Institute of Trading and Portfolio Management

Professional Options Trading Masterclass Video Series

POTM

Video 13

Option Spreads 2 – Bear Put Spread

Bear Put Spread

Quick Explanation

The Bear Put Spread is very similar to the Bull Call Spread except it is a bearish directional bet using Put Options. It is one of the most useful Options Trading Strategies for Retail Traders because it is relatively simple, requiring just two transactions to implement and the risk is limited to premium paid. It is primarily used when the outlook on an underlying Stock is Bearish, and the expectation is that the Stock will decrease in price to a certain range in the time frame of the contracts traded, but no lower than a certain level. It's often considered a cheaper alternative to the Long Put Options Strategy, because it involves Writing Puts to offset some of the cost of Buying Puts. The trade-off with doing this is that the potential $ profits are capped on the upside (limited). The main reason why you would use this Strategy is to try and profit from a Stock decreasing in price. You would typically use it when you expected the price of an asset to decrease by a certain amount, but not dramatically (as the profit potential is limited). The strategy is basically designed to reduce the upfront costs of buying Puts so that less capital investment is required, and it can also reduce the effect of time decay.

- **Directional Bet**
- **Bearish Strategy**
- **Simple**
- **Two Transactions**
- **Debit**
- **Max Risk (Limited)**
- **Max Gain (Limited)**

When to Use the Strategy

Buying a Put Option and Selling a Lower Strike Put Option where both contracts have the same time to expiration.

The main reason you would use a Bear Put Spread is because you are Bearish the underlying Stock and you expect it to fall in price but not below a certain level by the time of expiration of the two Put Option contracts you have bought and sold. The point of this is to get a marginal benefit of being Long the Put Option versus simply being Short Stock and to reduce the upfront cost of the Long Put Option Contract by writing a lower Strike Put to the one you have bought. There will be a net Debit (premium) paid over the two transactions because the Long Put Option you have bought is nearer the Money than the one you have sold and is therefore more “expensive” / higher priced. However, the cost of a Bear Put Spread is lower than simply being Long a Put. You are paying for the Higher Strike Put (Debit) and receiving a Credit for writing the lower Strike Put. The net effect is still a net Debit but the cost is reduced. The trade-off here versus paying more for a simple Long Put Option Strategy is that your $ upside is capped. So, you need to be confident of the Put Option Strike that you sell that the Stock will not fall more than that Strike price by the time of expiration in order to maximise your gain. If the underlying stock falls below the Strike you have sold, the Puts you have Sold will be In The Money (ITM) as to will your higher Strike Puts, but your Profit would be lower than if you had just been short the Stock. It could then be argued that the Marginal benefit of putting the strategy on over simply Shorting Stock diminishes. However, it is still true that the downside of putting the Bear Put Spread on versus simply Shorting Stock still has a marginal benefit because the downside is limited to the net premium you pay for the spread. So, if the underlying stock rallies and both contracts expire worthless you have only lost the premium you have paid for the spread (limited $ Downside), whereas if you were Short Stock, this may have required more capital and you could have lost a lot more. This is why the Bear Put Spread is ranked high in usefulness for Retail Traders. The $ upside may be limited but the $ risk is also limited. Additionally, it is a simple strategy and it is a Directional Bet. So, the Bear Put Spread Strategy has high usefulness in the specific situations that it can be used for.

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 a Lower Strike Put or we could buy an Out of the Money (OTM) Put and Sell a Lower Strike Put. In both scenarios there needs to be a marginal benefit in doing so over simply being Short Stock. The marginal benefit comes from a Risk Reward analysis of the specific fundamentals you are looking to expose yourself too and capital considerations. If you are expecting a moderate fall by the time of expiration of both contracts in the underlying Stock then it would better to either Short Stock or buy an ATM Put and Sell a Lower Strike Put. You must believe that the Strike you sell will be the price that the Stock will go to but no higher than that price. If you expect an aggressive fall in the Stock price by the time of expiration of both contracts you may be better off (but not always) buying an OTM Put (say 3-5%) and selling a Lower Strike that you believe even though you expect the Stock to fall aggressively, the Stock

will settle as close to the Lower Strike as possible by expiration but no lower. The biggest decision you need to make therefore when putting on the Bear Put Spread is the Strike that you choose for the Puts that you write.

