The Credit Spread

February 24, 2024

Contents

1 The Credit Spread

1.1 What

1. Put Credit Spread (or Bull Put Spread)

   Sell a Put Option with a higher strike price (more expensive option)

   Buy a Put Option with a lower strike price (cheaper option)

   It is a neutral to bullish strategy. You'll make money as long as the price of the Underlying does not move below the sold Put Option's strike price.

2. Call Credit Spread (or Bear Call Spread)

   Sell a Call Option with a lower strike price (more expensive option)

   Buy a Call Option with a higher strike price (cheaper option)

   It is a neutral to bearish strategy. You'll make money as long as the price of the Underlying does not move above the sold Call Option's strike price.

1.1.1 Recommendations

- We recommend the selling of the Option be:

  OTM

  Around 1.5 SD away from the current price levels, with less than a 20% chance of expiring ITM

  With 1.5 months to 1 week of life left on the option.

- We recommend the buying of the Option be:

  Further OTM

  More than 1.5 SD away from the current price levels, with less than a 15% probability of being ITM on expiration day.

  With 1.5 months to 1 week of life left on the Option.

  essentially the more OTM sister of the sold Option.

1.2 Risk/Reward

- Maximum Profit: Limited to the premium recieved minus the price paid for the bought Option.
- Maximum Risk: Limited to the difference between the strike price of the bought Option and the strike price of the sold Option minus the premium received for the Option you sold.

1.3 When

- Even though you are also buying Options, your profit-generator in this strategy is the selling of Options, as you're only buying Options to hedge your position. Since it is therefore mostly a premium selling strategy, look for Underlyings that have high IV Ranks (above 75).
- Put Credit Spread

  This strategy attempts to profit from people's excessive fear. So it is especially attractive in Underlyings that have experienced large price decreases and investors look to buy puts because they are very afraid that the stock will tank. You sell that to them. It's just that you also buy a cheaper one in order to limit your risk, just incase the fear-driven investors turn out to be right.
- Call Credit Spread

  This strategy attempts to profit from people's excessive greed. So it is especially attractive in Underlyings that have experience large price increases and investors look to buy calls because they think the ride will last forever. You sell that to them. It's just that you also buy a cheaper one in order to limit your risk, just in case the optomistic speculators turn out to be right

1.4 Pros

- Compared to a naked sell, this strategy limits your risk very sinficantly.
- As a result, your brokerage firm won't require as big a cash or margin requirement to trade this.
- Put Credit Spreads: You can make money if the Underlying rises, doesn't move, or even if it moves down slightly.
- Call Credit Spread: You can make money if the Underlying falls, doesn't move, or even if it moves up slightly.
- From the moment you place your trade, you know exactly what your maximum possible profit is and what your maximum possible risk is.
- Since it's mostly an Option premium selling strategy, odds tend to favor you.

1.5 Cons

- As it is a more complex strategy than selling naked, be prepared to pay more in commisions and don't expect your order to get filled as fast.
- Time decay is no longer overwhelmingly on your side as you have both a long (bought) and a short (sold) Option, so you are rater neutral on the positive effects of time decay.
- Despite your long Option hedge, this is still a directional trade; and if the Underlying moves significantly against your predicted direction, you stand to lose money (albeit your losses are capped).

1.6 The Greeks of The Credit Spread Strategies

- Δ: Depends

  Negative for Call Credit Spreads

  Positive for Put Credit Spreads
- Θ: Neutral

  The sold and bought Options offset each other's effects.
- Vega: Neutral

  Again the sold and bought Options offset each other's effects.