THE CREDIT SPREADS BLUEPRINT

A STEP-BY-STEP GUIDE TO TRADE CREDIT SPREADS SAFELY & PROFITABLY (EVEN IF YOU'RE JUST STARTING FROM SCRATCH)

By OptionsWithDavis.com

1 STEP 1: BUILD YOUR CREDIT SPREADS WATCHLIST

The very first step to do before you start trading Credit Spreads is to create your “Credit Spreads Watchlist”.

This is where you can build a watchlist of both Stocks and ETFs.

Symbol	Last	%Change
AMZN	138.41	-0.11%
CRM	208.70	+0.22%
EWZ	31.57	-0.69%
GDX	29.46	+0.99%
GDXJ	35.41	+1.26%
GLD	177.60	0.00%
GOOGL	129.56	-0.10%
IBM	143.12	-0.09%
IWM	190.99	+0.14%
KO	61.17	+0.41%
NVDA	408.55	-3.62%
QQQ	366.24	-0.64%
SMH	146.21	-2.51%
SPY	445.65	-0.06%
XBI	79.87	-0.09%
XLE	89.90	+1.54%
XLF	34.92	+0.20%
XLK	166.90	-0.74%
XOP	148.81	+1.18%

Now, while you can build a watchlist of both Stocks and ETFs, my preference will always be to trade it on ETFs.

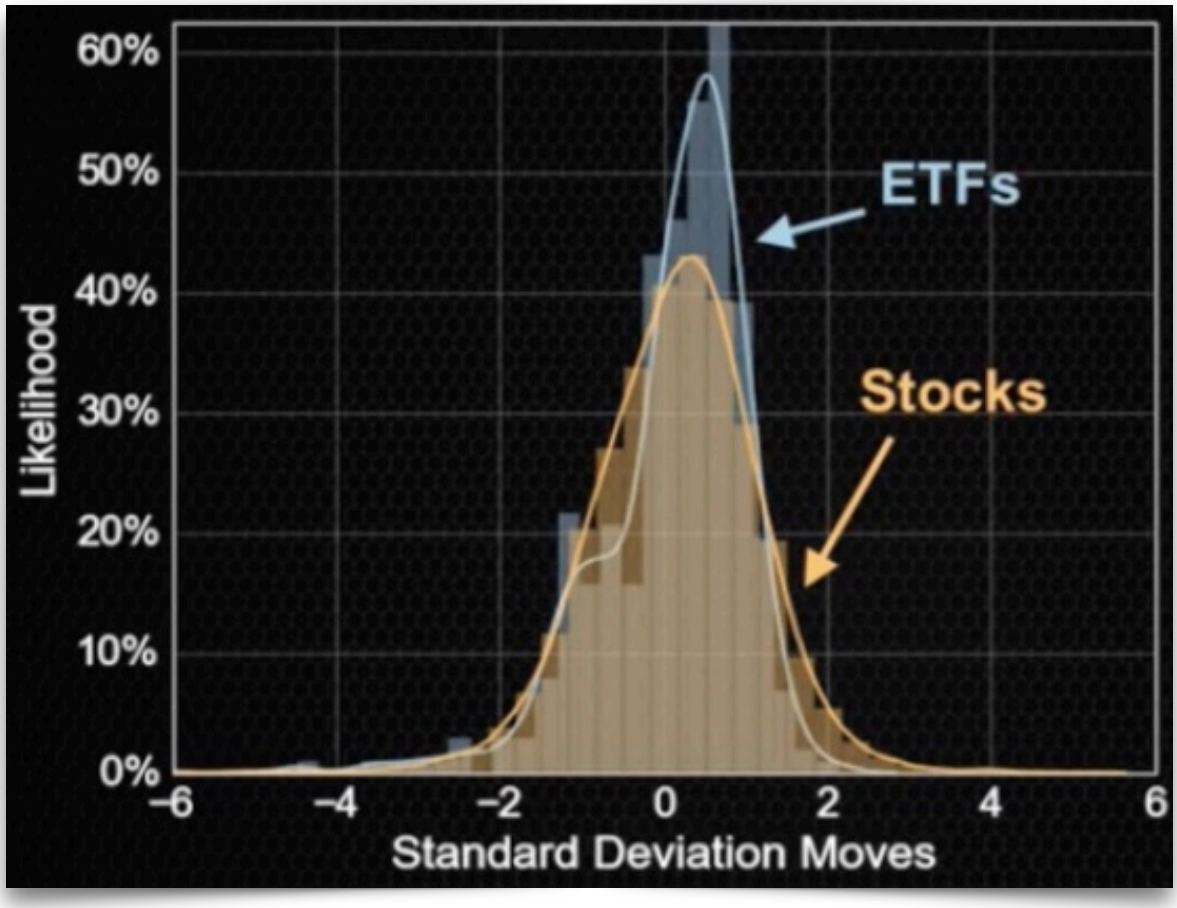
Why?

