

HOW TO TRADE CREDIT SPREADS FOR INCOME



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A lot of people discuss options as an income producing strategy but how many strategies are truly income producing. From my perspective, for something to be considered income producing, there needs to be a relatively high probability of making money. Low probability strategies, while they may have a much higher profit potential per trade, are relatively inconsistent to count on.

From an options standpoint, one of the best ways to combine high probability and leverage is using credit vertical spreads. In this tutorial you are going to learn some option basics that creates the foundation for credit vertical spreads as well as a strategy for strike and expiration selection and trade management..



WHAT IS A VERTICAL SPREAD?

There are a lot of option trades that have creative names like butterflies, iron condors, jade lizards, etc. Vertical spreads aren't one of those. The name was derived from floor traders constructing a trade that was vertical on the board at the CBOE.

A vertical spread is simply when a call or put is both bought and sold for the same expiration. For example, a call will be bought and sold at different strike prices and within the same expiration. A put vertical spread is when a put is both bought and sold for different expirations and the same strike price. Since the options being bought and sold are different prices, the spread will be entered at either a credit or debit.

The example below is a short call vertical spread created on the TD Ameritrade's trading platform thinkorswim. It's a call vertical because we're using calls and it's "short" because it is sold for a credit.

Spread	Side	Qty	Symbol	Exp	Strike	Type	Link	Price	Order	TIF	Exchange
VERTICAL	SELL	-1	SPY	27 MAY 20 (V)	295	CALL		.74	LMT	DAY	BEST
	BUY	+1	SPY	27 MAY 20 (...)	297	CALL		CREDIT			

The example below is a short put vertical spread because we're using puts and it's "short" because it is sold for a credit.

Spread	Side	Qty	Symbol	Exp	Strike	Type	Link	Price	Order	TIF	Exchange
VERTICAL	SELL	-1	SPY	27 MAY 20 (V)	279	PUT		.63	LMT	DAY	BEST
	BUY	+1	SPY	27 MAY 20 (...)	277	PUT		CREDIT			

While these examples are of short verticals, you can also do long verticals. In the end, a long put vertical is the same as a short call vertical if the same strikes and expirations are selected. If you're trying to construct a high probability vertical, it favors doing short verticals since it's more efficient to trade out-of-the-money (OTM) options.

