11.5 BEAR PUT SPREAD STRATEGY

Explainer Video

The bear put spread strategy is more or less similar to call spread strategy, but with put options and to be used when we expect the underlying asset's price to go down. This strategy is used when we are Bearish on the underlying asset. This strategy would also limit our upside potential profit as well as losses. In this strategy a net premium is paid as compared to received.

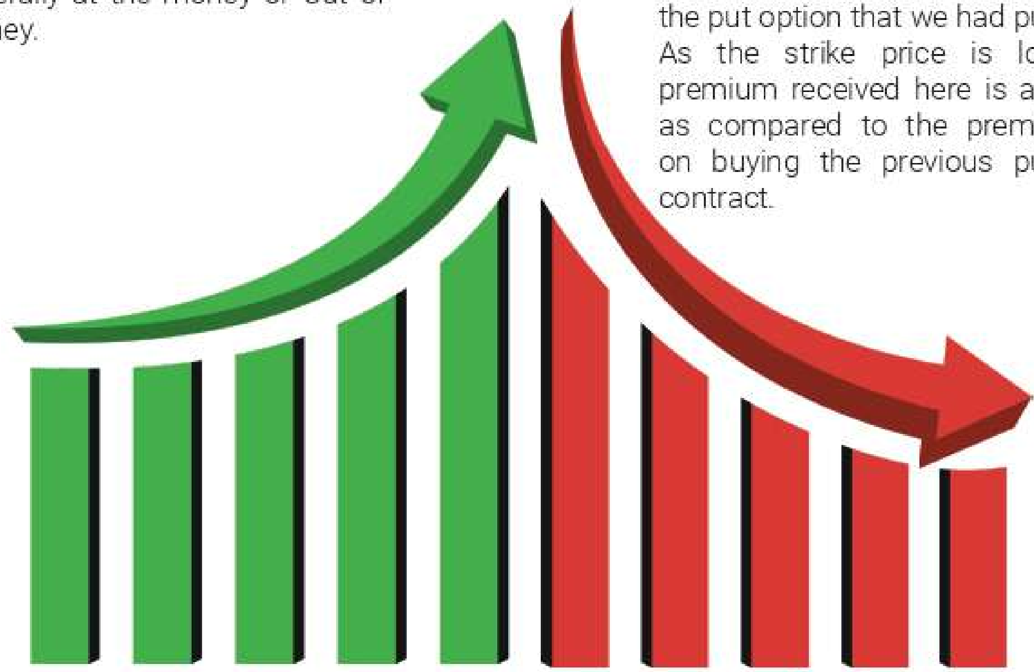
STEPS TO FORM A BEAR PUT STRATEGY

BUY

We buy a Put Option with which is generally at the money or Out of money.

SELL

We sell a put option with Strike price that is lower than the strike price of the put option that we had purchased. As the strike price is lower, the premium received here is also lower as compared to the premium paid on buying the previous put option contract.

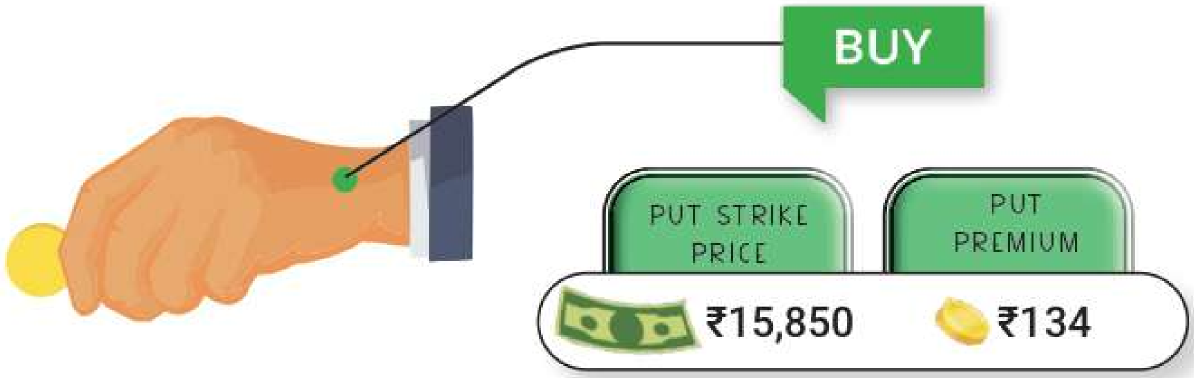


MAXIMUM LOSS = NET PREMIUM

BREAKEVEN = STRIKE PRICE OF PUT PURCHASED – NET PREMIUM

MAXIMUM PROFIT = DIFFERENCE IN STRIKE – NET PREMIUM

For instance, we buy a put option at strike price of ₹15850 for ₹134 for an asset with current market price a ₹134 and sell a put option contract for ₹36 at strike price of ₹15,600



Netting the two positions.

COST OF THE STRATEGY = ₹134 – ₹36 = ₹98

THIS IS OUR NET INVESTMENT IN THIS STRATEGY.