That's because ETFs are less volatile than Stocks.

And when we're trading Credit Spreads (or any Short Options Strategies), we generally do not want the underlying to be very volatile.

That's because the more volatile the underlying is, the likelier it can breach our Credit Spread, which is what we don't want.

So while increased volatility can mean juicer premiums, it also means a riskier trade.



The graph above shows a comparison of the Standard Deviations Moves between ETFs and Stocks.

As you can see, Stocks are much more volatile as it can make much bigger moves than ETFs.

That means that Stocks are likelier to breach our Credit Spreads compared to ETFs.

In comparison, ETFs tend to stay in a narrower range. That's because ETFs are a basket of Stocks.

So even if there is a single Stock in the ETF that makes a huge move, it's being muted by the other Stocks in the ETF.

And even if the ETF made an adverse move against your position, it wouldn't move as much compared to Stocks.

But with Stocks, a single sudden news (regardless if it's positive or negative news) can create a huge move that can potentially breach our Credit Spread.

That is why I prefer trading ETFs over Stocks.

And if you want consistency in your trading results and a smoother P&L as your account grows, then you'd likely want to trade ETFs over Stocks as well.

2 STEP 2: IDENTIFY OVERBOUGHT & OVERSOLD CONDITIONS

One of the biggest things that many people struggle with when trading Credit Spreads is WHEN to put on a trade.

So if you're relatively new to trading Credit Spreads or have never traded Credit Spreads before, then a simple way to identify when you should enter into a Credit Spread is by identifying "Overbought" and "Oversold" conditions in the market.

So how do you do that?

By using an indicator called the Stochastic Oscillator (or some people may prefer the Relative Strength Index a.k.a. RSI).

Now, this is not the only way to enter into a Credit Spread trade, but if you're just starting out trading Credit Spreads or you've been struggling to get consistent results so far, then using this indicator can help put the odds in your favor.

So what exactly is the Stochastic Indicator?

It's basically an indicator to identify whether there could be a potential turning point in the market.

For example, if the market is "Oversold", that means that the market has already sold off quite a bit and there's a potential chance it could reverse back up.

For example, in the image above, you can see that the Stochastic Oscillator shows that the current market condition is Oversold.

This is indicated by the blue squiggly line going below the bottom purple line.

This Oversold signal can suggest that the market might be reversing back up, and we can consider placing a Bull Put Spread.

Similarly, if the blue squiggly line goes above the top purple line, then the Stochastic Oscillator is indicating that the current market condition is Overbought.

And this Overbought signal can suggest that the market might be reversing back down, and we can consider placing a Bear Call Spread.

What's important to note is that these are just "indications" and not a sign that the market is "guaranteed" to reverse.

There will be times when an Overbought signal can become even more Overbought as the market continues to go up.

And there will be times when an Oversold signal can become even more Oversold.

All we're doing is placing the odds in our favor.

For example, would it be more strategic to place a Bull Put Spread when the Stochastic Oscillator shows an Oversold or Overbought signal?

That's right, when it's Oversold.

That's because we at least place the trade at a point where the market has a better chance of going up than going down.

Remember, we cannot win every single trade, and we certainly do not expect to do so.

Probability already dictates that there will always be losing trades and we want to be prepared for it.

That's why risk management and position sizing is critical to prevent any single losing trade from wiping out our account.

And if you're curious as to how I setup the Stochastic Oscillator, then I've created this video below just for you (click the thumbnail below to watch):

Now that we know how to identify Overbought & Oversold conditions in the market, it's time to move on to the next step!

And that is to…

3 STEP 3: IDENTIFY SUPPORT & RESISTANCE LEVELS

Now that we already know how to identify Overbought & Oversold conditions in the market, the next thing to identify are Support & Resistance levels.

Basically, Support & Resistance levels are places on the chart where the market had a change in direction.

For example, Support levels are places where the price had gone down and then bounced back up.

As you can seen on the chart in the previous page, there were a few places where the price had tried to go down but then bounced back up.

We consider these as areas of Support.

So what we want to do is draw a line across the chart to identify price levels where the market might possibly bounce back up again.

