Understanding Credit Spreads for Bullish Moves

Options
Strategies

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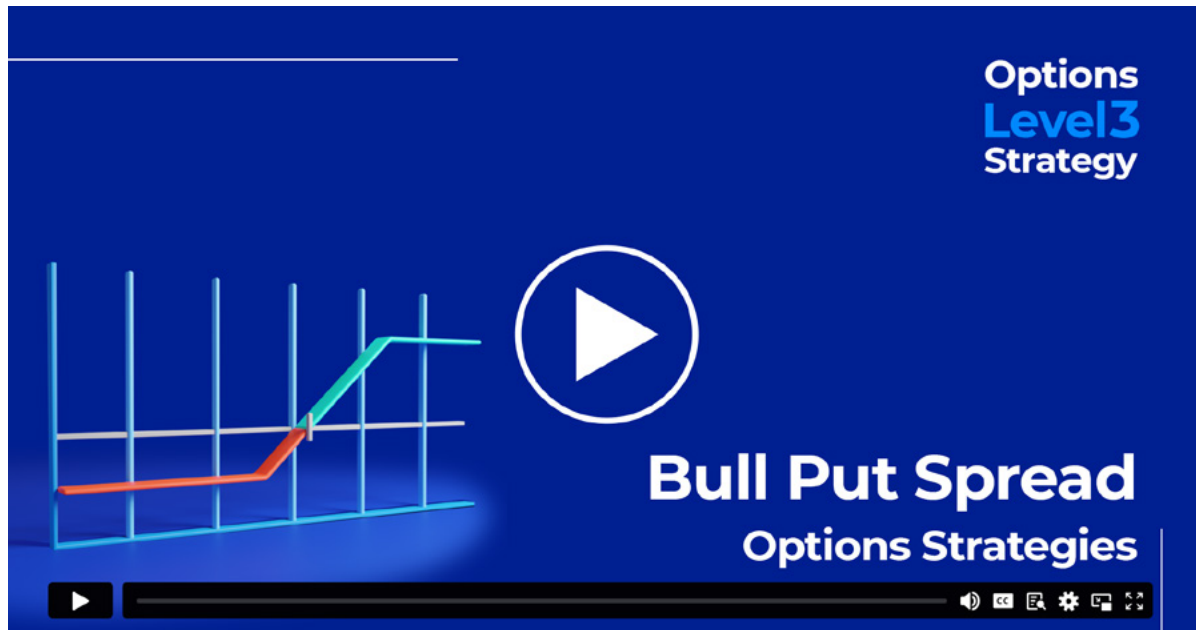

Introduction

For investors who are bullish on a particular stock or sector over the near term but want to limit their potential losses, the bull put spread options strategy can be an appealing alternative. This strategy involves buying put options at a lower strike price while selling put options at a higher strike price on the same underlying stock or sector. The position is opened with a net credit.

What is a bull put spread?

A bull put spread is a trading strategy that involves two actions:

1. **Sell a Put Option**

   The position's profit comes from the premium collected from the sale of this option. The short put's value can drop with a rise in the underlying price or a decline in volatility. The trade profits when the put expires out-of-the-money or is bought to close the position at a lower price than its initial sale. While selling a strike closer to the underlying price will offer a higher premium, it also increases the risk of the option finishing in the money and early assignment.

2. **Buy a Lower Strike Put Option**

   This leg is bought simultaneously with the short put. The long put reduces the premium collected and limits the short put's risk.

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Bull put spread risk/reward profile:

a. **Reward:** The net premium collected.
b. **Breakeven:** Higher strike minus the premium received.
c. **Risk:** The difference between the two strikes minus the premium collected and early assignment on the short leg.

