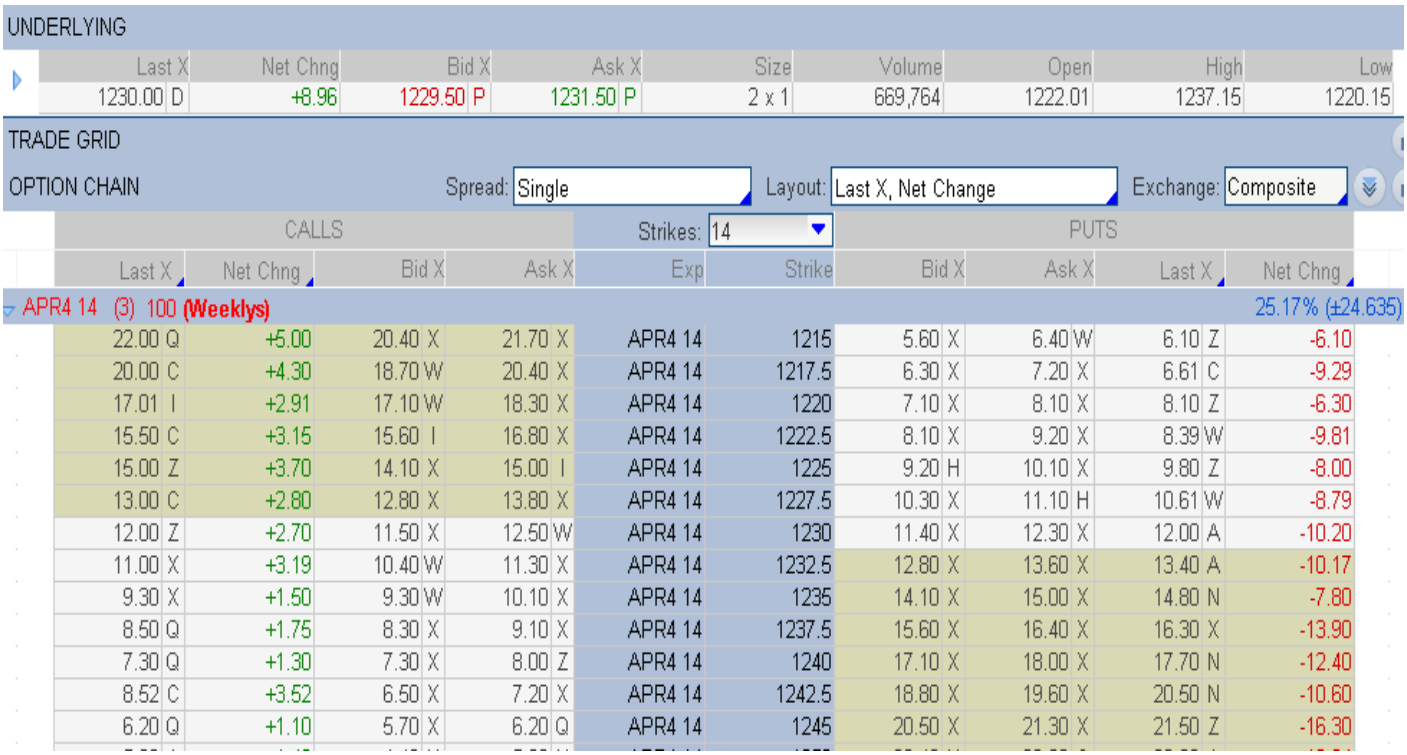
The Bullish – Bearish Credit Spread Trade

The Optionomics Group LLC

The basic credit spread strategy is what I call 'The Bullish - Bearish Credit Spread Trade'. It involves the selling of either a weekly - ***Bullish put spread*** or a weekly - ***Bearish call spread*** depending on the Market Edge 'Opinion' for the underlying stock. When properly utilized, this trade can be profitable in three out of five possible scenarios. The following example will give you a good idea how this trade should play out.