Similarly, Resistance levels are places where the price had gone up and then came back down.

Likewise, we want to draw a line across to identify possible price levels where the market might come back down.

So by identifying Overbought & Oversold conditions and coupling it with identifying Support & Resistance levels, we have further increased the odds in our favor that the trade can work out.

The next step is to begin constructing our trade.

4 STEP 4: IDENTIFY YOUR DTE & SHORT LEG STRIKE PRICE

Now that we're ready to start constructing our trade, the very first step is to select the DTE (days-to-expiration a.k.a. the expiration date of the option).

So how do we decide which DTE to choose when there are so many DTEs ranging from 0 days all the way to over 365 days to select from?

This is where we want to refer to statistics to guide our trading decisions.

SPY Expected vs Realized Since 1993	7 days	14 days	21 days	30 days	45 days
Average Expected Move as a +/- % Move	2.1%	2.5%	3.5%	4.2%	5.7%
Average Realized Move as a +/- % Move	2.2%	3.0%	3.8%	4.3%	5.2%
Expected Bigger Than Realized?	No	No	No	No	Yes

SPY Expected vs Realized Since 1993	45 days	60 days	90 days
Average Expected Move as a +/- % Move	5.7%	7.9%	9.7%
Average Realized Move as a +/- % Move	5.2%	6.5%	7.7%
Expected Bigger Than Realized?	Yes	Yes	Yes

The table in the previous page shows a study by the TastyTrade research team the Expected Move vs Realised Move from 1993 onwards.

This means this is a statistically significant study that we need to pay attention to if we want the odds to be in our favor when trading Options.

In case you're not familiar with what the Expected Move is and the importance of it relative to the Realized Move, then watch this video below first:

This video will give you the right foundation to understand the importance of the Expected Move vs Realized Move study.

Once you've finished watching the video, come back to this blueprint again and I'll see you in the next page.

Welcome back.

Finished watching the video already?

Great. So if you've watched the video, by now you should understand that what we're looking for when choosing the DTE is where the Realized Move is actually smaller than the Expected Move.

And if you refer to the table again (showing it here again for your convenience), you will notice that only from 45 days onwards the Realized Move is actually smaller than the Expected Move:

SPY Expected vs Realized Since 1993	7 days	14 days	21 days	30 days	45 days
Average Expected Move as a +/- % Move	2.1%	2.5%	3.5%	4.2%	5.7%
Average Realized Move as a +/- % Move	2.2%	3.0%	3.8%	4.3%	5.2%
Expected Bigger Than Realized?	No	No	No	No	Yes

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Average Realized Move as a +/- % Move	5.2%	6.5%	7.7%
Expected Bigger Than Realized?	Yes	Yes	Yes

So that is why we generally want to choose a DTE that is 45 days and above.

But we also don't want to go too far out because then the Theta Decay would be a little too slow.

So somewhere between 45 DTE to 65 DTE would be our sweet spot.

Now that we've selected our DTE, the next step is to pick our Short Strike for our Credit Spread.

So for this example, we will use the Bull Put Spread.

Let's recap a little.

To place a Bull Put Spread, we need to first identify an Oversold condition in the market and then a Support Level.

Once we've done this, the next step is to identify which Strike Price to go for.

And for this, we ideally want to select a Strike Price that is BELOW the Support level.

So if the Support level you've identified is $100, then you want to pick a Strike Price that is below $100.

If you're a little more aggressive, you can choose the Strike Price that is just below the Support level. This would be a Strike Price with a higher delta, which means higher premium but lower probability of profit.

And if you're a little more conservative, you can shoot the Strike Price that is slightly further from the Support level. This would be a Strike Price with a relatively lower delta, which means lower premium but higher probability of profit.

Please note that there is not one that is better than the other.

Instead, it's just a tradeoff.

In the world of Options, everything is a tradeoff.

So if you want more premium, then go for the relatively higher delta (which will be closer to the market price).

And if you want a higher win rate, then go for the relatively lower delta (which will be further from the market price).

For the Bear Call Spread, it's the opposite.

That means we want to find the Strike Price that is ABOVE the Resistance level.

Then similarly, if you want more premium, go for the relatively higher delta (which will be closer to the market price).

And if you want a higher win rate, then go for the relatively lower delta (which will be further from the market price).

Now that we've identified where the Short Strike (a.k.a. Short Leg) of our Credit Spread should be, it's time to pick the Long Strike (a.k.a. Long Leg).

This Long Strike will determine the width of your Credit Spread.

