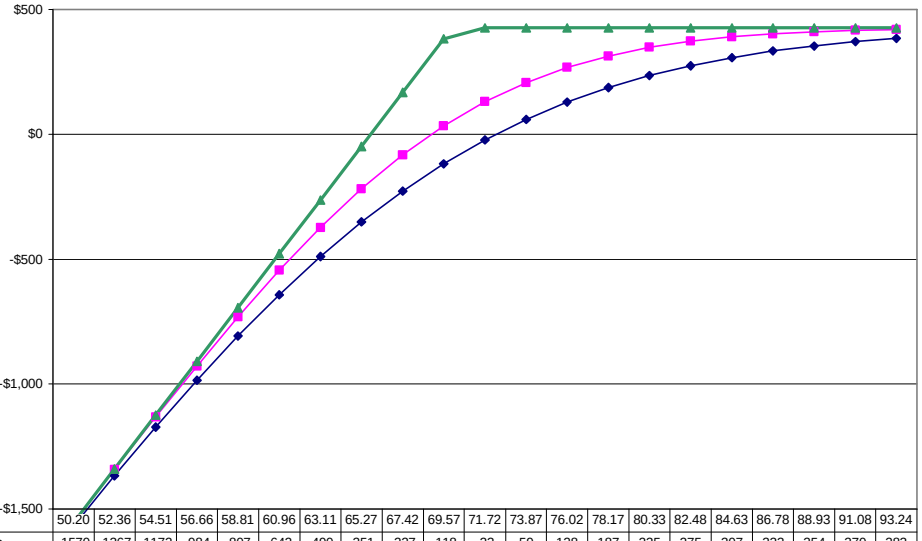
The Graphs shown in this report were produced by our option position template, Whatifi4.Xls (free to Value Line Options subscribers). With this template, you can evaluate the combined gains and losses of as many as four different stock and or option positions over three different time periods (see "Whatifi4.Xls," Our New Position Evaluation Template," Ot080602.Pdf in our *Reports Archive*). To search for favorable spreads, we can use our template, Spreadsearch2.Xls, which is also free to subscribers (see "Searching for Spreads with Spreadsearch2.Xls," Ot080526.Pdf in our *Reports Archive*).

Graph 1 - Bull Put Spread on Cree: Write June $70 Put at $4.25 and Buy June $55 Put at $0.68



	50.20	52.36	54.51	56.66	58.81	60.96	63.11	65.27	67.42	69.57	71.72	73.87	76.02	78.17	80.33	82.48	84.63	86.78	88.93	91.08	93.24
5/4/2010	-920	-845	-760	-666	-568	-468	-369	-274	-184	-101	-27	39	96	145	186	221	249	273	291	306	318
5/27/2010	-1017	-945	-853	-743	-620	-490	-358	-232	-115	-12	75	147	204	248	281	305	322	334	342	348	351
6/19/2010	-1143	-1143	-1143	-977	-762	-547	-332	-116	99	314	357	357	357	357	357	357	357	357	357	357	357
Percent Change	-30%	-27%	-24%	-21%	-18%	-15%	-12%	-9%	-6%	-3%	0%	3%	6%	9%	12%	15%	18%	21%	24%	27%	30%

Graph 2 - Write June $70 Put at $4.25



	50.20	52.36	54.51	56.66	58.81	60.96	63.11	65.27	67.42	69.57	71.72	73.87	76.02	78.17	80.33	82.48	84.63	86.78	88.93	91.08	93.24
5/4/2010	-1570	-1367	-1172	-984	-807	-642	-490	-351	-227	-118	-23	59	128	187	235	275	307	333	354	370	383
5/27/2010	-1555	-1342	-1133	-928	-731	-545	-373	-218	-82	34	130	207	267	313	347	372	390	402	410	416	419
6/19/2010	-1555	-1339	-1124	-909	-694	-479	-264	-48	167	382	425	425	425	425	425	425	425	425	425	425	425
Percent Change	-30%	-27%	-24%	-21%	-18%	-15%	-12%	-9%	-6%	-3%	0%	3%	6%	9%	12%	15%	18%	21%	24%	27%	30%

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