# TRADING CREDIT SPREADS
## The Bull Put Spread
Lesson 8

Trading a credit spread is considered to be one of the safest and most conservative of the option strategies and is the type of strategy that will work in a bullish, bearish or sideways market. In this lesson, the focus will be on credit spreads; that is, spreads that credit money to your account rather than taking money out of your account. There are two types of credit spreads, one for bullish trades and the other for bearish trades. The basic theory behind any spread position is that you are entering a trade that is directional but with an insurance policy to protect you should the stock move against you. This type of trade is preferable to a "naked" position in the market because you have limited your risk.

Positioning yourself in a credit spread involves selling one position and buying another. The credit spread involves selling one strike price and collecting the premium, and using part of that premium to buy another strike price as the insurance policy. First, let's look at the bullish position.

### The Bull-Put Spread

A Bull-Put Spread is a credit spread done when stocks are moving up off of a trend line. Notice the chart for SHLD; the stock is bouncing off of the support line that is drawn at about the $115 level.


As the stock moves back up into the channel we are able to position ourselves in a Bull-Put Spread (BUPS). In this example, we would sell the 110 put and buy the 105 put. Sell the put option at the first strike price below support and buy the put option at the next strike price below that. The premium received for the 110 put will be greater than the premium paid out for the 105 put. Therefore, a credit results, and money will be credited to your brokerage account on the next business day. The total risk in this type of trade, should the stock move against the position, is $5 (the difference between the two strike prices) minus the premium credit. For example, in the above trade on 11/15/05: the bid for the Dec 110 put was $4.70, the ask for the Dec 105 put was $3.20. The net credit per share for this position was: $4.70 - $3.20 = $1.50. The spread is put in place by selling the Dec

110 put and buying the Dec 105 put. The same number contracts are bought/sold for each position.

For Example:

Sell 10 contracts of the Dec 110 put @ 4.70 = $4700 paid to us

Buy 10 contracts of the Dec 105 put @ 3.20 = $3200 paid out

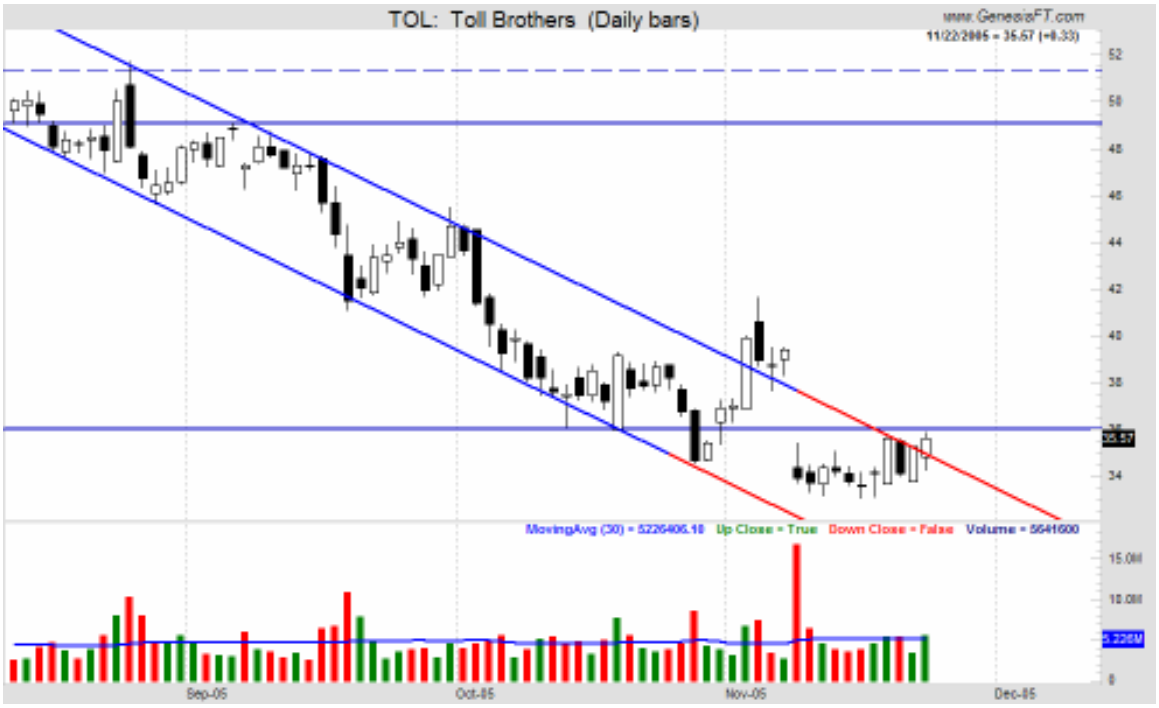
Net credit to our account: $4700 - $3200 = $1500

The credit of $1500 would be in our brokerage account the next trading day.