5 STEP 5: CHOOSING YOUR LONG STRIKE PRICE

So now that we've already selected the Strike Price for our Short Leg, how do we determine the Strike Price for our Long Leg?

For this, there are two methods.

Method #1: Fixed Width

This is the most common method that many people go for.

Basically, you just choose a fixed dollar width and increase your contracts based on your risk allocation for the trade.

For example, let's say you want to go with a fixed $5 width Bull Put Spread. And your risk allocation for the trade is $500.

And after constructing the Bull Put Spread, it looks like this:

For this Bull Put Spread, you were able to get a credit of $1.25 with a max risk of $3.75. That means the premium you will receive for this is $125 and your max risk is $375.

And because your risk allocation to the trade is only $500, you're not able to increase your contract size.

That's because 2 contracts will take your risk to $750, which is over your max risk allocation for the trade.

So you're only able to trade 1 contract for the trade until your account grows and you're able to risk $750 on each trade.

Method 2: Dynamic Width According to Risk Allocation

The second method is to determine your Long Leg Strike Price by your risk allocation of the trade.

So for example, if your max risk allocation on the trade is $500, then you're able to construct a Bull Put Spread like this:

So in this case, your Bull Put Spread is $6 wide with a credit of $1.50 and a max risk of $4.50.

That means the premium you will receive for this is $150 and your max risk is $450.

Your max risk is still within your risk allocation of $500.

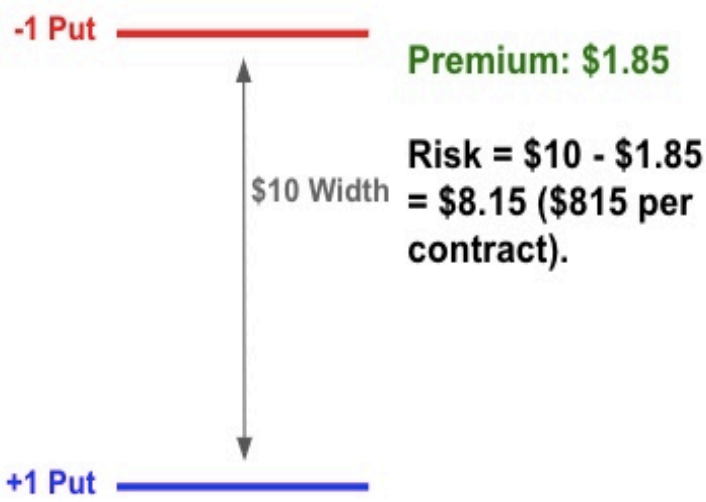
So you might be asking, “Which method is better?”

Well let’s compare.

Assuming we have a risk allocation of $800 per trade, we’re able to construct 2 trades like these:

2 Contracts of $5 Width

1 Contract of $10 Width



The first Bull Put Spread has a total premium of $200 with a max risk of $800, and the second Bull Put Spread has a premium of $185 with a max risk of $815.

Now, at first glance, you might say, “I’d definitely go for 2 contracts of $5 width because it gives more premium and has slightly lesser max risk”.

However, what many people miss is where the Long Strike Price is at.

If you noticed, the second Bull Put Spread’s Long Strike Price is further away from where the current market price is compared to the first Bull Put Spread’s Long Strike Price.

What does this mean?

It means that it’s easier for the market to hit the max loss of the trade for the first Bull Put Spread than the second Bull Put Spread.

So while the first Bull Put Spread may have more credit and slightly lesser max risk, it’s easier to hit that max risk compared to the second Bull Put Spread.

As an example, let’s say you held the trade to expiration and the market settles just below the Long Strike Price of the first Bull Put Spread.

In this case, the first Bull Put Spread will lose $800, whereas the second Bull Put Spread may likely lose only around half of its max risk.

That's because it has not gone below the Long Strike Price of the second Bull Put Spread.

Ultimately, which you decide depends on whether your focus is getting more credit upfront, or having a less riskier construct.

If you favor having more credit on your Bull Put Spread (which means a higher profit potential), but don't mind that it's easier to hit the max loss on the trade, then go for the first method of having fixed width.

If you favor having a less riskier trade in terms of the breakeven price being further away from the market price, but don't mind the slightly lesser credit, then go for the second method of having dynamic width based on your risk allocation.

Now that we know how to construct both legs of our Credit Spread, it's time to move on to the next step!