UNDERLYING

Last X	Net Chng	Bid X	Ask X	Size	Volume	Open	High	Low
1230.00 D	+8.96	1229.50 P	1231.50 P	2 x 1	669,764	1222.01	1237.15	1220.15

TRADE GRID

OPTION CHAIN Spread: Single Layout: Last X, Net Change Exchange: Composite

CALLS				Strikes: 14		PUTS			
Last X	Net Chng	Bid X	Ask X	Exp	Strike	Bid X	Ask X	Last X	Net Chng
APR4 14 (3) 100 (Weeklys)									25.17% (±24.635)
22.00 Q	+5.00	20.40 X	21.70 X	APR4 14	1215	5.60 X	6.40 W	6.10 Z	-6.10
20.00 C	+4.30	18.70 W	20.40 X	APR4 14	1217.5	6.30 X	7.20 X	6.61 C	-9.29
17.01 I	+2.91	17.10 W	18.30 X	APR4 14	1220	7.10 X	8.10 X	8.10 Z	-6.30
15.50 C	+3.15	15.60 I	16.80 X	APR4 14	1222.5	8.10 X	9.20 X	8.39 W	-9.81
15.00 Z	+3.70	14.10 X	15.00 I	APR4 14	1225	9.20 H	10.10 X	9.80 Z	-8.00
13.00 C	+2.80	12.80 X	13.80 X	APR4 14	1227.5	10.30 X	11.10 H	10.61 W	-8.79
12.00 Z	+2.70	11.50 X	12.50 W	APR4 14	1230	11.40 X	12.30 X	12.00 A	-10.20
11.00 X	+3.19	10.40 W	11.30 X	APR4 14	1232.5	12.80 X	13.60 X	13.40 A	-10.17
9.30 X	+1.50	9.30 W	10.10 X	APR4 14	1235	14.10 X	15.00 X	14.80 N	-7.80
8.50 Q	+1.75	8.30 X	9.10 X	APR4 14	1237.5	15.60 X	16.40 X	16.30 X	-13.90
7.30 Q	+1.30	7.30 X	8.00 Z	APR4 14	1240	17.10 X	18.00 X	17.70 N	-12.40
8.52 C	+3.52	6.50 X	7.20 X	APR4 14	1242.5	18.80 X	19.60 X	20.50 N	-10.60
6.20 Q	+1.10	5.70 X	6.20 Q	APR4 14	1245	20.50 X	21.30 X	21.50 Z	-16.30

Let's assume that Market Edge has a Bullish 'Opinion' for PCLN and you think that it is going to rally over the short-term. You decide to sell a bullish 1230 -1222.5 put credit spread. You would ***sell*** the 1230 put for $12.00 and ***buy*** the 1222.5 put for $9.00. This spread would result in a credit of $3.00 ($12.00 - $9.00) and a maximum risk of $4.50 ($7.50 differences in strike prices - $3.00 credit). The trade would look like the following:

Bullish - Put Verticle Credit Spreads

*Stock	Open Date	Open Stock Price	Short Put 04/14/18 Strike Price	Long Put 04/14/18 Strike Price	Credit Spread	Max Risk	% Of Spread	Quick Target	% Risk Capital Max Risk
PCLN	04/10/18	$1,230.00	1230.0	1222.5	$3.00	$4.50	40.0%	$0.05	-2.3%

Possible outcomes:

1) If you are correct and the stock closes above $1230 at expiration, you would keep the $3.00 ($300) credit for a ***Full $300 Win***.

2) If the stock closes at $1230 at expiration, you also would keep the $300 credit for a ***Full $300 Win***.

3) If you are sort of wrong and the stock closes at $1228.20, a decline of $1.80, you would keep $1.20 ($120) of the $3.00 credit ($3.00 – $1.80) for a ***Partial $120 Win*.**

4) If you are a little more wrong and the stock closes at $1226.20, a decline of $3.80, you would lose $0.80 ($80) - ($3.80 – $3.00) for a ***Partial $80 Loss***.