Quick reference guide:
Bull Put Spread

Market outlook	Bullish
Position net debit or credit	Credit (premium collected)
Margin required	The difference between the strikes, minus the premium collected
Number of legs	Two – one lower strike long put and one higher strike short put
Maximum profit	The premium collected
Profits from	The options expiring with the underlying above the short strike put, or from the underlying price rising, or from volatility dropping
Maximum loss	The difference between the strikes minus the premium collected. This occurs if the underlying price drops below the long put strike.
Breakeven	Short strike minus the premium received
Risk from	The underlying price drops at or below the strike of the long put or assignment on the short put before expiration
Options level required	Level 3 – Click here for additional information

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Strategy comparison:

Let's use an example to compare the bull put spread to other bullish strategies, like buying a call or the stock. Apple Inc., with the symbol AAPL, appears to be moving upward from support at about $170 to resistance at approximately $180.

Our first trader, BPS, is using the bull put spread to attempt to profit from the upward price movement. Our next trader, LC, is buying a call option to trade the move. Finally, ST is a trader who buys stock they think will increase in price.

BPS is selling the 165/170 bull put spread with 30 days until expiration for 1.23.

Trade

Spread	Delta	Theta	Max Profit	Max Loss
Vertical	14.8	0.97	123.00	-377.00

Side	Open / Close	Quantity	Symbol	Expiration	Strike	Type
Sell	Open	-1	AAPL	12 Apr 24	170	Put
Buy	Open	1	AAPL	12 Apr 24	165	Put

Order Type	LimitPrice	Stop Price	Route	Duration	Account Number
Limit	1.23 (CR)	1.23 (CR)	Intelligent	Day	SIM1097305M

Natural	Mid
1.14 (CR)	1.23 (CR)

Activation Rule ... CREDIT Analyze Place Order

***Watch the Webinar** – "Understanding the Bull Put Spread: Balancing Risk and Reward in Options Trading.". Learn how this credit spread strategy is utilized in bullish or sideways markets to potentially collect premium.*

LC is buying a 170 call for 9.55. They chose an option with a farther expiration. This is because they are trying to time the exit so the underlying target price is reached while the option still has more than 30 days until expiration. This reduces the effect of time decay on the position.

Trade

Spread	Delta	Theta	Max Profit	Max Loss
Single	63.99	-6.76	∞	-955.00

Side	Open / Close	Quantity	Symbol	Expiration	Strike	Type
Buy	Open	1	AAPL	17 May 24	170	Call

Order Type	LimitPrice	Stop Price	Route	Duration	Account Number
Limit	9.55	9.55	Intelligent	Day	SIM1097305M

Natural	Mid
9.65	9.55

Activation Rule ... DEBIT Analyze Place Order

ST is buying 100 shares of Apple stock for $173.70 per share.

Order Confirmation

Would you like to place the following order(s)?

Buy 100 AAPL @ 173.7000 Limit

Order Details

Account: SIM1097305M
Duration: Day
Route: Intelligent

Symbol Snapshot

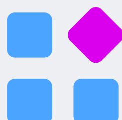
Apple Inc (AAPL) - NASDAQ
Last: $173.70 x 100 (TRF)
Bid: $173.69 x 500
Ask: $173.70 x 1800
As of: 3/12/2024 3:44:47 PM

Estimated Cost of Trade: $17,370.00
Estimated Commission: $1.00

Don't show me this again for Trade Bar and Macros Equity orders

Yes No

	Bull Put Spread	Long Call	Long Stock
Trade cost /margin	$377 (Difference between strikes minus premium X 100)	$955 Premium X 100 shares	$17,370 $173.70 X 100 shares
Maximum loss	$382	$955	$17,370
Breakeven price	$168.77	$179.55	N/A
Maximum profit	$123	Unlimited	Unlimited
Realistic profit at the target of $180	$123 – options expired out-of-the-money	$276.30 – sold on April 12th, underlying at $180	$630 – sold on expiration day of options at $180
Rate of return at the target	32.6%	29%	3.6%
Drawbacks/Risks	1. Options expiring with the underlying below the short strike 2. Assignment risk on the short put 3. More commissions	1. Higher cost 2. Option expires with the underlying below breakeven 3. Underlying price doesn't move fast/ far enough	1. Highest cost 2. Lowest rate of return 3. The stock price drops below purchase price
Features	1. Lower cost 2. Lower max risk 3. Higher rate of return 4. Can profit with little or no price movement	1. Unlimited potential profit 2. Simple strategy, one leg 3. One commission 4. No assignment risk	1. No time limit/ decay 2. Can receive dividends 3. Simple strategy 4. One commission