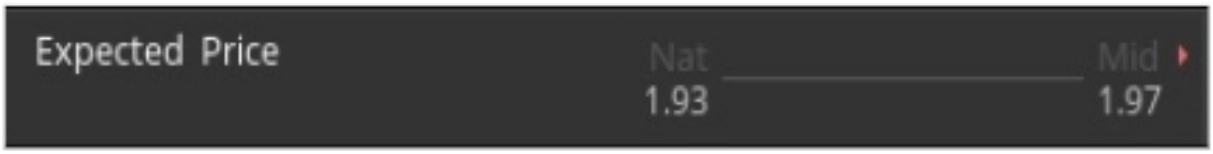
And that is to…

6 STEP 6: PLACE THE TRADE AS A LIMIT ORDER

Once you're satisfied with the construct of your Credit Spread, the next step would be to place the trade.

And the way that I like to do it is with a Limit Order.

When placing the trade, most brokers should show you a slider that looks like this:



Basically, this slider tells you what is the "natural" price and the "mid" price.

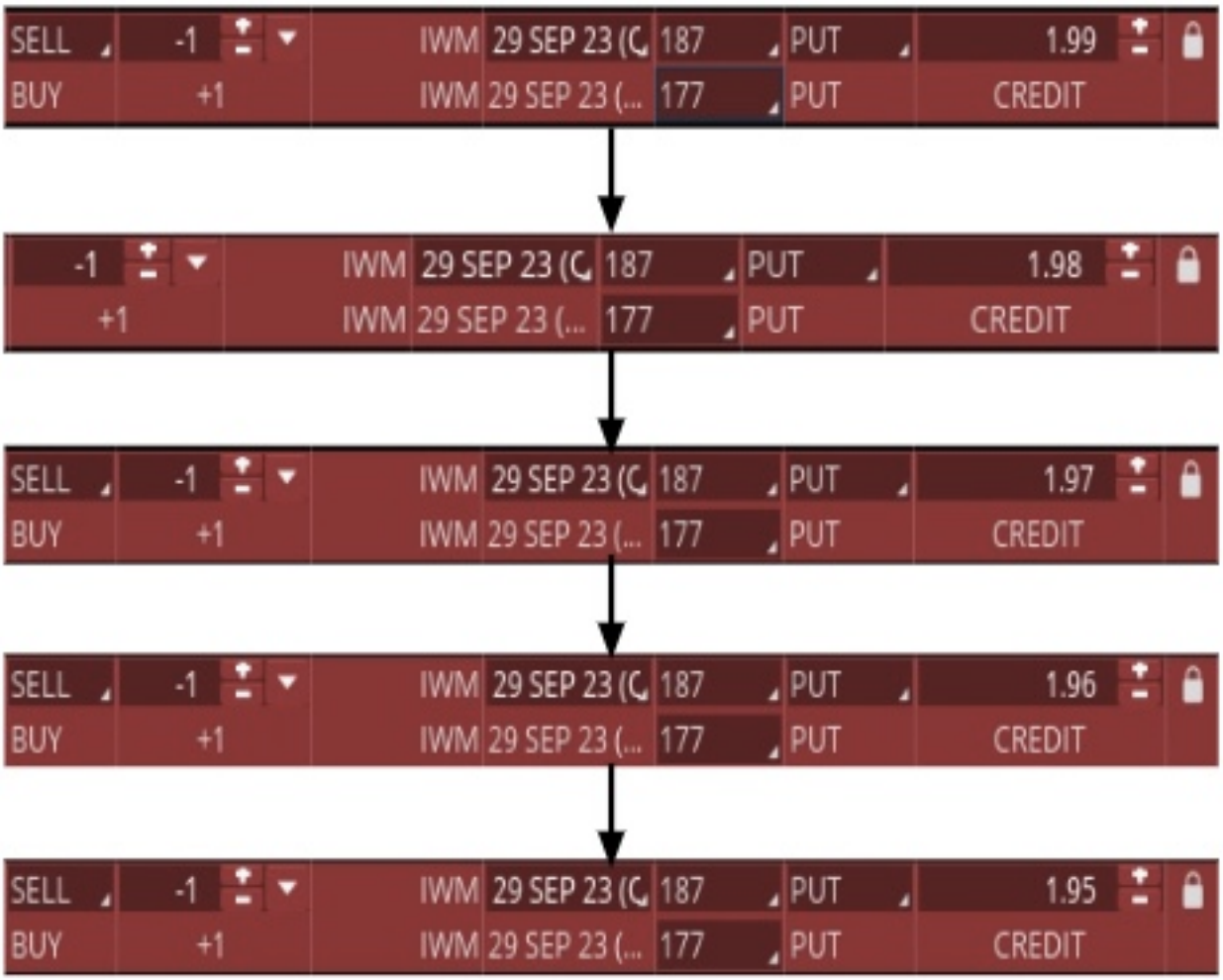
The "natural" price is the price which you will be guaranteed to get filled at. This is also what I generally consider the worst price to get filled at.