5) If you are dead wrong and the stock closes below $1222.50, you would lose the maximum risk amount $4.50 ($450) for a ***Full $450 Loss*.**

So, if you are wrong but not by more than $3.00, your trade will either breakeven or be profitable. No other trade in the option or equity markets gives you this kind of edge! The only scenario in which you lose a lot of money when creating a bullish put spread is if the stock breaks down hard. This is why you need to have sufficient risk capital to cover a series of losses of this nature if and when they occur.

The same outcome would occur if you are bearish on PCLN. You would sell a bearish 1230 – 1237.5 call credit spread. You would ***sell*** the 1230 call for $12.00 and ***buy*** the 1237.5 call for $9.00. This trade would result in a credit of $3.00 ($12.00 - $9.00) and a maximum risk of $4.50 ($7.50 differences in strike prices minus the $3.00 credit).

Bearish - Call Vertical Credit Spreads

**Stock	Open Date	Open Stock Price	Short Call 04/14/18 Strike Price	Long Call 04/14/18 Strike Price	Credit Spread	Max Risk	% Of Spread	Quick Target	% Risk Capital Max Risk
PCLN	04/10/18	$1,230.00	1230.0	1235.0	$2.40	$2.60	48.0%	$0.05	-1.3%

Possible outcomes:

1) If you are correct and the stock closes below $1230 at expiration, you would keep the $3.00 ($300) credit for a ***Full $300 Win***.

2) If the stock closes at $1230 at expiration, you would also keep the $3.00 credit for a ***Full $300 Win.***

3) If you are sort of wrong and the stock closes up at $1231.80, an increase of $1.80, you would keep $1.20 of the initial $3.00 credit ($3.00 – $1.80) for a ***Partial $120 Win*.**

4) If you are a little more wrong and the stock closes up at $1233.80, a gain of $3.80, you would lose $0.80 ($80) ($3.80 – $3.00) for a ***Partial $80 Loss***.

5) If you are dead wrong and the stock closes above $1237.50, you would lose the maximum risk amount - $4.50 for a ***Full $450 Loss***.

I think that you will agree with me that the risk/reward of selling weekly, credit spreads makes a lot of sense and can be a very profitable trade. But that is only half the story. Weekly options have gradually grown to be the hottest option trading product in the U.S. market. That is why I recommend them as a good strategy for any

option trader. By combining this strategy with the power of the Market Edge Opinions, a solid approach has been developed which should prove to be profitable in any market environment.

Below are several questions and answers which should help you further understand how credit spreads work and why selling premium is a great strategy.

Q: What Should My Win - Loss Percentages Be?

A: I'm asked this all of time and it is a good question. The probability model gives us the answer. Typically, you would be selling the ATM option (put or call) and buying an option whose strike price is further away from the current price of the underlying stock, either ATM +1+2 +3 (calls) or ATM -1 -2 -3 (puts). Without the benefit of the Market Edge selections, you should have a Full Win 50% of the time and keep the entire credit. That is because the ATM option you sell, whether a put or call has a 50% chance of expiring out of the money. It is impossible for both of them to finish in the money. On the negative side, 25% of the time things will go completely against you and you will get hit for the Full Loss. The other 25% of the time, the stock will settle somewhere between the long option and the short option strike prices and you will either keep or lose some of the credit (Partial Win or Partial Loss).

