

15. Bear Put Spread.

It's a second chapter on Bearish Strategies. The bear put spread option trading strategy is employed when the options trader thinks that the price of the underlying asset will go down moderately in the near term. It can be implemented by buying a higher striking in-the-money put option and selling a lower striking out-of-the-money put option of the same underlying security with the same expiration date.

Bear Put Spread Construction:

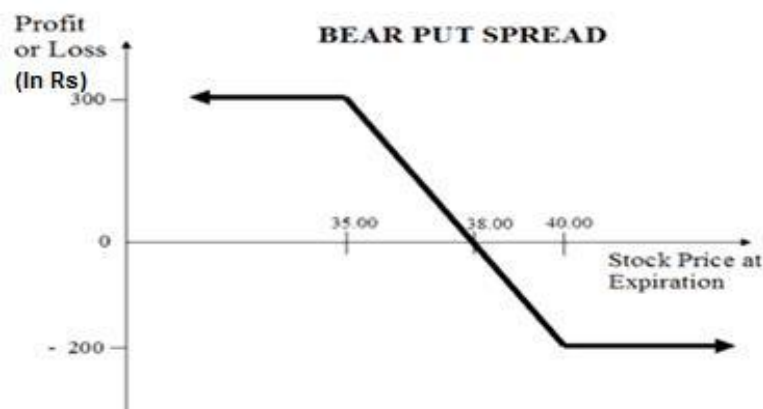
Buy 1 ITM Put; Sell 1 OTM Put

By shorting the out-of-the-money put, the options trader reduces the cost of establishing the bearish position but forgoes the chance of making a large profit in the event that the underlying asset price plummets. The bear put spread options strategy is also known as the bear put debit spread as a debit is taken upon entering the trade.

Example:

- Suppose XYZ stock is trading at Rs.38 in June. Option trader is bearish on XYZ and decides to enter a bear put spread position by buying a JUL 40 put for Rs.300 and sell a JUL 35 put for Rs.100 at the same time, resulting in a net debit of Rs.200 for entering this position.
- The price of XYZ stock subsequently drops to Rs.34 at expiration. Both puts expire in-the-money with the JUL 40 call bought having Rs.600 in intrinsic value and the JUL 35 call sold having Rs.100 in intrinsic value. The spread would then have a net value of Rs.5 (the difference in strike price). Deducting the debit taken when he placed the trade, his net profit is Rs.300. This is also his maximum possible profit.
- If the stock had rallied to Rs.42 instead, both options expire worthless, and the options trader loses the entire debit of Rs.200 taken to enter the trade. This is also the maximum possible loss.

Bear Put Spread Payoff Diagram:



Limited Downside Profit

To reach maximum profit, the stock price need to close below the strike price of the out-of-the-money puts on the expiration date. Both options expire in the money but the higher strike put that was purchased will have higher intrinsic value than the lower strike put that was sold. Thus, maximum profit for the bear put spread option strategy is equal to the difference in strike price minus the debit taken when the position was entered.

The formula for calculating maximum profit is given below:

- $\text{Max Profit} = \text{Strike Price of Long Put} - \text{Strike Price of Short Put} - \text{Net Premium Paid} - \text{Commissions Paid}$
- Max Profit Achieved When Price of Underlying \leq Strike Price of Short Put

Limited Upside Risk

If the stock price rise above the in-the-money put option strike price at the expiration date, then the bear put spread strategy suffers a maximum loss equal to the debit taken when putting on the trade.

The formula for calculating maximum loss is given below:

- $\text{Max Loss} = \text{Net Premium Paid} + \text{Commissions Paid}$
- Max Loss Occurs When Price of Underlying \geq Strike Price of Long Put

Breakeven Point(s)

The underlier price at which break-even is achieved for the bear put spread position can be calculated using the following formula.

Breakeven Point = Strike Price of Long Put - Net Premium Paid

For more details or any queries related to option strategies kindly contact us on knowledge@grovalue.in