12 The Bear Put Spread

Chapter 1 on option basics, chapter 4 on bull call spreads, chapter 6 on puts, chapter 7 on put selling, and chapter 8 buying provide useful background for this chapter.

It is possible to construct bear or bull spreads using either calls or puts. Just as there are advantages to using the upwardly profitable call to create a bull spread, there are advantages to using the downwardly profitable put to create a bear spread.

12.1 The Bear Put Spread

As the name implies, when you open a bear spread, you expect the stock to drop in price. To create a bear put spread, you sell a put at a lower strike and buy a put at a higher strike. This is a debit spread, since the put with the higher strike will be deeper in-the-money and therefore cost more than the put with the lower strike put pays. And since the expiration dates are the same, it's classified as a vertical spread.

The maximum return is limited to the difference between the strikes, less your initial investment. You'll receive this if the stock closes anywhere below the lower strike price at expiration. Your maximum loss is limited to your original investment, which will occur if the stock closes anywhere above the higher strike at expiration.

Example

Shares of McKinnon's Instant Haggis (PUKE) are selling for $25. There is an April $30 put for 2-points, and an April $20 put for 7-points. You buy the $30 put and sell the $20 put for a net debit of 5-points. You will need $2,000 cash in your account to secure the $20 put.

The profit graph for the bear put spread is shown in Figure 12.1, with the specific numbers for the above example attached. Not too surprisingly, it looks like a bull spread graph turned upside down. As you can see, the maximum loss and maximum profit occurs at and below the strikes, with a break-even price of $25. Here are formulas you can use to calculate these important points easily:

Maximum Loss = Initial Investment

Maximum Profit = High Strike - Low Strike - Initial Investment

Break-even price = High Strike - Initial Investment

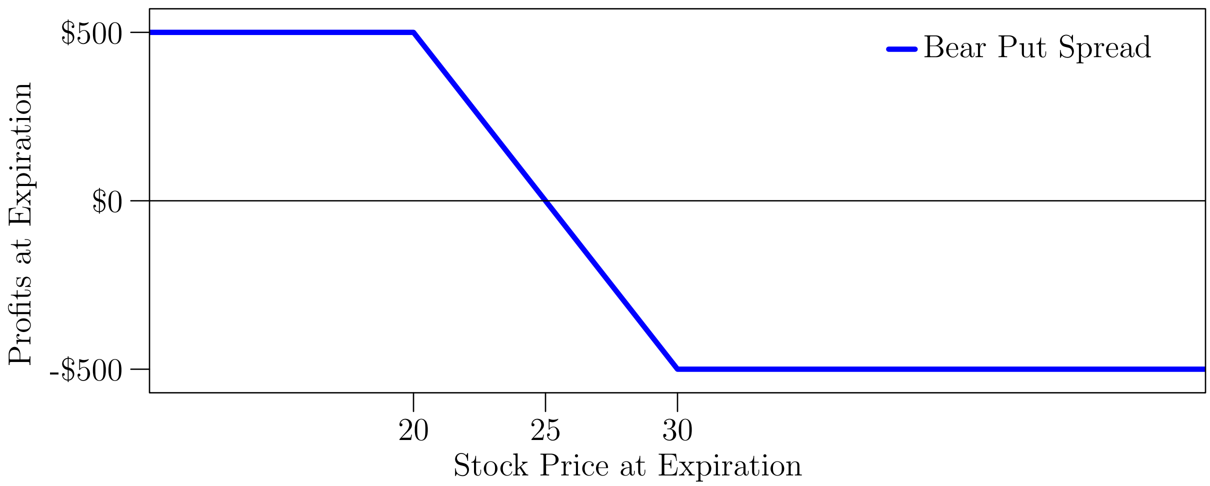

Figure 12.1: Profit graph of bear put spread.

As has been mentioned frequently, puts lose time value faster than calls when they go into-the-money. This has a positive effect on bear put spreads — they widen faster than call spreads. In our current example, if shares of PUKE quickly dropped to $18, the $30 put would be very near 12-points, with almost no time value. But the short $20 put would also have very little time value, probably selling for about 4-points, and widening the spread to 8-points.

12.2 Selecting a Bear Put Spread

An extremely conservative bear put spread could be set up with both puts in-the-money. For example, with a stock trading at $28, you could open a bear put spread with strikes of $35 and $30. As long as the shares stay below $28, you will make your profit. It will be small, but you are very likely to get it. And if the stock climbs above $30, you have less danger of realizing your maximum loss.

At the other extreme, you can set-up the spread so that both legs are out-of-the-money. For example, with a stock at $28, you could buy a $25 put and sell a $20 put. Your stock must drop a full 8-points to make the maximum profit, but if it does, it will be a nice one.

Probably the best balance of risk and reward is to arrange the strikes so the stock is somewhere in the upper-half of the strike range. Right in the middle is fine. This also goes along nicely with the fundamental principle of option investing, which is to sell time value and buy intrinsic value. Using our example stock price of $28 once again, either a spread of $30 and $25, or even one with the strikes at $30 and $20 could be considered.

If you wish to consider the volatility of the stock when you rank your bear spreads, you may find the discussion in section 4.5 to be of interest.

12.3 What do I do With My Brand New Bear Spread?

As with most spreads, very little in the way of follow up action needs to be taken. If the stock moves below the lower strike, you will want to watch the short put to make sure you won't be assigned shares. If you think the decline is going to be severe, you might consider buying back the short put and hanging on to the long put to generate more profits. And since spreads with puts widen fairly quickly (for a spread), you might just close the position early.

12.4 Chapter Glossary

Debit Spread A spread where the short side does not completely pay for the purchase of the long side of the spread. The difference in these two amounts is the net debit that you will pay to open the spread.

12.5 Up to the Minute Summary

- Bear spreads are best entered with put options. You sell a put with a lower strike, and buy a put with a higher strike.
- The maximum return possible is the difference between the strikes, less the initial investment.
- Spreads with puts widen faster than spreads with calls.
- The best balance of risk and reward with a bear put spread is to arrange the strikes so that the stock is roughly in the middle.
- Little followup is required for a bear put spread. If the stock drops below the short put, you should pay attention so you won't be assigned. Should you acquire a profitable spread, you may consider closing early.