The following table is an example of how things should play out after 100 or so transactions. Let's assume that you sell a 10 lot, 5-wide (difference between the strike prices) vertical credit spread every week at an average credit of $2.00 ($200) per spread. Your maximum risk is $3.00 ($300) per spread. Your risk capital should be $20,000. You have a 50% Random Win Rate since ATM options have a 50% chance of expiring out of the money. Ticket Charges of $5.00 per trade and $0.50 per contract are factored into the results. The outcome should look something like this:

Random 50% Win Rate Projections	**Monthly Dollar Profit /Loss**
50.0% of Trades = Full Win ($200)	$1,000.00
12.5% of Trades = Partial Win ($100)	$ 100.00
12.5% of Trades = Partial Loss ($100)	$ -100.00
25.0% of Trades = Maximum Loss ($300)	$ -750.00
Commissions	$ -15.00
Monthly Dollar Gain/Loss	$ 235.00
Risk Capital	$20,000.00
Monthly Percentage Gain	1.2**%**
Annualized Percentage Gain	14.1**%**

Q: What Should My Results Be If I Use The Market Edge Selections?

A: The table above shows the likely outcome of the credit spread trade with a Random 50% - Win Rate. The example shows that the trade should produce an annualized return of around 14% based on Risk Capital of $20,000. Now take a look at the table below. These projections are based on a 60% Win Rate, which is what you should expect when using the Market Edge selections. Note that the Market Edge Annualized Percentage Gain is considerably higher than the Random - 50% Win Projections.

Market Edge Advantage 60% Win Rate Projections	**Monthly Dollar Profit /Loss**
60.0% of Trades = Full Win ($200)	$ 1,200.00
12.5% of Trades = Partial Win ($100)	$ 100.00
12.5% of Trades = Partial Loss ($100)	$ -100.00
15.0% of Trades = Maximum Loss ($300)	$ -450.00
Commissions	$ -15.00
Monthly Dollar Gain/Loss	$ 735.00
Risk Capital	$20,000.00
Monthly Percentage Gain	3.7**%**
Annualized Percentage Gain	44.1**%**

While these projections are by no means a guarantee of future results, adding the Market Edge selections to the overall game plan should provide a nice boost to your profitability.

Q: How Many Consecutive Losing Trades Can I Expect?

A: Based on the above projections, if you have a 50% win rate you can expect seven consecutive losing trades with a 99% confidence rate. Another way of stating this is that in a group of 100 trades, if you have a 50% win rate, you can expect losing runs of 7 in a row 1% of the time. With a 60% win rate, you can expect losing runs of 6 in a row 1% of the time. It sounds like a small percentage but rest assured it will occur. That is why you need risk capital when employing this and every other option strategy.

Q: If I Only Want To Initiate Two Credit Spreads How Do I Know Which Ones Are The Best Plays?

A: You would apply what I call the 40% - 60% rule. Simply put, you divide the credit spread by the difference in the strike prices and play the one which has the largest value. Let's assume that Stock A has 5.0 wide strikes while Stock B's strikes are 2.5 wide. Let's also assume that the credit received from Stock A's spread is $2.50 while the credit from Stock B is $1.00. Dividing the $2.50 credit by the difference in Stock A's strike prices (5.0) equals 50%; meaning you are getting 50% of the spread. Dividing the $1.00 credit by the difference in Stock B's strikes (2.5) would equal 40%. Stock A would be the better play.

Under normal market conditions, the following are the credit amounts that you should try to get based on the width of the strike price for the spread. You can accept less than the ideal credit but this is what you should shoot for as it is 40% of the spread.

Credit Spread Width	Ideal Credit
1.0 Wide	$0.40
2.5 Wide	$1.00
5.0 Wide	$2.00
7.5 Wide	$3.00
10.0 Wide	$4.00

It should be noted that option premiums are largely dependent on the perceived volatility of both the underlying stock and the market as a whole. This volatility expectation is best reflected in the daily readings of the VIX indicator. VIX is the ticker symbol for the CBOE Volatility Index, which shows the market's expectation of volatility over the next 30-days. It is constructed using the implied volatilities of a wide range of S&P 500 Index put and call options and is widely used as a measure of market risk. VIX is often referred to as the "fear gauge." VIX values greater than 30 are generally associated with a large amount of volatility as a result of investor fear or uncertainty while values below 20 generally correspond to less stressful, even complacent times in the markets. When VIX is between 20 & 30, 40% premiums are usually obtainable. As VIX moves above 30, larger premiums are possible while the premiums decline when VIX is below 20. The weekly VIX reading is located on the top of the selections report.

