The Debit Spread

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1.1 What

1. Put Debit Spread (or Bear Put Spread)

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

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

   It is a neutral to bearish strategy. You'll make money as long as the price of the Underlying moves down enough to offset the premium paid.

2. Call Debit Spread (or Bull Call Spread)

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

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

   It is a neutral to bullish strategy. You'll make money as long as the price of the Underlying moves up enough to offset the premium paid.

1.1.1 Recommendations

- We recommend the buying of the Option be:

  Either slightly ITM, ATM or very slightly OTM

  Less than .5 SD away from the current price levels, with at least a 40% chance of expiring ITM

  An Option you would feel confident buying on its own

- We recommend the selling of the Option be:

  OTM

  Around 1.5 SD away from the current price levels, with less than 20% probability of being ITM on expiration day.

  However, these conditions can be relaxed in order to get more premium, as your risk is hedged by the long Option.

1.2 Risk/Reward

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

1.3 When

- Even though you are selling Options, your profit generator in this strategy is the buying of the Options, as your selling Options as you are selling Options to offset the premium you spent. Since it is therefore mostly a premium buying strategy, look for Underlyings that have low IV Ranks (below 20).

- Put Debit Spread

  This strategy is essentially buying a Put Option, but reducing the premium you have to pay for it by selling a further away Put Option. So the situation you're looking for is the same as the one you would be looking for when trying to buy a Put Option outright, ie. you think that the Underlying will decrease significantly in price before the Option expires. Maybe you think that the stock has gotten overbought and is bound for a correction, or that some bad news will hit the company and the stock price will suffer.

- Call Debit Spread

  This strategy is essentially buying a Call Option, but reducing the premium you have to pay for it by selling a further away Call. So the situation you are looking for is the same one you would be looking for when trying the buy a Call Option outright, ie. you think the stock price will increase significantly in price before the Option expires. Maybe you think that the stock has gotten oversold and is bound for a correction, or that some good news will hit the company and the stock price will benefit from it.

1.4 Pros

- Compared to just buying an Option outright, this limits the amount of money you pay in premium.

- As a result, you increase your probabilites of success, and they will be significantly better than the ones you would have to had had you just bouth the Option.

- From the moment you place your trade, you know exactly what your maximum possible profit is and what your maximum possible risk is.

- As it is a relatively low-risk strategy, brokerage firms will not require cash or margin deposits in order for you to trade this.

- If the price of the Underlying moves significantly towards your prediction, you stand to make a lot of money (around a 50% return on the initial capital spent). These gains will not be infinite, however, as they are capped by the short Option position.

1.5 Cons

- As it is mostly an Option-buying strategy, you need the Underlying to move towards your predicted direction more than the amount you paid for the premium. This means that you only make money if the Underlying moves significantly one way.

- Compared to premium-selling strategies, the probability of success are much lower (usually around 40%).

- As it is a more complex strategy than buying naked, be prepared to pay more in commisions and don't expect your order to get filled as fast.

1.6 The Greeks of The Debit Spread Strategies

- Δ: Depends

  Positive for Call Debit Spreads

  Negative for Put Debit 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.