OptionProfessor.com Quick Alert

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LEARN CALL SPREAD RISK REVERSAL?

BY THE OPTION PROFESSOR

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With the Stock Market DECLINING substantially and the VIX being so ELEVATED; we thought it may be a time to LEARN more about OPTION STRATEGIES. TRADERS who see stocks they are willing and able to BUY at LOWER PRICES but want to POSITION for a POTENTIAL UPMOVE in the longer term. There has been some Unusual Option Activity with this strategy

Some define the Strategy as a CALL SPREAD RISK REVERSAL but we will just explain each leg (position) and review a number of the risks and opportunities the strategy could provide. We will use XYZ as an HYPOTHETICAL THEORETICAL EXAMPLE.

The stock XYZ has a 52-week high of 141.59 and a 52 week low of 21.65 with a closing price 23.97 for this example.

We will use three (3) different XYZ options to illustrate the strategy and they will be used simultaneously in concert.

The first is a XYZ January 2024 PUT option strike price of 17.50 @ 6. The second is a XYZ January CALL strike price of 30 @ 9.40. The third is a XYZ January CALL strike price of 65 @ 3.60. These are the 3 options used in the strategy.

The TRADER SELLS the Jan XYZ PUTS at 6....BUYS the Jan XYZ CALLS at 9.40..SELLS the Jan XYZ CALLS at 3.60.

The Put sale is a CREDIT of 6 and OBLIGATES the TRADER to BUY XYZ at 17.50 if stock is PUT to the TRADER.

The TRADER BUYS the XYZ CALL SPREAD ---Long the Jan XYZ 30 Call @ 9.40 Short the Jan XYZ 65 Call @ 3.60

The Long Call Spread is a DEBIT of 5.80 and the TRADER has the right to buy XYZ at 30 and must deliver at 65.

Until EXPIRATION in January 2024; The TRADER has contracted to BUY XYZ at 17.50 and has the right to buy RBLX at 30 and must deliver XYZ at 65. The TRADER has used the premium received on the put to pay for the call spread.

The TRADER is willing and HAS THE CASH SECURED MONEY to buy XYZ and has a CALL SPREAD at 30-65 until Jan 2024.

We will LIMIT what could occur in OUR OPINION as we will focus on best & worst case scenarios. If XYZ is PUT to the TRADER at 17.50; any price of XYZ UNDER 17.50 would be a LOSS. If XYZ never rises ABOVE 30 and time expires; the call spread would expire WORTHLESS BUT the call spread was paid for with the premium received on the put! Let's look at some of the OPPORTUNITIES. At expiration date; if XYZ never went down to 17.50 but in fact closed above 65, the call spread maximum value could reach 35 (difference between 30 and 65). The net cost was a CREDIT of 20 cents. If the TRADER was put XYZ at 17.50 and subsequently rose to ABOVE 65 by the expiration date; the TRADER could benefit from the stock bought at 17.50 AND the spread. The TRADER is making a LONG TERM (Jan 2024) COMMITMENT & RISK.

This disclosure is not EXHAUSTIVE but is a strategy suitable TRADERS look to if they think LONGER TERM stocks will turn as TRADERS may have sold calls and bought puts to hedge the DOWNSIDE....here TRADERS are trying to capture premium and using it to position for a longer term rebound on stocks they believe in that they believe will rise substantially in the future

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- The Option Professor, 05/12/2022

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