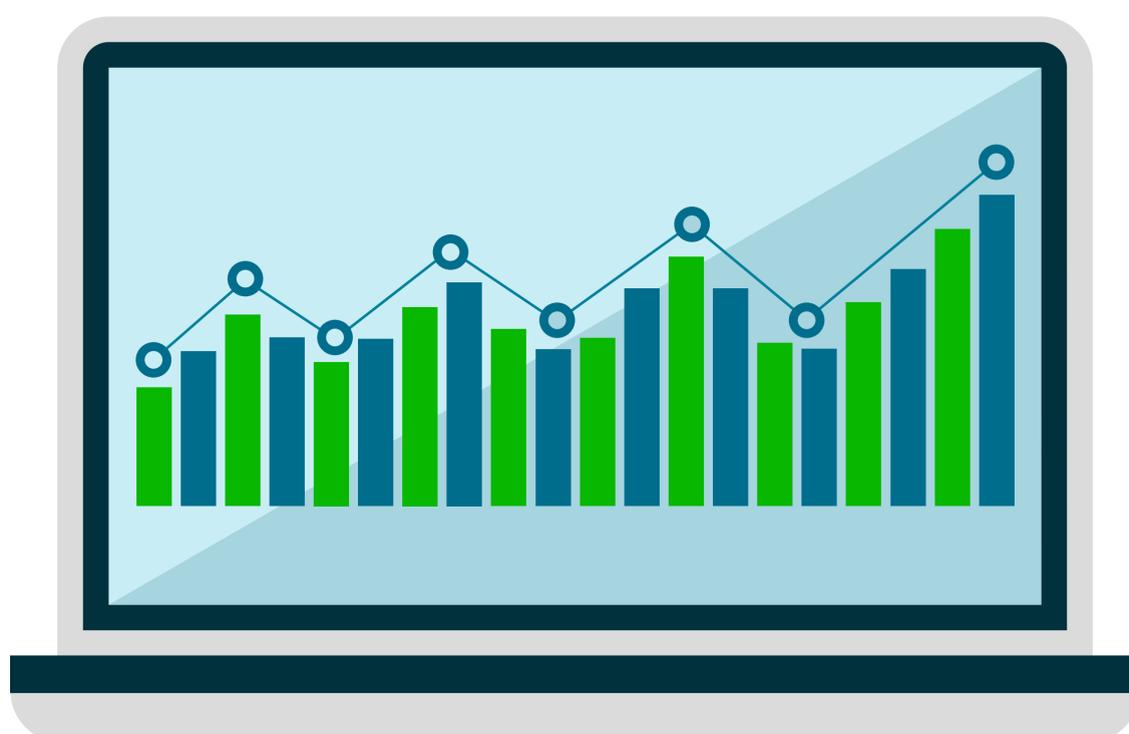
SHORT VERTICAL SPREAD SETUP

The ultimate objective when selling a vertical is for the options to expire worthless. It is at that point that the spread reaches maximum gain because you received your money when you entered the trade.

Options are organized as either in-the-money (ITM), at-the-money (ATM) or OTM. For example, if I were to buy a \$95 call when the stock is at \$100, the option is ITM since I can buy the stock for \$95 and sell it for \$100. Therefore, the option has \$5 of value called “intrinsic value.”

When considering strike price selection, it’s important to consider where you want to position your trade. In the above example, think about the probability of that option being worthless at expiration. Since it is already ITM, the option has less than a 50% chance of expiring worthless. If you were selling that option, you have less than a 50% chance of keeping the money you got paid when you sold it. That doesn’t sound like a high probability approach, does it?

If selling ITM is a low probability approach, then selling out of the money is a high probability approach.



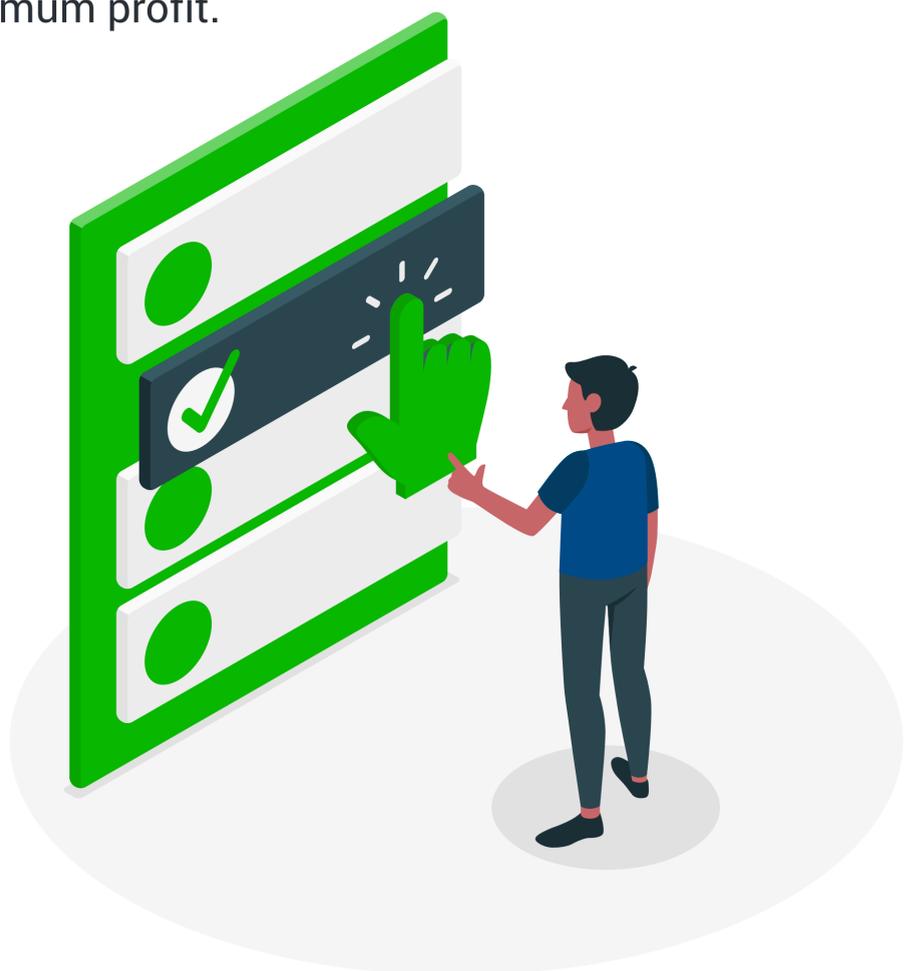
STRIKE SELECTION

You now know that you are going to setup the short vertical so it is OTM, but there are a lot of strike prices that are in that position.