Q: What Should I Do If I Get Lucky And My Credit Spread Becomes A Big Winner Right Off The Bat? Is There A Way To Lock In The Profit Before Expiration?

A: This is a good question and I am asked it all of the time. There is no 100% correct way to handle this "happy problem", but here are several suggestions that should get the job done.

First of all we have to define what is a Big Winner? Some traders want to take the spread off if it goes a few ticks in their favor. This is a bad decision. It is usually best to let the price run. So by definition, a Big Winner is when you have captured at least 80% of the potential profit. If you put the spread on for a $2.00 credit, 80% would be $1.60. If you put it on for $0.40, $0.32 would be 80%. Following are several methods to lock in a profit when this occurs. Some are better than others. The choice is up to you.

1) Buy back the spread. Remember, you originally ***sold*** the spread so to unwind it you would want to ***buy*** it back. This is my least favorite way to handle this situation since it doesn't give you any additional profit potential.

2) Buy back the short leg and leave the long leg on as a ***"Free Roll".*** This strategy lets you lock in most of the profit while giving you some additional upside potential if the underlying stock **"blows back".** If the underlying stock continues in the direction that gave you the Big Winner, you will lose the amount of premium left in the Free Roll option and your trade will end up profiting less than 80%. But if the stock retraces the move, you could receive additional profit from the Free Roll option.

3) Buy another option with a strike price which is immediately above or below the short leg of the spread. This strategy insures the 80% profit and could also have additional upside. The option that you buy will probably have as much premium in it as the 20% that is left in the spread. If the stock blows

back you are now long a debit spread but you own the additional option for free. This method guarantees that you will capture the 80% and still have some upside potential.

4) You can roll up or roll down the credit spread to the current price. Using this method lets you capture a double credit for the week. You buy back the spread that is at least an 80% winner and then sell another credit spread at the new ATM. The problem with this strategy is that if you get a blow back, you may end up losing money for the week as your new spread could end up being a big loser.

Q: What Is The 'Break Even Price'?

A: The Break Even Price is the price that the stock must hold for the trade to be profitable. For bullish put spreads, it is the short put strike price ***minus*** the credit. For bearish call spreads, it is the short call strike price ***plus*** the credit. If you were to initiate a bullish put spread for stock GS ($245.11) by selling the 245 put and buying the 240 put for a $1.63 credit, the Break Even Price that the stock would need to stay ***above*** by expiration for the trade to be profitable would be $243.37 (245 - $1.63). Conversely, if you initiated a bearish call spread for stock AAPL ($156.90) by selling the 155 call and buying the 160 call for a $2.14 credit, the Break Even Price that the stock would need to stay ***below*** by expiration for the trade to be profitable would be $157.14 (155 + $2.14).

Q: If This Deal Is So Great Why Won't Everyone Use It Which Would Cause It To Fail?

A: It is possible but unlikely. It is important that you understand several points. First, the market has millions of participants trading trillions of dollars every day. The probability of all of them using Market Edge and changing the worldwide market is next to impossible. Second, even if that were to happen, the probability model assures us that the ATM put or call will always have a 50% chance of settling in the money and ATM +1, +2 or ATM -1, -2 will always have less of a chance of ending up in the money. So, if the short leg of the spread, the ATM Put or Call was to get depressed and the long leg, ATM +1, +2 call or ATM -1-2 put got inflated to the point that the profit potential disappeared, the market makers would put the market back in line. If for some crazy reason that didn't occur, you would take advantage of the situation by moving your spreads around to gain an edge on the other traders. In short there is always a counter strategy that will work.