With the Bear Put 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 written 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 written contracts will move into a losing position. Although this won't cost you anything, because the options you own will continue to increase in price at the same rate. 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.

You have the chance to make a bigger Return On Investment (ROI) than you would by simply buying Puts, 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 being 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 and exactly how much you stand to make. The disadvantages are limited, which is perhaps why it's such a popular strategy. There are more commissions to pay than if you were simply buying Puts, but the benefits mentioned above should more than offset that minor downside. The only other real disadvantage is that your profits are limited and if the price of the underlying security falls beyond the strike price of the short Put Options you won't make further gains.

Another use for a Bear Put Spread could be to Hedge a Long Stock Position. By Buying an ATM or slightly OTM Put Option and selling a Lower Strike Put this would lower the cost of a simple Long Put Hedge against a Long Stock Position. However, again the $ upside would be capped but at least if there is a 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 sell off (Fundamentals don't change), if it made sense to do so. As the $ downside on a Long Stock position is theoretically limited as a Stock can only go to Zero, it is still highly desirable especially for Long Term holders of Stocks like Pension Fund holders to Hedge against their Stocks selling off for prolonged periods and to not lose money if Stock Holdings in a pension fall. This is another reason why this Directional bet has high usefulness for Retail Traders as it can act as an effective hedge on Long Stock positions and add significant value to your overall portfolio.

Break Even

Leg A = Buy ATM or OTM Put Option, Leg B = Write Lower Strike Put Option

Break-even point is when **Price of Underlying Security = Strike Price Leg A – (Price of Options Leg A – Price of Options Leg B)**

Profit Calculations (Maximum Upside)

Maximum Profit is Limited

Maximum profit is made when **Price of Underlying Security < or = Strike Price Leg B**

Maximum profit, per option owned is **(Strike Price Leg A – Strike Price Leg B) – (Price of Option Leg A – Price of Option Leg B)**

Risk Calculations (Maximum Downside)

Maximum loss is limited.

Maximum loss is made when **Price of Underlying Security > or = Strike Price Leg A**

Maximum loss per option owned is **Price of Option in Leg A – Price of Option Leg B**

Strategy Example

Here we have provided an example of the Bear Put Spread strategy, showing how it would be used and a few potential outcomes at the point of expiration. Please be aware this example is purely to provide a rough overview of how it can work and it doesn't necessarily use exact prices. For the purposes of this example we have ignored the commission costs.

- Company X stock is trading at $50 and you expect it to fall in price but not any lower than $47.
- At The Money Puts on Company X stock (Strike price $50) are trading at $2 and Out of The Money Puts on Company X stock (strike price $47) are trading at $0.50.

- You buy 1 At The Money Put Option contract with a Strike Price of $50 and Expiration date of Feb 22nd (4 weeks from now) at a cost of $200 (One contract = 100 shares). This is Leg A.
- You write 1 Out The Money Put Option contract with a strike price of $47 and Expiration date of Feb 22nd (4 Weeks from now) for a credit of $50 (One contract = 100 shares) This is Leg B.
- You have now constructed a Bear Put Spread and incurred a net debit of $150.

If Company X stock decreases to $47 by expiration

The Put Options you bought in Leg A will be In The Money and worth around $3 each, and the ones written in Leg B will be At The Money and worthless. The ones owned will be worth around $300 in total which means a profit of $150 after accounting for your initial Debit of $150.

If Company X stock decreases to $48 by expiration

The Put Options you bought in Leg A will be In The Money and worth approximately $2 each, while the ones you wrote in Leg B will be Out of The Money and worthless. The ones you hold will be worth $200 in total, giving you a net profit of $50 after taking your initial Debit of $150 into account.

If Company X stock stays at $50, or increases, by expiration

The Put Options in both Leg A and Leg B will expire worthless. With no returns to come and no liabilities, you have simply lost your initial $150 investment.

If Company X stock increased dramatically, you still wouldn't lose any more than your initial $150 investment. Equally, if Company X stock fell even lower than $47, your profits wouldn't increase above the $150, because the position in Leg B would start to lose you money at the same rate the position in Leg A would make you money.

Remember: You can close your positions at any time prior to expiration if you want to take your profits at a particular point, or cut your losses. Also, you can increase the profit potential of the spread by writing the options in Leg B with a lower strike price.