One of the great things about options is that they are priced based on the time to expiration, the distance from the stock price and the supply/demand of the option. The affects of supply and demand are reflected in the implied volatility of the option. The implied volatility measures the expected movement in the price of the stock and therefore allows you to derive the probability of the price reaching certain points.

One way to approximate the probability of a strike price expiring ITM is by using the delta for a given strike price. For example, if a call strike price that has a delta of 0.30, it means that the stock has a 30% probability closing \$0.01 above your strike price at expiration. A put strike price with a delta of 0.30 means that the stock has a 30% probability of expiring \$0.01 below your strike price at expiration.

When selecting a strike price, the objective is to sell an OTM put or call with a 0.30 to 0.40 delta. This will allow you to achieve a 60% to 70% probability of reaching maximum profit.



EXPIRATION SELECTION

Just like strike prices, there are a number of expirations that can be chosen. Some stocks have monthly and weekly options that trade. Monthly options that expire on the third Friday are typically more liquid, but weekly options typically have more strike price selection. Liquidity is measured by the spread between the bid and ask prices.

There is a balance you're trying to strike with expiration selection. You want to have enough time for the stock to do what you need it to and provide flexibility of closing the trade early for a partial profit. However, you also don't want to have too much time so that it will require you watching the paint dry as time decay is minimal.

A good way to achieve the balance of time decay with flexibility is to sell around 20 to 50 days to expiration.

In the image below, you'll see an example of the option chain that was used to select the verticals shown above. The expiration selected has 30 days to expiration using the 27 MAY 20 expiration. The call strike has a 0.36 delta and was the short strike used in the vertical example above. The put strike has a delta of 0.39 delta and was the short strike in the vertical example above.

CALLS						Strikes: 30		PUTS					
	Impl Vol	Prob...	Delta	Bid X	Ask X	Exp	Strike	Bid X	Ask X	Impl Vol	Prob...	Delta	
▼ 27 MAY 20	(30)	100 (Weeklys)											36.05% (±23.816)
	35.50%	36.81%	.67	16.47	16.61	27 MAY 20	274	7.39	7.50	35.50%	63.19%	-33	
	35.19%	38.02%	.66	15.75	15.89	27 MAY 20	275	7.67	7.78	35.19%	61.98%	-34	
	34.88%	39.24%	.65	15.04	15.18	27 MAY 20	276	7.96	8.06	34.88%	60.76%	-35	
	34.58%	40.50%	.63	14.34	14.48	27 MAY 20	277	8.26	8.37	34.58%	59.50%	-37	
	34.27%	41.79%	.62	13.65	13.79	27 MAY 20	278	8.57	8.68	34.27%	58.21%	-38	
	33.97%	43.11%	.61	12.98	13.12	27 MAY 20	279	8.89	9.01	33.97%	56.89%	-39	
	33.68%	44.45%	.59	12.31	12.45	27 MAY 20	280	9.23	9.35	33.68%	55.55%	-41	
	33.38%	45.82%	.58	11.66	11.80	27 MAY 20	281	9.57	9.69	33.38%	54.18%	-42	
	33.09%	47.21%	.57	11.02	11.16	27 MAY 20	282	9.93	10.06	33.09%	52.79%	-43	
	32.80%	48.63%	.55	10.41	10.54	27 MAY 20	283	10.31	10.43	32.80%	51.37%	-45	
	32.51%	50.07%	.54	9.79	9.93	27 MAY 20	284	10.70	10.83	32.51%	49.93%	-46	
	32.23%	51.53%	.52	9.20	9.34	27 MAY 20	285	11.10	11.23	32.23%	48.47%	-48	
	31.94%	53.01%	.51	8.63	8.76	27 MAY 20	286	11.52	11.66	31.94%	46.99%	-49	
	31.66%	54.50%	.49	8.07	8.20	27 MAY 20	287	11.96	12.10	31.66%	45.50%	-51	
	31.38%	56.02%	.48	7.53	7.66	27 MAY 20	288	12.42	12.56	31.38%	43.98%	-52	
	31.11%	57.54%	.46	7.00	7.13	27 MAY 20	289	12.89	13.03	31.11%	42.46%	-54	
	30.83%	59.08%	.44	6.50	6.62	27 MAY 20	290	13.38	13.52	30.83%	40.92%	-55	
	30.56%	60.62%	.43	6.01	6.14	27 MAY 20	291	13.90	14.04	30.56%	39.38%	-57	
	30.29%	62.17%	.41	5.54	5.67	27 MAY 20	292	14.43	14.57	30.29%	37.83%	-59	
	30.02%	63.72%	.40	5.10	5.22	27 MAY 20	293	14.98	15.12	30.02%	36.28%	-60	
	29.76%	65.27%	.38	4.68	4.79	27 MAY 20	294	15.55	15.70	29.76%	34.73%	-62	
	29.49%	66.82%	.36	4.28	4.39	27 MAY 20	295	16.15	16.29	29.49%	33.18%	-64	
	29.23%	68.36%	.35	3.90	4.00	27 MAY 20	296	16.77	16.91	29.23%	31.64%	-65	
	28.97%	69.89%	.33	3.54	3.64	27 MAY 20	297	17.33	17.59	28.97%	30.11%	-67	
	28.71%	71.41%	.31	N/A	N/A	27 MAY 20	298	N/A	N/A	28.71%	28.59%	-68	
	28.46%	72.91%	.30	N/A	N/A	27 MAY 20	299	N/A	N/A	28.46%	27.09%	-70	
	28.20%	74.39%	.28	2.59	2.67	27 MAY 20	300	19.37	19.73	28.20%	25.61%	-72	
	27.95%	75.85%	.27	N/A	N/A	27 MAY 20	301	N/A	N/A	27.95%	24.15%	-73	

