Institute of Trading and Portfolio Management

Professional Options Trading Masterclass Video Series

POTM

Video 19

Ladder Spreads 2 – Bear Put Ladder Spread

Bear Put Ladder Spread

Quick Explanation

Buy 1X At The Money or Slightly Out of The Money Put Option and Write 2X Lower Strike Puts (with differing Strikes) for the same expiration.

The Bear Put Ladder Spread Strategy as the name suggests is a Bearish Directional Strategy. It is very similar to the Bear Put Spread in which the aim is to profit from a move lower in the underlying Stock price by owning Put Options but at the same time doing this in a less costlier way than simply owning Put options, by writing a lower Strike Put Option at a Strike price that you believe the Stock will not go below by the time of expiration of the 2X Put Option contracts. The only difference between the Bear Put Spread and the Bear Put Ladder Spread is the amount of transactions that are required to establish the trade, the ratio by which Put Options are written and the cost of doing so. In the Bear Put Spread the amount of transactions is 2X i.e. Buy 1X Put Option and Sell 1X lower Strike Put Option with the same expiration. With the Bear Put Ladder Spread, there are 3X transactions. Buy 1X Put Option and Sell 2X Lower Strike Puts at different Strikes. The Strategy can be put on for a small Debit or even a Credit.

- **Directional Bet**
- **Bearish Strategy**
- **Simple**
- **Three Transactions**
- **Debit or Credit**
- **Max Risk (Limited)**
- **Max Gain (Limited)**

When to Use the Strategy

Putting on a Bear Put Ladder Spread versus establishing a Bear Put Spread, a Long-Put Option or simply shorting Stock is essentially a trade-off between upfront cost (Debit or Credit) and forgone profit opportunity. It is a useful strategy incrementally for Retail Traders because if you can get it on at good prices and you have a very high degree of certainty that the underlying Stock will not fall by expiration below a certain price, it will be a lower priced strategy (Debit or Credit) than simply buying a Bear Put Spread (Debit) or owning an outright Long Put Option position (Debit). The only problem is if the underlying Stock does go down more than both the lower Strikes of the Puts you have written, you will still make money (if the underlying stock doesn't fall too much), but less than simply owning a Bear Put Spread or a Long-Put Option or simply shorting Stock. If the underlying Stock does fall a lot you can actually lose money on the trade. We have marked the risk as Medium-Unlimited in the Usefulness stakes. Even though the theoretical loss is limited by the fact that a Stock can only fall to Zero, losses can be high if a Stock does fall by a lot. So even though the profits here are limited and the risk is "limited" we assume large losses can occur as this is just prudent. In reality however, losses should not be big if you are prudent enough to choose the right Strikes to sell and the Stock does crater. You can always buy back Puts in continuous markets which is why we rank this strategy as High. So, there is a degree of flexibility here. It can be used in many circumstances for incremental added portfolio value by Retail Traders as the cost of the strategy is low or even beneficial in the receipt of a Credit.

How to Use the Strategy

There are two main ways to use the strategy. We can buy an At The Money (ATM) Put and sell 2X lower Strike Puts at differing Strikes or we could buy a slightly Out of the Money (OTM) Put and Sell 2X lower Strike Puts at differing Strikes. In both scenarios there needs to be a marginal benefit in doing so over simply putting on a Bear Put Spread, a Long Put or simply shorting Stock. The marginal benefit comes from a Risk Reward analysis of the specific fundamentals you are looking to expose yourself to and capital considerations. The Capital consideration is fairly straight forward as it would be a lot lower capital (margin) requirement to put on a Long Put, Bear Put Spread or Bear Put Ladder Spread than to simply own Stock. The opportunity cost of doing so is where the real value add to your portfolio (or not) arises i.e. the risk reward. If you are expecting a moderate fall in the underlying Stock by the time of expiration of both legs of the trade then it would be better to either be short Stock or buy an At The Money (ATM) Put and Sell a lower Strike Put as a Bear Put Spread or buying an At The Money Put and writing 2X differing lower Strikes thus establishing a Bear Put Ladder Spread rather than buying an Out of The Money Put and writing a lower Strike Put establishing a Bear Put Spread or an Out of the Money Put and establishing a Bear Put Ladder Spread by writing 2X lower strike calls. This is because your view is that the stock is not going to move much lower, so why buy an Out of the Money Put and lower your chances of maximizing profitability? It doesn't make any sense to do so. As with the Bear Put Spread the most important thing for a Bear Put Ladder Spread to add incremental value to your portfolio and hence to maximize "usefulness" and profitability, you must believe with the Bear Put Ladder Spread that the Strike of the higher Strike Put that you sell will be the price that the Stock will go to but no lower than that price. If you expect a dramatic collapse in the Stock price by the time of expiration of both contracts you may be better off (but not always) buying an OTM Put and selling the 2X lower Strikes that you believe the underlying Stock will not fall beyond the higher Strike Put you sell. It is the same principle as before when you expected a moderate fall in the stock, except now you're expecting big fall in the stock. The point is, regardless of your view on how aggressive or moderate the fall will be, profit is maximized when the underlying stock settles at or as close to the Strike price of the higher Strike Put you sell by the time of expiration. The biggest decision you need to make therefore when putting on the Bear Put Ladder Spread is the Strikes that you choose for the Puts that you write. The higher Strike Put that you write needs to be the level that you genuinely believe the Stock cannot fall below and the second lower Strike Put you sell must be even lower than this.