MAXIMUM LOSS = Net premium

= ₹98

BREAK EVEN POINT = Strike price of long put – Net premium

= ₹15,850 – ₹98 = ₹15,752

MAXIMUM PROFIT = Difference in Strike prices - Net Premium

= (₹15,850 – ₹15,600) – ₹98 = ₹152

If the price is above ₹15,752, we will be incurring losses.At prices below ₹15,752, we will start making profits. But our profits will also be capped at ₹152.

Lets take a look at another example to understand this better.

LOT SIZE
100 shares

CURRENT MARKET PRICE
₹550

BUY
ATM Put Option

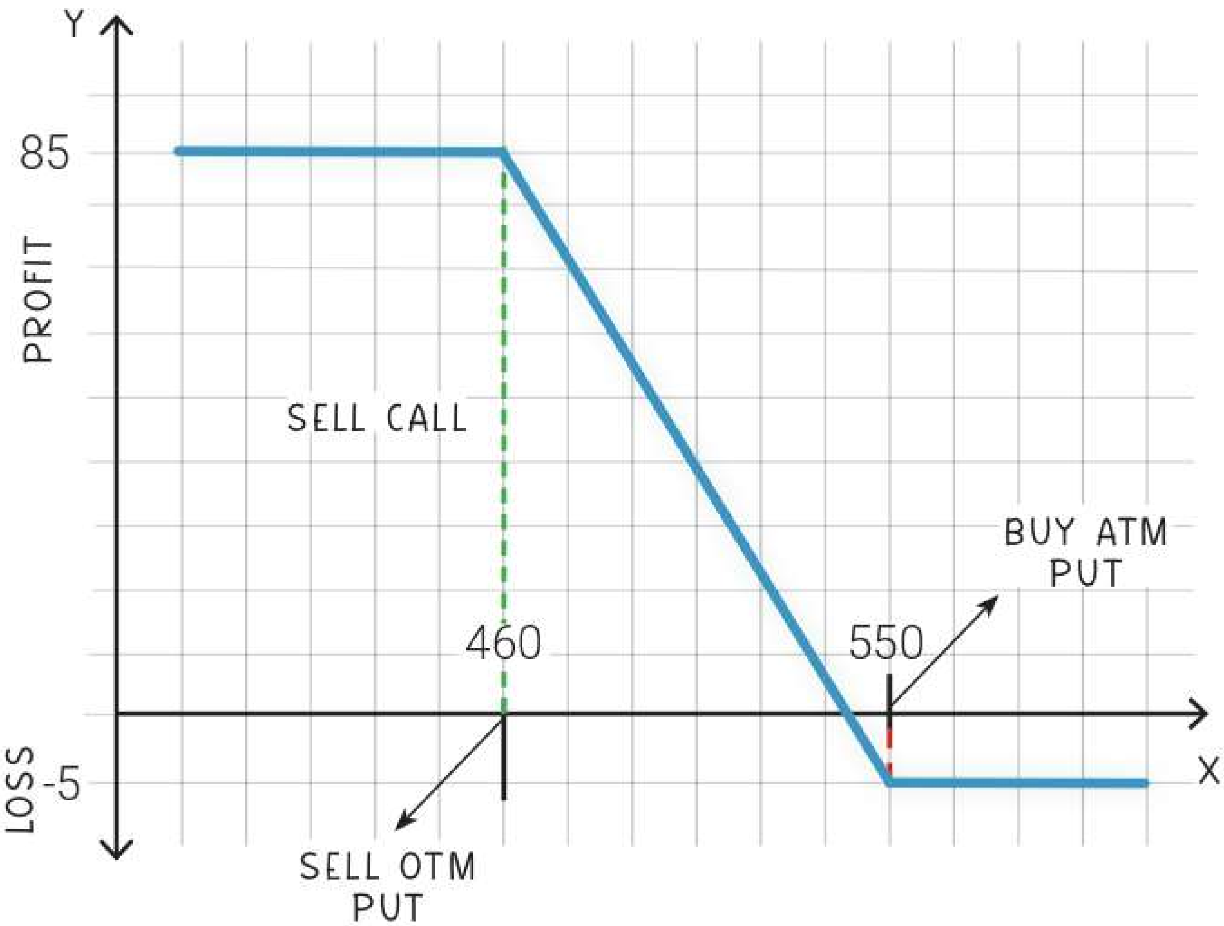
PUT STRIKE PRICE
₹550

PUT PREMIUM
₹25

SELL
OTM Put Option

PUT STRIKE PRICE
₹460

PUT PREMIUM
₹20



Price	Buy Option 550PE	Sell Option 460PE
Price > ₹550	✗ Exercised	✗ Exercised
Price = ₹500	✓ Exercised	✗ Exercised
Price < ₹460	✓ Exercised	✓ Exercised

NET INVESTMENT/MAXIMUM LOSS = Net premium

= ₹25 – ₹20

= **₹5** per share

BREAK EVEN POINT = Strike price of long put – Net premium

= ₹550 – ₹5

= **₹545**

If the price is above ₹545, we will be incurring losses. As we reach ₹545, we hit the break-even point.
At prices below ₹545, we will start making profits. But our profits will also be capped at ₹460.

MAXIMUM PROFIT = Difference in Strike prices - Net Premium

= (₹550 – ₹460) – ₹5

= **₹85**