By Jay Pestrichelli

An out-of the-money (OTM) credit has its maximum payoff when both legs of the spread expire worthless and all the credit is kept. The trick is coming up with *strike prices* that eventually will expire worthless, resulting in a regular generation of positive income on free cash.

One of the more popular methods to determine strikes is using probabilities in addition to whatever market thesis you have. Most brokers these days will provide an easy way to tell the probability of *expiration* of an option, but if yours doesn't, there are free tools out there to use. See Figure 1 for an example.

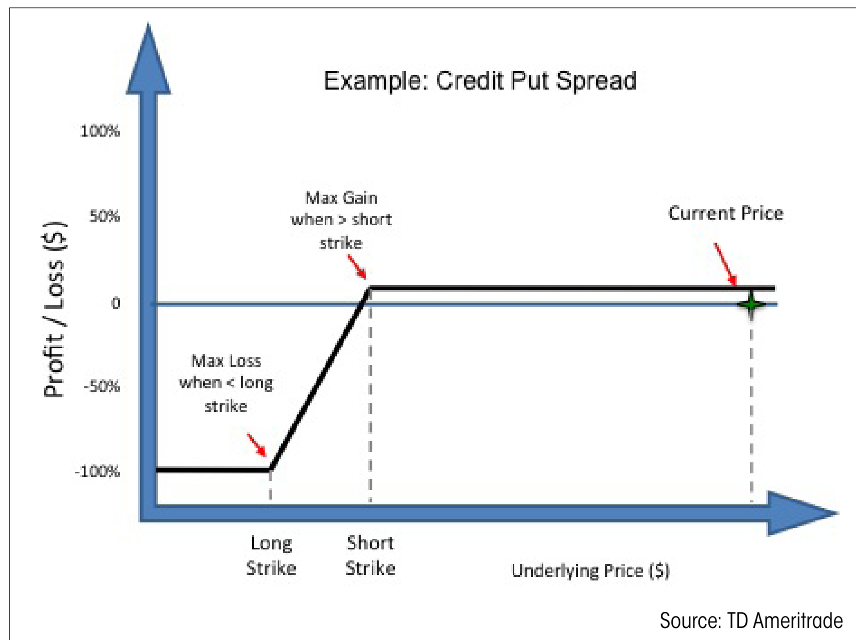

FIGURE 1: Probability Analysis of SPX

IT'S NOT ABOUT BEING RIGHT

The beauty about this strategy is that you don't have to be right about the direction of the underlying stock price, just not really wrong. That means moderate moves either way can yield success. Figure 2, a risk graph, il-