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Conditions for a bull put spread

The bull put spread tends to be used when the trader holds a neutral to moderately bullish outlook on a stock or index over the short-term time frame of the options. The trader expects the puts to expire worthless so they can potentially capture the entire net credit received when initiating the spread as profit. The bull put spread may have a lower cost and may potentially offer lower risk than buying call options outright.

Traders may opt for a bull put spread when implied volatility is relatively high, as this could make the options more favorably priced, resulting in a larger credit upon entry. The spread benefits from decreasing volatility and time decay, both of which may lower the spread price if the trader needs to buy to close it before expiration.

Strike selection

If the short strike is closer to the underlying price, more credit will be received at entry, but risk of assignment or the option finishing in the money greatly increases. The short strike should be at or near a support level. This may increase the probability of the option expiring out of the money.

The long put's strike should be far enough below the short strike to receive a sufficient premium when the spread is opened. The difference between the strikes determines the maximum risk, which must be considered when choosing the long strike.

How to place a bull put spread trade

1. **Select a Stock or Index**

   Identify a stock or index expected to rise in price or drop in volatility.

2. **Choose Strike Prices and Expiration**

   Pick two put options with different strike prices, ensuring the long put has a lower strike. Both options should share the same expiration date.

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3 **Considerations**

a. The strike of the bought put determines the position's risk because the difference between strikes minus the premium collected is the potential loss. The premium paid for the long put will reduce the premium collected from the short put. The maximum loss is the difference between the strikes minus the premium collected.

b) The strike of the sold put should be as high as possible to collect a premium but below where the price of the stock or index is expected to be when the options expire. The maximum profit is the net premium collected at entry.

c) Because this is a credit spread, time decay helps the position. The options in the spread can be allowed to expire if they are out of the money. To experience more significant time decay, expirations that are less than thirty days out could be chosen. Time decay increases exponentially within the last thirty days before options expiration.

d) Choosing longer expirations may offer greater premiums, but they experience slower time decay and may increase the possibility of assignment on the short put. Selecting deeper out-of-the-money options may lower the chance of assignment and the premium received.

Exiting the bull put spread

1 Some traders opt to hold the bull put spread position until the options expire. If both options expire out of the money, the total premium collected at entry will become profit minus commissions and fees.

2 Close the spread by selling the bought put and buying back the sold put option. Profit is realized if this is done at a lower value than the premium collected when the spread was opened.

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3. Since time decay helps the position's profitability, you may consider using options with approximately 30 days or less before expiration, which may carry greater risk. Closing the spread before options expiry may result in a smaller profit.

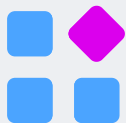
4. If the underlying price is below the short put's strike and the short option has not been assigned, the spread can be closed, or the short put bought to close. This may result in a loss that is potentially less than the maximum.

Test before you trade

Access the TradeStation platform in Simulated Trading mode to acquaint yourself with strategy analysis and order entry. Utilize this environment to practice placing bull put spreads without exposing real money, allowing you to gain confidence in executing the strategy.

Conclusion

The bull put spread is a helpful strategy for investors seeking to profit from expected stock rises while managing risk. This involves selling a put option and buying a lower strike put. The strategy looks to profit from collecting premiums and benefits from time decay, decreased volatility, and upward price movement in the underlying. It offers limited reward and potential increased loss and requires thoughtful strike selection and diligent trade monitoring. Traders typically want the options to expire out-of-the-money to maximize potential profits. Explore and learn the intricacies of the bull put spread, as it could potentially be used as a versatile tool for navigating bullish market conditions and managing financial objectives.



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