The "mid" price is where you can get a better credit (because you get more than the "natural" price), but may not necessarily get filled.

So when I place my trades, I usually start off using the "mid" price and add a few cents to see if I can get a better fill (that means to get more credit on the trade).

So if the mid price shows as $1.97, I may start off with putting in my Limit Order as $1.99.

And if it doesn't get filled, and I do want to get filled at that point in time, then I will adjust my Limit Order downwards like this:



As you can see in the image above, I adjusted my Limit Order down each time until I'm able to get filled (which usually is better than the "natural" price).

But if you want to stick to the credit that you've set, then it's also perfectly fine to not adjust down and simply wait until the market gets to the point where your Limit Order gets filled.

7 STEP 7: PLAN YOUR EXIT STRATEGY

The last thing you want is to worry and panic when the market breaches our Credit Spread and you're not sure what to do.

That is why you MUST plan out your exit strategy in advance so you know what you're going to do when the market gets there.

You see, we cannot control what the market does. It will do whatever it wants to do.

However, we can control what we do. And we already know that there are only so many places the market can go.

It can go all the way up. It can go all the way down. And it can go sideways.

So we can actually plan out ALL the exit scenarios before the market gets there and simply execute according to our plan.

This way wherever the market goes, especially when it breaches our Credit Spread, we already know what to do without any hesitation.

Even if it means to take a loss on the trade.

While we all dread having losing trades, you must accept and embrace the fact that there will be losing trades at one time or another.

Just by probability alone, we know that we will have losing trades.

So when the losing trades comes, we must take a loss on it and not let one loss become so big that it can wipe out our whole account.

So how do you plan your exit scenarios? Here are some statistics from the TastyTrade research team to aid you in this:

SPY 20Δ Put Spread	$1 Wide		$5 Wide		$10 Wide	
	Exp.	Winner	Exp.	Winner	Exp.	Winner
Duration	44	17	44	16	44	16
Win Ratio	89%	94%	90%	95%	90%	95%
Daily PL	$0.1	$0.2	$0.4	$0.9	$0.8	$1.5

Put Spread	$5 Wide		$10 Wide	
	Exp.	Early	Exp.	Early
Win Rate	90%	79%	90%	81%
Annu. ROC	33%	47%	33%	40%
Avg. Loss	-$285	-$77	-$398	-$121

The table in the previous page shows a study comparing different exit strategies for Put Spreads (a.k.a. Bull Put Spreads) on SPY.

The study examined 3 different exit strategies:

Exit Strategy #1: Hold the trade to Expiration.
Exit Strategy #2: Exit at 50% Take Profit or Hold to Expiration, whichever comes first.
Exit Strategy #3: Exit at 21 DTE (Days-to-Expiration).

And the study shows that Exit Strategy #2 & #3 are more effective than Exit Strategy #1.

So when trading Credit Spreads, you want to employ either Exit Strategy #2 or Exit Strategy #3 since they yield better results than Exit Strategy #1.

Additionally, there's an Exit Strategy #4 which is a combination of Exit Strategy #2 and #3:

Exit Strategy #4: Exit at 50% Take Profit or Exit at 21 DTE, whichever comes first.

What this exit strategy does is that it reduces your risk when you exit at 21 DTE (if the 50% Take Profit) doesn't hit, and it also Takes Profit quicker than just holding to 21 DTE so you can free up your Buying Power to place other trades.

So now you know the Exit Strategies, you're ready to start trading Credit Spreads!

8 CONCLUSION

Congrats on getting all the way end to this Blueprint!

I hope you've found a lot of value in this Blueprint that I've put together for you, and more importantly, learned how powerful Credit Spreads can be to create a consistent income for you.

Now, this isn't the end, but rather just the beginning of your journey.

There's so much more to Credit Spreads than what I've shared in this Blueprint.

I strongly suggest to check out all my videos on Credit Spreads on my YouTube channel here: https://www.youtube.com/watch?v=pU31ElpTMrg&list=PLn4dMDRu5KCAvNTiJI0IenB4UiU5F2a1u

Last but not least…

May the Options favor you! :)

- Davis