Q: All Right - What's The Catch?

A: There are several situations that can develop which could have an adverse effect on trades involving the selling of credit spreads. The probability is fairly low that any of these events will occur but they need to be addressed so you will not lay awake at night trying to figure them out for yourself. The Bullish – Bearish Credit Spread Trade gives you the opportunity to initiate between one to four bullish ***put*** or bearish ***call*** credit spreads every week. Over a number of transactions, the results of these trades should be as follows: 50% of the spreads should produce a Full Win. 12.5% should result in either a Partial Win or Partial Loss while the remaining 25% should end with a Full Loss.

Problem #1: Mathematical models that produce a 50%-win rate are subject to losing streaks of around seven consecutive losses in a row. Trading only two spreads per week could result in three to four consecutive weeks of losing trades.

Solution #1: As noted above, the Market Edge 'Opinions' have a solid record of being correct around 70% of the time with the winners outperforming the losers by a 3:1 ratio. That's the good news. The bad news is that the performance record is based on a holding period of around 60 days. The Bullish – Bearish Credit Spread Trade outlined above has a one or two week holding period which is harder to forecast than a 60 day period.

However, earlier on it was noted that the ATM put or call option should expire out of the money around 50% of the time. With the addition of the Market Edge Opinions, over time around 60% of the trades should result in Full Wins. It should also be noted that for a Full Win to occur, all the stock has to do is close unchanged or move slightly in the spreads direction by expiration. A Full Loss however, requires the stock to have an adverse move of around 3% or more in a week.

Problem #2: As noted above, you want to get around 40% of the spread's value each week. This is usually obtainable and lets the model do its thing. However, in times when volatility dries up as measured by very low VIX readings, getting 40% can be hard to do.

Solution #2: There is not much you can do when volatility dries up. The good news is that when volatility declines, it usually doesn't last for long. Also, by providing selections to our subscribers which are based on Monday morning's opening prices, I am able to review the various credit spreads that are available and select the ones that offer the largest payouts

Let's Go to the Races

I strongly suggest that you paper trade this trade for a couple of weeks before you start trading for real. If your on-line-brokerage firm doesn't have a virtual platform that allows you to paper trade options, e-mail us at optionomics@marketedge.com and we will direct you to an appropriate web site. They both have basic platforms which are easy to navigate. After a few weeks of paper trades, you should be comfortable with trading the Bullish – Bearish Credit Spreads and be ready to roll. You should have the proper amount of risk capital in your account and be confident as to what steps you need to take to execute your trades.

On Monday morning around 10:30 AM EST, go to the Optionomics web site (optionomicsgroup.com) to retrieve the Selections for the week. Once you have a trade in place, I recommend that you do nothing until Friday morning after 11:00 AM EST. Remember, over time, 60% of the trades should be Full Winners and you will collect the entire credit. Partial Winners should occur around 12.5% of the time and you will need to take some form of action to lock in the profit. Partial Losers should also occur around 12.5%. The remaining 15% of the time will usually result in a maximum loss (Full Loser) that you will have to shake off and go on to the next trade.

The following actions should be taken depending on the likely outcome of the trade:

1) If the spread is a ***Full Winner***, hold it until expiration. This occurs when the stock closes above the short put's strike price for a bull spread or below the short call's strike price for a bear spread. Both legs of the spread will expire worthless.

2) If the spread is a ***Partial Winner***, take the trade off before the close of business on Friday. This situation occurs when the stock has sort of gone your way, but it isn't above the short put's strike price for a bull spread or below the short call's strike price for a bear spread. You will have to reverse the spread by buying back the short leg and selling the long leg for a small debit.

3) If the short leg of your credit spread has been assigned, you are now short the stock instead of being short the option. This is not a problem since your risk has not changed. If there is premium in the long leg, you can buy back the short stock position and sell your long option which will either reduce any losses or lock in any gains. If you do nothing and your long option is in the money, it will be exercised after expiration which will cover your short stock position. If the long option is out of the money, you will

have to cover the short by buying back the stock. Check with your broker as some will charge you a fee to do this.