SHLD was trading at $115.77 at the time the trade was initiated. If SHLD moves up in price, no action is needed; the position is safe. If SHLD stays flat and neither moves up or down in price, no action is needed, the position is safe. If SHLD moves down in price, no action is needed until it approaches $110 a share. Remember that the Dec 110 put was sold. That means that you can be required to buy SHLD for 110 per share. As long as the stock stays above $110, you are not going to be required to buy the stock. If the stock trades at $110 or below and is at that price on expiration day, then you will be required to purchase the stock at that price. Remember that as a protection you have the right to sell the stock to the market maker/specialist for $105 since we own that put. The worst case scenario risk in this trade is $5 - $1.50 = $3.50 per share. The spread value (110-105 = 5) $5 minus the premium received $1.50. That is a risk of $350 per

contract or $3500 on 10 contracts. Of course, you will use alarms, stop losses, and defensive moves to avoid losing that amount of money.

When doing a bull-put spread, you will have money on hold in your brokerage account until the trade is complete. In the above example the risk money is the money on hold-- $350/ contract plus the premium received - $150 per contract. The money on hold can be cash, stock, mutual funds, etc.




Notice in the above chart that TOL has bullish moves off of the support line and bearish moves down from resistance line. This stock is trending down so fast that it would be unwise to do a spread since the stock will threaten your position.


The above chart on Cummins Inc. represents a stock that is in an up trend; in this case a bull-put spread will work well since the stock is moving upward.

Instead of setting a stop loss on this position, you set an alarm/alert to warn that the stock is moving against you. The bull-put spread is not threatened as long as the stock either moves up or stays at the same price. The stock can decline in price and the spread is not in danger until the stock breaks through the support line and begins to move lower. The alarm needs to be set just below support so that a warning is given to prepare you for defensive action. This action needs to be taken before the stock trades at or below our first strike price.

THE DEFENSIVE MOVE:

Defending this position is not difficult. First, buy back the put you sold – same strike price and same month. Buying this put back ends the obligation and protects your investment. Second, keep the other position in place (the put you bought) and sell it at a profit as the stock moves lower. There are times when the stock will break support and begin to head down and you buy back the put you sold only to have the stock rebound back up through support. When this happens, simply resell the put again and re-establish your spread position.

I will review the defensive move and add a few advanced thoughts as part of lesson 10. Be sure and paper trade this strategy until you show yourself to be successful. In lesson 9, I will go over the Bearish credit spread.

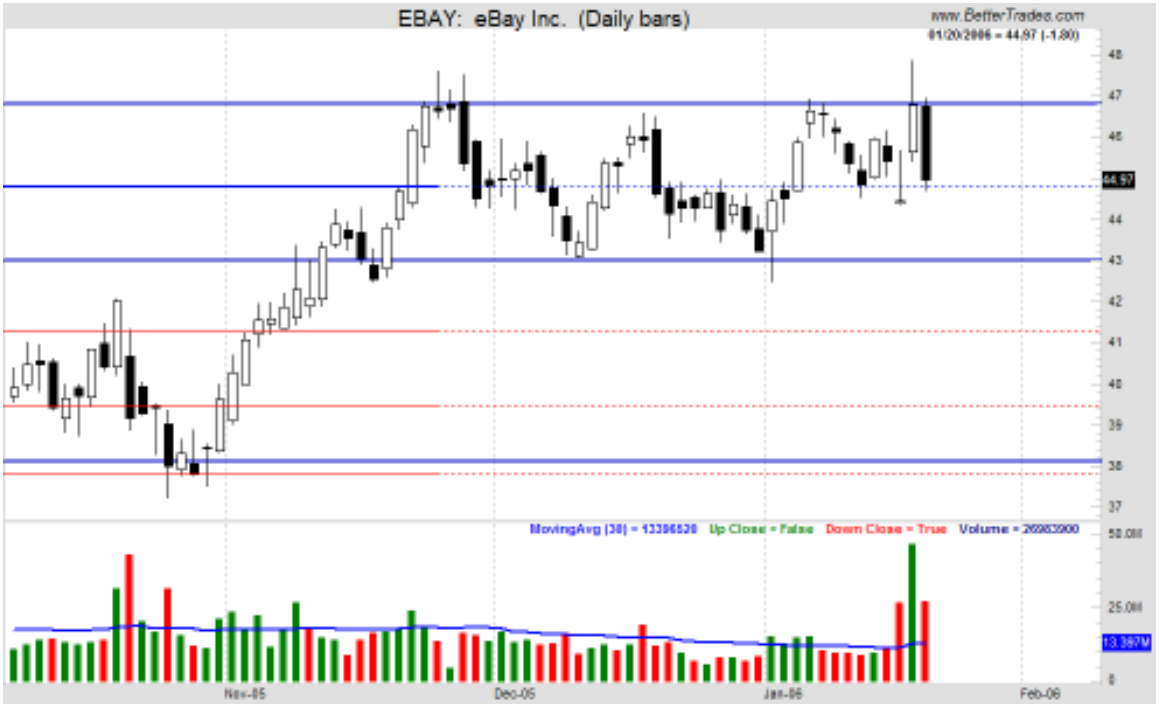
Trade well and follow the rules

Dale Zamzow

# Lesson 9
# The Bear Call Spread

The Bear Call Spread is abbreviated BECS, I will use this abbreviation for the rest of the lesson. The BECS is like the Bull Put Spread in that it is a credit spread. The difference is that the BECS is used when stocks are in a bearish position. This strategy is used for stocks that are at resistance and moving down.