HOW DO YOU MAKE MONEY?

You learned earlier in this tutorial that price, time and volatility affect the pricing of an option. Remember, when you sell a vertical, the most you can make is the premium received when it's sold. So you want price, time and volatility to move in a way that will diminish the amount of extrinsic or time value of the option.

For a short call vertical, you want the price to go down, which is bearish or negative delta trade. For a short put vertical, you want the price to go up, which is bullish or a positive delta trade.

In both trades, you benefit as time passes when the options are OTM. The rate of time decay is called theta and therefore these are positive theta trades when OTM. As the option approaches expiration, the amount of time decay or theta that you make increases exponentially until they expire worthless.

Implied volatility varies from day to day as the expectations for future movement change. If the implied volatility falls, it benefits short verticals that are OTM. Thus, short verticals are a negative vega trade since vega measures the affect of implied volatility on your options. It's negative because you want implied volatility to fall.

The maximum gain of a short vertical is the premium received. The max loss is the strike width minus the credit. For example, a short vertical with a \$1 difference in the strike prices and a \$0.30 credit has a max loss of \$0.70 a share or \$70 per contract. The ROR of that trade would be the max gain divided by the max loss ($0.30/0.70 \times 100$) or 42%.



PLACING THE TRADE

There are a lot of optionable stocks, but not all are worth trading options on. When evaluating a company with which to trade short vertical spreads, there are some considerations you'll want to make.

- 01 Options should be priced in pennies. That means that as you adjust the price of an option or vertical, the minimum incremental change is at least \$0.01.
- 02 The bid/ask spread shouldn't be more than 5% of the ask price. The bid/ask spread represents the difference in price between the bid and the ask prices.
- 03 Ideally, you'll have \$0.50 to \$1 difference between the strikes. For higher priced stocks you may have \$2.50, \$5 or \$10 increments, but the strikes should be at most 5% of the stock price.
- 04 The typical strike width for a short vertical is \$1 to \$2. The exception is for higher priced stocks, but it's important to keep the strike prices tighter to achieve a higher reward-to-risk.
- 05 The minimum ROR is 30% when selling a vertical where the short strike is between a 0.30 to 0.40 delta.

