19. Diagonal Bear Put Spread.

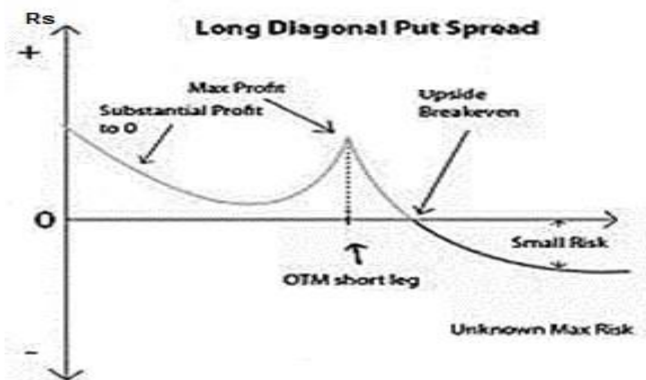
Diagonal bear put spread is employed when the trader is bearish on the underlying stock over the longer term but is neutral to mildly bearish in the near term. This strategy involves buying long-term puts and simultaneously writing an equal number of near-month puts of the same underlying stock with a lower strike. Construction of diagonal bear put spread is given as follows.

Buy 1 Long-Term ITM Put; Sell 1 Near Term OTM Put

Example:

In the month of APR, XYZ stock trading at Rs.40 and an options trader believes that is going to drop gradually for the next four months. He enters a diagonal bear put spread by buying a AUG 40 put for Rs.300 and writing a MAY 35 put for Rs.100. The net investment required to put on the spread is a debit of Rs.200. The stock price of XYZ goes down by Rs.1 a month and closes at Rs.36 on expiration date of the long term put. As each near-month put expires, the options trader writes another put of the same strike for Rs.100. In total, another Rs.300 was collected for writing 3 more near month puts. Additionally, with the stock price at Rs.36, the AUG 40 put expires in the money with Rs.400 in intrinsic value. Thus, in total, his profit is Rs.400 (intrinsic value of the AUG 40 put) + Rs.300 (additional premiums collected) - Rs.200 (initial debit) = Rs.500. If the price of XYZ had risen to Rs.42 and stayed at Rs.42 until August instead, both options expire worthless. The trader will also be unable to write additional puts since they are too far out-of-the-money to bring in significant premiums. Hence, he will lose his entire investment of Rs.200, which is also his maximum possible loss. Suppose the price of XYZ did not move and remains at Rs.40 until expiration of the long term put, the trader will still profit as the total amount of premium collected is Rs.400 while the AUG 40 put cost Rs.300, resulting in a Rs.100 profit.

Profit and loss over a period of time:



In above diagram, we can see the areas where trader makes profit and loss.

Limited Upside Profit:

The ideal situation for the diagonal bear put spread buyer is when the underlying stock price remains unchanged and only goes down and below the strike price of the put sold when the long term put expires. In this scenario, as soon as the near month put expires worthless, the options trader can write another put and repeat this process every month until expiration of the longer term put to reduce the cost of the trade. It may even be possible at some point in time to own the long term put "for free". Under this ideal situation, maximum profit for the diagonal bear put spread is obtained and is equal to all the premiums collected for writing the near-month puts plus the difference in strike price of the two put options minus the initial debit taken to put on the trade.

Limited Downside Risk:

The maximum possible loss for the diagonal bear put spread is limited to the initial debit taken to put on the spread. This happens when the stock price goes up and stays up until expiration of the longer term put.

In next session we will revise all the Bearish strategies which we have discussed till now. For more details or any queries kindly contact us on knowledge@grovalue.in