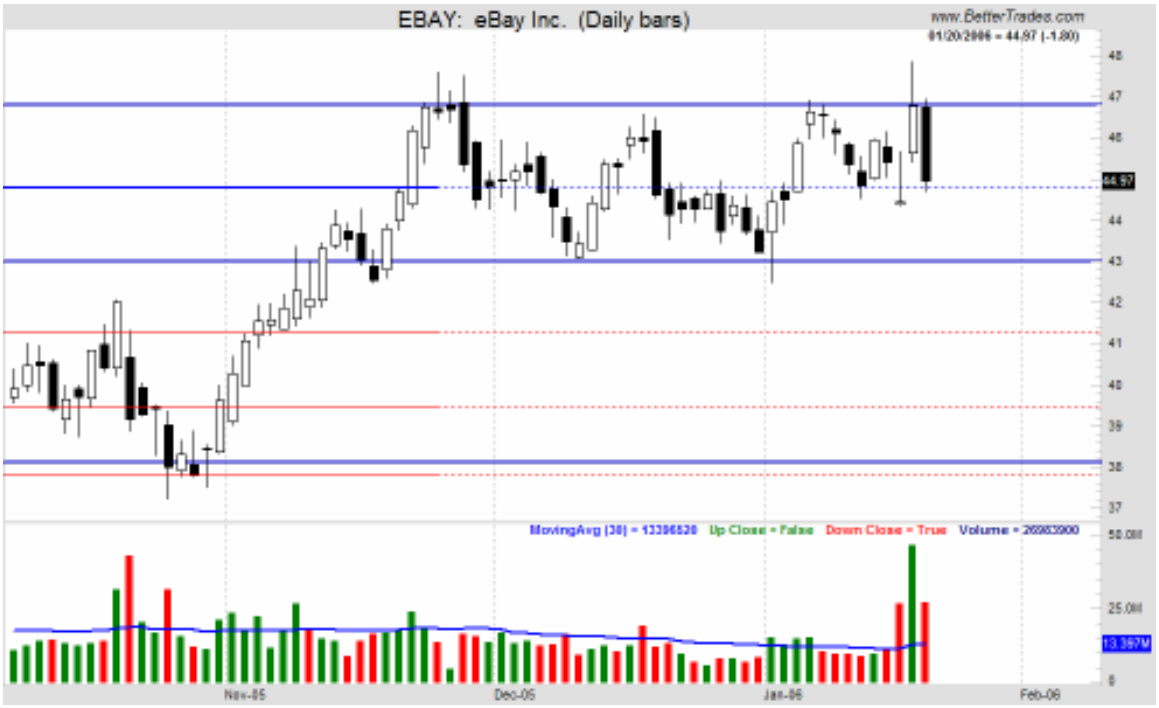
This trading strategy is considerably safer than selling "naked" calls and has the added safety of a built in insurance policy. Like the BUPS the BECS allows you to have a defensive play in mind should the stock move against you. Let's look at an example of a Bear Call Spread.



The chart above shows EBAY as it channels between 43 and 47 dollars. You will notice that yesterday on the chart the stock reached a high and turned over at resistance. At the beginning of the last day on the chart I was able to Sell the Feb 47.5 call and buy the Feb 50 call. The net credit to the account would be $.65 per share. This is the trade in detail: 1) sell the Feb. 47.50 call and receive 95 cents per share; 2) buy the Feb. 50 call and pay 30 cents per share; 3) the net credit to your account is $.95-$.30 = $.65 per share. One contract would yield $65, 10 contracts yields $650. The risk to you is the difference between the strike prices: $50 - $47.50 = $2.50 per share, less the premium received of $.65. So the total risk to you in the worst case scenario is $2.50 - $.65 = $1.85 per share. Trading one contract the risk is $185, ten contracts the risk is $1850. These numbers also represent the amount of money on hold in your account. Remember, this amount of money is on hold until the trade is finished. The amount on hold does not need to be cash, it could be stock or mutual funds on hold. Having an alarm set so that you can take defensive action if the stock moves against you, will lower the possibility of losing the money you have at risk.

Let's take a look at this trade in detail. You enter the trade as EBAY turns over at resistance and begins to come back down. Sell the call at the first strike price above resistance (resistance is about $46.80) which is the $47.50

call.  Buy the call at the next strike price above that which is the $50 call.  Both of these are Feb options for the time period represented on the chart.




You should also place an alert at a price just above resistance so that you will be warned if the stock reverses direction and moves through the resistance line.  In this case the alert will be at about $47.  As long as the stock stays below the resistance line, you are safe and you can let the options expire and keep the money.  The only time you are threatened is if the stock moves above the resistance line.