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Turn Every Friday Into Pay Day

Consistent Cash Flow With Options

In the regular class, we learned all about the Covered Call strategy.

That's a great strategy if you're already trading stocks.

But what if you can't/don't want to tie up capital in 100 shares?

That's where Credit Spreads come in!

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Credit Spread Basics

Credit Spreads are one of the bread-and-butter strategies employed by options traders.

It's something that we use all the time.

They are simple, high-probability trades that generate consistent cashflow with limited risk.

And unlike Covered Calls, they tie up relatively little capital.

Credit Spread Basics

What we're talking about today is a type of Vertical Spread.

Technically, any options spread entered for a net credit could be considered a credit spread.

Today I'm sharing with you what I like to call "Line In The Sand" trades.

Here's why…

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Line In The Sand

Let's say you think SPY is heading lower.

With a credit spread, you can "draw a line in the sand", at say $515.

By doing this, you're effectively saying "I want to get paid as long as SPY stays below $515".

In this example, let's say the 515 credit spread is selling for $1.00

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How Many Directions Can A Stock Move?

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Line In The Sand

With your "line in the sand" at $515, you get paid the same $100 *no matter what SPY does…*

…As long as it stays below your line in the sand.

If SPY goes down? **You get paid.**

If SPY goes sideways? **You get paid.**

Even if SPY goes up, as long as it doesn't go above $515, **you get paid!**

Unlike with traditional trades where you need to get the direction right to make money…

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Credit Spreads let you make money in "2.5" out of 3 directions!

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Let's look at this in more detail…

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How Credit Spreads Work

When you create a credit spread, you're actually trading 2 options at the same time.

You Sell-To-Open one option, which brings in a credit (e.g., $1.50).

At the same time, you Buy-To-Open another option for a lesser debit ($.50).

The difference between these two is called the "spread" ($1.00)

How Credit Spreads Work

In the SPY example, we were looking at a **call** credit spread, which is a bearish trade.

By selling the 515-strike call option, we were drawing a "line in the sand" at $515.

As long as SPY stays below $515 by expiration, we get to keep the $1.00 credit.

The long option is purchased as protection in case the stock moves against you (this "covers" you so you're not selling naked).

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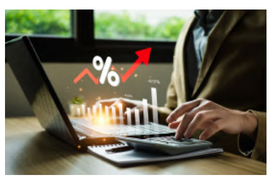
How Credit Spreads Work

With a credit spread, the ideal scenario is that both options expire worthless.

Remember, we're net-short options, so we benefit from them going down in value.

If they go down to zero (at expiration), we don't even have to buy them back.

Simple let them expire and keep the credit received – avoid extra commissions!



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Let's go over multiple scenarios to understand the risks

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The Trade

Short (**STO**) **SPY 515-strike call** for **$1.50**

Long (**BTO**) **SPY 520-strike call** for **$0.50**

Net trade cost: **-$1.00** (credit)

Maximum profit: **$1.00**

Maximum loss: **$4.00**

Breakeven: **$516.00**

Scenario 1: SPY Below $515

This is the best and most-likely scenario.

Both options expire worthless:

Short call value: +$1.50 - $0 = **+$1.50** (keep 100% of premium)
Long call value: -$0.50 + $0 = **-$0.50** (lose 100% of premium)

Trade value: **$0** (max gain: 100% of $1.00 net credit)

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Scenario 2: SPY At $525

This is the worst-case scenario – the stock blows through our line in the sand.

The long call protects us from losses above $520.

Short call value: +$1.50 - $10.00 = **-$8.50**
Long call value: -$0.50 + $5.00 = **+$4.50**

Trade value: **-$4** (max loss: -$5 spread, less $1.00 net credit)

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Scenario 3: SPY at $517.32

What if SPY is somewhere above our line in the sand, but not yet at our max loss protection level of $520?

The short call is losing value, and the long call is still out of the money. The spread is at a loss overall, but not a max loss. The loss is equal to the amount that the short call is in the money, less the net credit received.

Short call value: +$1.50 - $2.32 = **-$0.82**
Long call value: -$0.50 + $0 = **-$0.50** (lose 100% of premium)

Trade value: **-$1.32** (-$2.32 spread, less $1.00 net credit)

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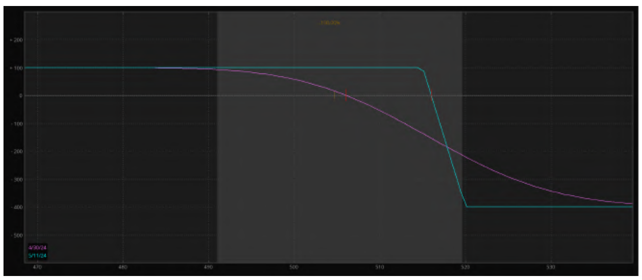
It helps to see a risk graph to understand these scenarios

Call Credit Spread Risk Graph



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Some Things To Note

Credit spreads should **always*** be sold Out Of The Money – this is what puts the probabilities in your favor.

Aim to sell the .30 Delta options, ideally just beyond a recent support/resistance

Do NOT sell credit spreads against the trend! If the trend is bullish, look to sell put spreads on a pullback, NOT calls at a top. If the trend is bearish, look to sell call spreads on a bounce, NOT puts at a bottom.

Remember that your max risk will be larger than the net credit, so you must have good probabilities!

The further OTM you sell, the safer but lower premium / worse R:R

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Did I mention you can do this with puts, too? :)

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Put Credit Spreads

Everything works exactly the same, just opposite:

With puts, you need the stock to stay *above* your short strike.

Max risk is still the difference between your strikes.

Max profit is still the net credit received.

Put Credit Spreads

Remember that the one you ***sell*** is the one ***closer to*** the stock (but still OTM).

The one you ***buy*** for protection is the one ***farther away*** from the stock (further OTM).

If you're seeing a net debit rather than a net credit, it means you have these backwards.

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Wrapping It Up

Always trade WITH the trend:

Bullish/Neutral: Sell **puts**

Bearish/Neutral: Sell **calls**

Your short strike is your "line in the sand". Choose a strike price that the stock is not likely to get beyond by expiration - ideally just beyond a recent support/ resistance level, and around a .30 Delta.

Your long option is there to protect you from big losses. Remember to NEVER TRADE NAKED.

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Wrapping It Up

I love to do these with weekly option expirations – every Friday (when the options expire) becomes Pay Day!

Your short strike is your "line in the sand". Choose a strike price that the stock is not likely to get beyond by expiration - ideally just beyond a recent support/ resistance level, and around a .30 Delta.

Your long option is there to protect you from big losses.
Remember we **NEVER TRADE NAKED**.

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Let’s Finish Out The Class In Thinkorswim