With the Bear Put Ladder Spread you are making money in two ways. You are making profit on the Puts you are going Long as the underlying Stock Price goes down. But you are also making money on the Puts you have written due to time decay. The ideal scenario is that the price of the underlying security goes down to around the strike price of the higher Strike written Put options contracts, because this is where the maximum profit is. If the underlying security continues to go down in price beyond that point, then the higher Strike written Put contract will move into a losing position. If the underlying Stock price continues to go even lower beyond the lower Strike Put Option contract you have written, both Put Option Contracts you have written will be losing Money. Remember you have only bought 1X ATM or slightly OTM Put Option at the higher Strike level and sold 2X Put Options at 2X lower Strikes. You will still make money by the time of expiration if the underlying Stock settles above the higher Strike Put you have Written and if it settles between the 2X Strikes you have written. However, if the underlying Stock settles at the time of expiration below both the Strikes you have written your profit will diminish quickly and you could end up losing money because the options you own will NOT continue to increase in price at the same rate as the 2X Put Options contracts you are short. Additionally, the spread will lose money if the underlying security doesn't fall in price. Although you will profit from the short position, as the contracts you have written will expire worthless, the options you own will also expire worthless. The potential losses are limited though, because you cannot lose any more than the cost of putting the spread on or if you receive a credit the number should be subtracted from your breakeven calculations from the Strikes of the Puts you have sold as you have received this money upfront. Remember as well in terms of risk of losing money due to an aggressive fall in the Stock, there is always the flexibility of buying one or both of the Put Options you have written back if you believe the Stock price will settle lower than the higher Strike or both Strikes you have sold. So, there is some degree of flexibility here. If you buy one of them back you will be left with a Bear Put Spread. If you buy both back you will be left with a Long-Put position.

With the Bear Put Ladder Spread you have the chance to make a bigger Return On Investment (ROI) than you would by simply buying Puts or a Bear Put Spread, and also you will have reduced losses if the underlying security rises in value. This is a simple Risk Reward strategy and comparison to simply having a Bear Put Spread, Long Puts or being Short Stock, which appeals because you know exactly how much you stand to lose at the point of putting the spread on. However, you cannot know exactly how much you stand to make or lose if the Stock falls aggressively through both Strikes of the Put Options you have written, although you will have the ability to know roughly, so it's a moot point.

The disadvantages are limited. There are more commissions to pay than if you were simply buying a Bear Put Spread or going Long Puts. Another disadvantage is that your profits are limited and if the price of the underlying security falls beyond the strike prices of Puts you have written, you won't make further gains and you could end up losing money if it falls aggressively lower. Lastly this strategy does require a larger amount of margin in your Options trading account versus establishing a Bear Put Spread because you are writing 2X as many Puts as you are buying.

Another use for a Bear Put Ladder Spread could be to Hedge a Long Stock Position. By Buying an ATM or slightly OTM Put Option and selling 2X lower Strike Puts..., this would lower the cost of a simple Long Put Hedge against a Long Stock Position and you may even get a Credit for doing so i.e. you get paid to get a Hedge! However again the $ upside would be capped, but at least if there is a decent fall in the Stock that was unexpected you would save losing money on your Long Stock position and will have increased ammunition to buy more into a technical fall (Fundamentals don't change) if it made sense to do so. This is another reason why this Directional bet has high usefulness for Retail Traders as it can act as an effective low-cost hedge on Long Stock positions and can add significant value to your overall portfolio.

Strategy Example

Due to the complex nature of the 3X transactions and the variability in the Debit / Credit payment, breakeven, profit / loss calculations it is better to use an example than to use a formulaic process in explaining how the Strategy works.

The first thing you need to do before use this strategy is to determine what strikes you are going to use. You should probably simply buy at the money Puts for the long leg of the spread, but you need to put some thought into the strikes for the two short legs. It is best to write one batch of options with a strike equal to approximately what price you think the underlying security will fall to, but not go lower than, and write another batch of options with the next lowest strike.