What You Can Expect

Frequency Of Play:	Weekly
Investment Option Time Horizon:	One Week
Maximum # Of New Plays Per Week:	Four
Maximum # Of Open Positions:	Four
Risk Tolerance:	Medium
Option Experience:	Low
Suggested Amount Of Risk Capital To Trade All Of The Traders Selections:	$20,000

Summary

The Bullish – Bearish Credit Spread Trade is an ideal approach for those who have a short-term *option* investment time horizon, limited risk capital and a decent tolerance for risk. The average price for the stock selections is around $125 per share while the maximum number of Open Positions at any time is four. A fully invested cash account would require risk capital of around $5,000. Finally, it is not necessary to purchase all of the recommendations since each is an independent event with similar technical characteristics so the performance should be the same. That being said, diversification into a number of selections is always recommended. I think that you will agree that The Bullish – Bearish Credit Spread Trade makes a lot of sense and can be a very profitable approach in any market environment.

Traders Worksheets

Week Start: **Market Posture:**

Bullish Blow Off Bottom - Put Spread - Long Deferred Call - (Short Put Above Long Put)

Open Date	Stock Symbol	Open Stock Price	Short-Exp ATM Put Strike	Long-Exp ATM -2 Put Strike	Open Spread Credit	Long-Deferred ITM - Call Strike	Open Call Debit	Open Combo Debit	Close Date	Close Stock Price	Close Combo Credit	Total Profit Loss
			/	/		/						
			/	/		/						
			/	/		/						

Bearish Blow Off Top - Call Spread - Long Deferred Put - (Short Call Below Long Call)

Open Date	Stock Symbol	Open Stock Price	Short-Exp ATM Call Strike	Long-Exp ATM +2 Call Strike	Open Spread Credit	Long-Deferred ITM - Put Strike	Open Put Debit	Open Combo Debit	Close Date	Close Stock Price	Close Combo Credit	Total Profit Loss
			/	/		/						
			/	/		/						
			/	/		/						
Totals----->			**$ P/L**		**# Wins**		**# Loss**		**Win %**		**# Trades**	

Bullish Put Verticle Spread - (Short Put Above Long Put)

Open Date	Stock Symbol	Open Price	Short-Exp ATM Put	Long-Exp ATM -1 Put		Open Credit			Close Date	Close Spread	Close Stock Price	Total Profit Loss
			/	/								
			/	/								

Bearish Call Verticle Spread - (Short Call Below Long Call)

Open Date	Stock Symbol	Open Price	Short-Exp ATM Call	Long-Exp ATM +1 Call		Open Credit			Close Date	Close Spread	Close Stock Price	Total Profit Loss
			/	/								
			/	/								
Totals----->			**$ P/L**		**# Wins**		**# Loss**		**Win %**		**# Trades**	

Bullish One-Day Wonder Trade - (Short Exp Call Above Long Def Call)

Open Date	Symbol	Open Price	Short-Exp +1, +2 Call	Long-Def -1, -2 Call		Open Debit Spread	100% Target	Close Date	Close Stock Price	Close Spread		Total Profit Loss
			/	/								
			/	/								

Bearish One-Day Wonder Trade - (Short Exp Put Below Long Def Put)

Long Deferred Put Above Short Expiring Put						Open			Close			Total
Open Date	Symbol	Open Price	Short-Exp -1, -2 Put	Long-Def +1, +2 Put		Debit Spread	100% Target	Close Date	Stock Price	Close Spread		Profit Loss
			/	/								
			/	/								
Totals----->			**$ P/L**		**# Wins**	9	**# Loss**		**Win %**		**# Trades**	

Weekly Total:	**$ P/L**		**% P/L**		**# Wins-# Loss**			**Win %**		**# Trades**	