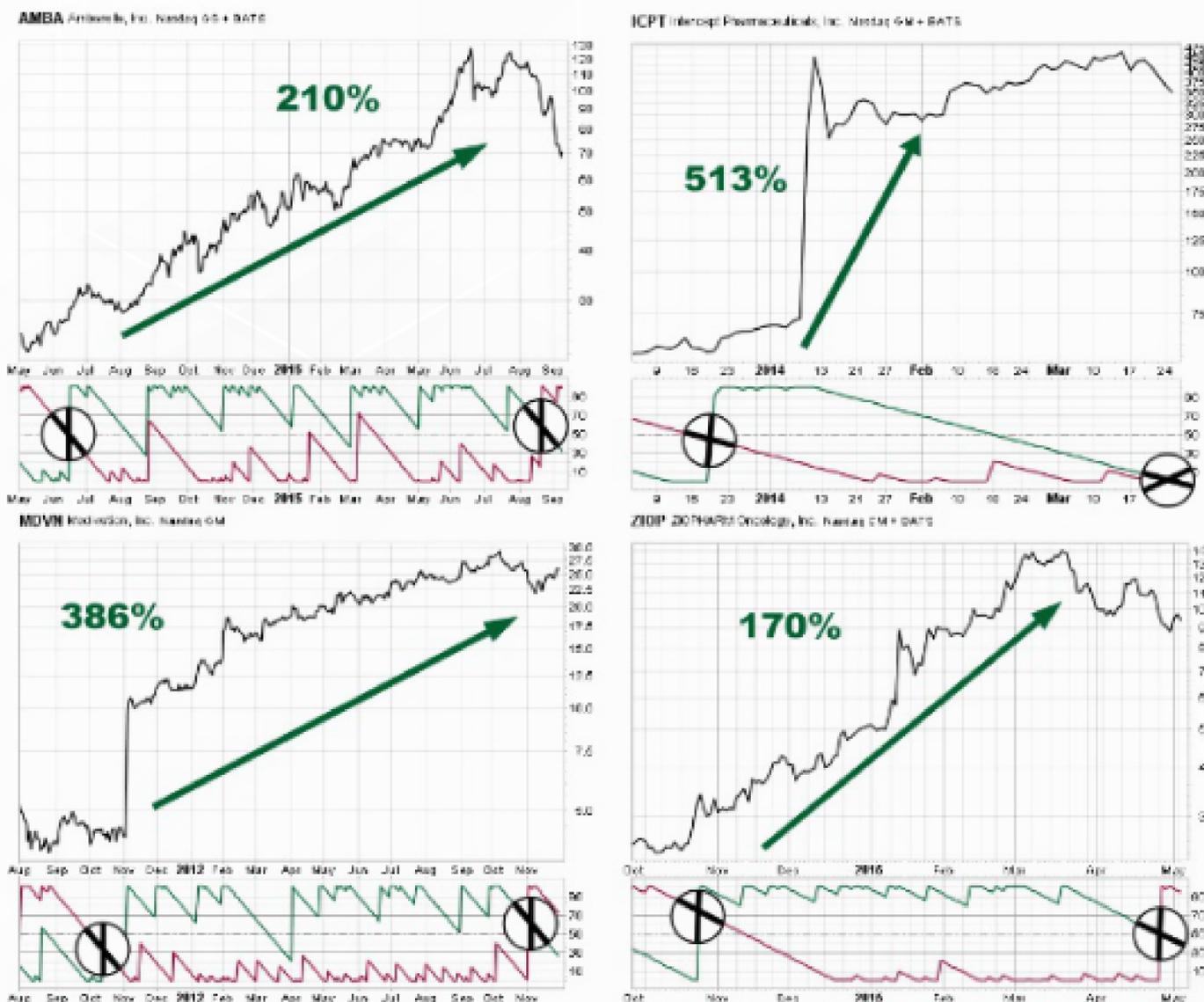
MANAGING THE TRADE

- 01 Exit at 70% of max gain or higher—this is determined by taking the cost to close the vertical divided by the initial credit.
- 02 Exit 4-10 days to expiration—by seeing that the trade is in a position to take a partial loss when it is likely to expire OTM, it will help reduce your average loser and improve risk-to-reward.

CONCLUSION

One of the hallmarks of any income strategy is the consistency of generating income. Utilizing high probability strategies like short vertical spreads can help you achieve greater consistency than simply buying options. The ability to consistently and quickly realize profits are particularly in higher during implied volatility periods like we're in today.

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