You can use lower strikes if you choose, but these will be a cheaper price, and you won't receive as much credit to offset the upfront cost of the long leg. The advantages of using lower strikes though, is that the strategy will require less margin and you can potentially make more profits.

Warning! Do not choose Strikes based on whether you will pay a Debit or a receive a Credit. The Stock won't settle at a particular price at expiration simply because you paid out or received money on the strategy. The Stock doesn't care whether you paid a debit or received a Credit. Choose the Strikes you sell based purely on your view of where you estimate the Stocks floor is near term NOT based on whether you receive a Credit or not. If it so happens that you receive a net Credit then of course that's a bonus. But if it's a small debit then it's still OK!

Now let's look at the sums of money involved in creating this spread. Please note, we haven't accounted for any commission costs.

- Puts with the $50 strike are trading at $2. You buy 1 contract, containing 100 options, for a total cost of $200.
- Puts with the $45 strike are trading at $.40. You write 1 contract, containing 100 options, for a credit of $40.
- Puts with the $44 strike price are trading at $.30. You write 1 contract, containing 100 options, for a further credit of $30.

The $200 spent on the long leg is partially offset by the $70 credit received for writing contracts in the second leg. The net result is you have created a debit spread, and the total cost is $130. We can now look at the potential profits, and losses, this strategy could return.

The potential profit is limited, and the maximum profit is made when the underlying security (in this case Company X stock) falls in price to the Strike Price of the higher Strike Put written or somewhere between the strikes of the Puts written (in this case between $44 and $45).

If the security falls lower than the lowest strike ($44), then the profits will start to diminish and the position can even move into a loss if the price goes low enough. If the security doesn't fall in price at all, or goes up in price, then the initial investment ($130) will be lost. We have provided some examples of what would happen in a few different scenarios.

Company X stock remains at $50 by expiry

- The options bought will be at the money, and worthless, while the ones written will be out of the money and also worthless. With no further returns or liability, the loss is the amount of the initial debit investment - $130.

Company X stock falls to $47 by expiry

- The options bought will be in the money and worth roughly $3 each for a total of $300.
- The options written will all be out of the money and therefore worthless.
- Your profit will be the $300 less your initial $130 investment. You will have made a total profit of $170.

Company X stock falls to $45 by expiry

- The options bought will be in the money, and worth roughly $5 each for a total of $500.
- The options written will all be out of the money and therefore worthless.
- You profit will be the $500, less your initial $130 investment for a total of $370.
- This is the maximum profit you can make, and it's made when Company X stock price is at $45 or anywhere between $44 and $45.

Company X stock falls to $40 by expiry

- The options bought will be in the money and worth around $10 each for a total of $1,000.
- The options written (strike $45) will be in the money and worth around $5 each for a total liability of $500.
- The options written (strike $44) will be in the money and worth around $4 each for a total liability of $400.
- The value of the options owned ($1,000), minus the liabilities ($900) and the initial investment ($130), gives you a total loss of $30.

- The further the price of Company X stock falls, the more you would lose. Remember, though, you can close the position early at any time by selling the options owned and buying back the ones written.

WARNING! Please do remember that with the Bull Call Ladder Spread and with the Bear Put Ladder Spread that there is no such thing as zero “Gap Risk” in Stocks or publicly traded assets. For example, if you have a Bull Call Ladder Spread position on and a company reports or pre-reports and guides to significantly higher Earnings than the market is expecting and while the market is closed, if the Stock opens the next day +20%, +30% or even higher, you will not have a chance to buy back the 2X Calls you have Written at favourable prices and losses can be high. The same goes for a Bear Put Ladder Spread. If a company reports or pre-reports and guides to significantly lower Earnings than the market is expecting i.e. the company announces a “Revenue Warning” and / or “Profit Warning” while the market is closed and the Stock opens the next day -20%, -30% or even lower, you will not have a chance to buy back the 2X Puts you have written at favourable prices and losses can be high. Obviously if you are using the Bull Ladder Spread as a Hedge to a Short Stock Position and the Stock Gaps much higher, you will lose money on your short stock position and you would not make money on your hedge but you would lose even more money overall because of the Hedge. Likewise, if you are using the Bear Put Ladder Spread as a Hedge to a Long Stock Position and the Stock Gaps down much lower you will lose money on your Long Stock position and you would not make money on your Hedge, you would lose even more money overall because of the Hedge. This is why it so important to get the Strikes that you sell right and to get the time to expiration right. Remember with trading Options versus simply trading Stock you are adding timing risk to every trade.