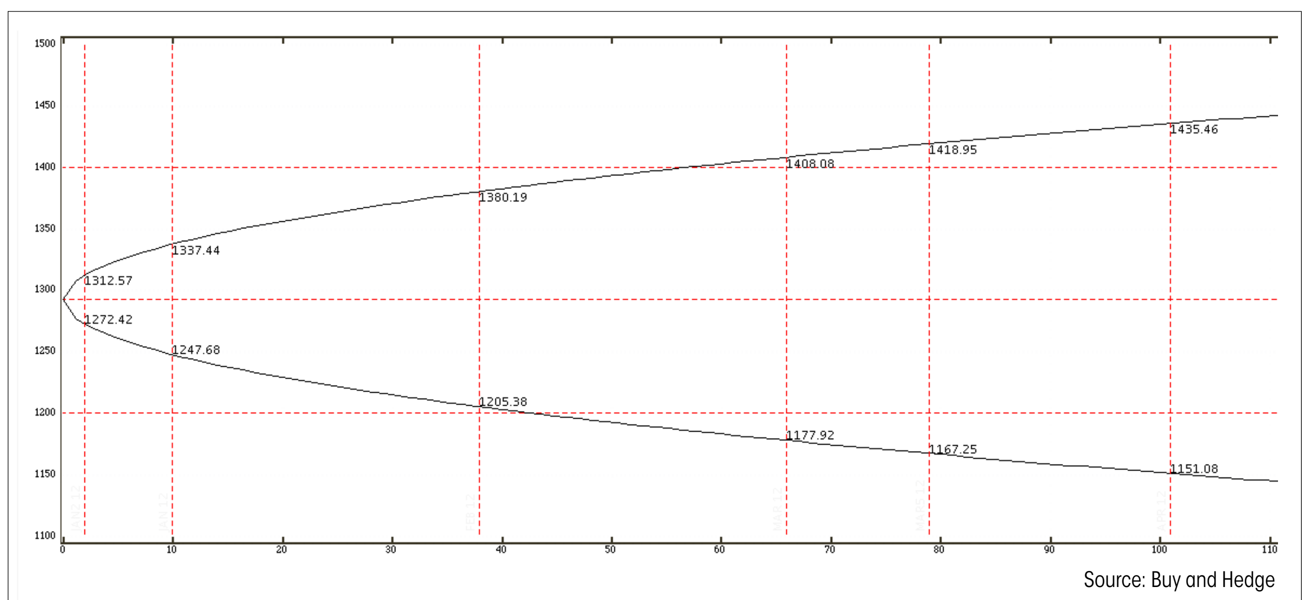

FIGURE 2: Risk Graph for Credit Put Spread

lustrates the cushion this tactic creates.

The risk, if you're really wrong, is that most of your investment can be lost. We call this a catastrophic loss, and it's why we pay extra attention to the risks.

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TAKING PROFITS

Typically, if things go well (and they probably will), the spreads will just expire worthless and bingo! The trade was successful. However, there are times when, despite your best efforts, the probabilities work in the favor of the unlikely. In these cases, it is important to know what to watch. Be prepared to protect your cash via an exit.

5 STEPS TO CREATING AN OTM CREDIT SPREAD

DETERMINE UNDERLYING

Check into options on index futures like the Nasdaq 100 (NDX), S&P 500 (SPX) or S&P 100 (OEX). They will allow you to cut the number of contracts and give the tax benefits of futures under rule 1256.

PICK SHORT OPTION STRIKE

The short strike (closest to the market) defines the point where you don't want the market to go past. Typically, this is a level that has shown support or resistance in the past.

PICK LONG OPTION STRIKE

The long option strike (farther away from the market) determines the size of the spread, which defines the initial margin requirement minus the spread premium and eventually is used in the reward calculation.

CHECK PROBABILITY

This is the probability that the short leg will expire in the money (ITM). Calculate the return of the trade by dividing the premium of the spread over the initial maintenance to get the percentage the trade will yield if successful.

CALCULATE RISK/REWARD

If the rate of return is more than the probability of risk, you have a risk/return ratio of less than 1.0. Your percent return is more than the percent risk you are taking, which is good. If this is not the case, go back to steps two and three to adjust your strikes until you get what you can live with below the 1.0 ratio.

There are many factors to watch like volatility, time until expiration and distance from strikes. The main metric to watch is when the premium of the spread doubles. That is when you should exit.

This means that the amount you planned on making is what the position has just lost. So if you wrote the spread for $3, which is the amount you planned to keep on expiration, and the premium is now $6, you've just lost $3. Take your lumps and exit before it gets worse.

This is exit criteria that may be on the conservative side, having you exit positions that eventually would have worked out; but more important, it allows you to avoid the large and potentially catastrophic loss of the entire investment.

The *beauty* about this strategy is that you don't have to be RIGHT about the direction of the underlying stock price, just not really WRONG.

CAVEAT EMPTOR

There is one caveat to this rule. In the first three days of a trade, ignore the double rule. Typically, time hasn't had enough time to erode, and spread values can double early on in the trade due to a number of factors. In other words, once you're in, you're in for at least three trading days. If the spread is still double on day four, it's time to get out.

When this tactic is used repeatedly, it can provide a steady stream of income. Like all tactics, there are risks in this one.

You have to exit before it goes very wrong. Don't ride it out. Remember to exit, so you can live and trade another day.

Jay Pestrichelli is a co-founder of *Zega Financial* and author of *Buy and Hedge — The 5 Iron Rules for Investing Over the Long Term.*

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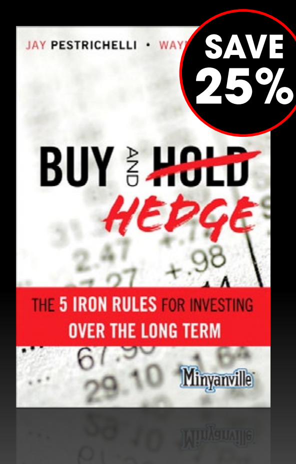

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