TMX THE FUTURE IS YOURS TO SEE.

Equity Options
Strategy

MONTRÉAL EXCHANGE

Bear Put Spread

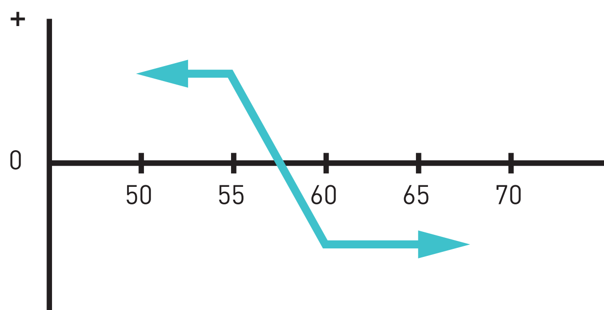
Description

A bear put spread is a type of vertical spread. It consists of buying one put in hopes of profiting from a decline in the underlying stock, and writing another put with the same expiration, but with a lower strike price, as a way to offset some of the cost. Because of the way the strike prices are selected, this strategy requires a net cash outlay (net debit) at the outset.

Assuming the stock moves down toward the lower strike price, the bear put spread works a lot like its long put component would as a standalone strategy. However, in contrast to a plain long put, the possibility of greater profits stops there. This is part of the tradeoff; the short put premium mitigates the cost of the strategy but also sets a ceiling on the profits.

A different pair of strike price choices might work, provided that the shorts put strike is below the long put strike. The choice is a matter of balancing tradeoffs and keeping to a realistic forecast.

The lower the short put strike, the higher the potential maximum profit; but that benefit has to be weighed against the disadvantage: a smaller amount of premium received.



Example

Long 1 XYZ 60 put
Short 1 XYZ 55 put

MAXIMUM GAIN
High strike - low strike - net premium paid

MAXIMUM LOSS
Net premium paid

BREAKEVEN
Long put strike - net debit paid

Outlook

Looking for a steady or declining stock price during the term of the options.

Profit from a near-term decline in the underlying stock.

Volatility

Slight, all other things being equal. Since the strategy involves being short one put and long another with the same expiration, the effects of volatility shifts on the two contracts may offset each other to a large degree.

Note, however, that the stock price can move in such a way that a volatility change would affect one price more than the other.

Time Decay

The passage of time hurts the position, though not quite as much as it does a plain long put position. Since the strategy involves being long one put and short another with the same expiration, the effects of time decay on the two contracts may offset each other to a large degree.

Regardless of the theoretical impact of time erosion on the two contracts, it makes sense to think the passage of time would be somewhat of a negative. If there are to be any returns on the investment, they must be realized by expiration. As expiration nears, so does the deadline for achieving any profits.

Assignment Risk

Yes. Early assignment, while possible at any time, generally occurs only when a put option goes deep into-the-money. Be warned, however, that using the long put to cover the short put assignment will require financing a long stock position for one business day.

And be aware, any situation where a stock is involved in a restructuring or capitalization event, such as for example a merger, takeover, spin-off or special dividend, could completely upset typical expectations regarding early exercise of options on the stock.

Expiration Risk

Yes. If held into expiration, this strategy entails added risk. The investor cannot know for sure until the following Monday whether or not the short put was assigned. The problem is most acute if the stock is trading just below, at or just above the short put strike. Guessing wrong either way could be costly.

Assume that on Friday afternoon the long put is deep-in-the-money, and that the short put is roughly at-the-money. Exercise (stock sale) is certain, but assignment (stock purchase) isn't. If the investor guesses wrong, the new position next week will be wrong, too. Say, assignment is anticipated but fails to occur; the investor won't discover the unintended net short stock position until the following Monday, and is subject to an adverse rise in the stock over the weekend. Now assume the investor bet against assignment and bought the stock in the market to liquidate the position. Come Monday, if assignment occurred after all, the investor has bought the same shares twice, for a net long stock position and exposure to a decline in the stock price.

Two ways to prepare: close the spread out early or be prepared for either outcome on Monday. Either way, it's important to monitor the stock, especially over the last day of trading.