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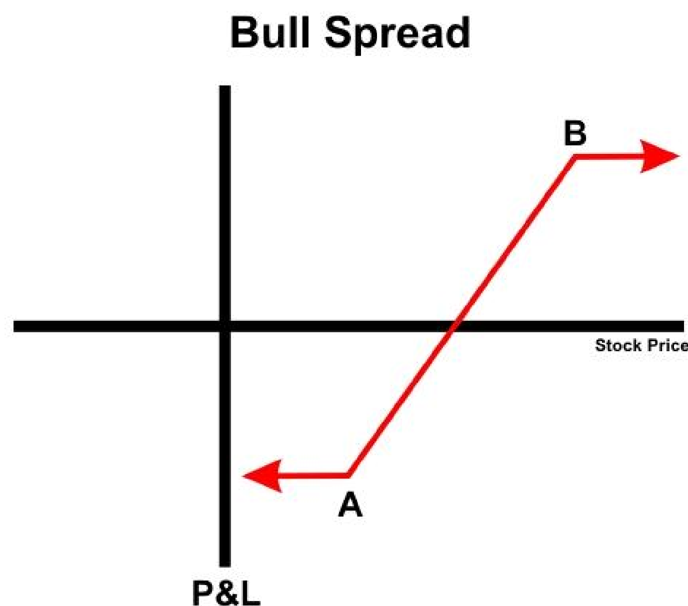
VETICAL SPREADS

There are two main types of vertical spreads. There is the vertical call spread and the vertical put spread. Each spread allows you to do two things. First, you can buy it, making you long the vertical spread. Second, you can sell it making you short the vertical spread. Both can be employed to take advantage of directional stock plays. When we use the term "directional stock play," we refer to using vertical spreads to capitalize on anticipated stock movements either up or down.

A bull spread is used when the investor feels that a stock is most likely to go up. As we recall, "bullish" means to have a positive outlook on a stock's future movement. There are two ways to set up a bull spread. The first is with the use of calls. In this case, a bullish investor would buy a vertical call spread (bull call spread). This is accomplished by buying a call with a lower strike price and selling a call with a higher strike price.

The second way to construct a bull spread is with the use of puts. A bullish investor could sell a vertical put spread (bull put spread) hoping to profit from an increase in the stock's value. The investor would sell a put with a higher strike price and buy a put with a lower strike price. Let's take a look at how the P&L chart of a Bull Spread looks below.



To recap, if you feel a stock will be increasing in value, you may put on a bull spread by either buying a vertical call spread (bull call spread) or selling a vertical put spread (bull put spread)

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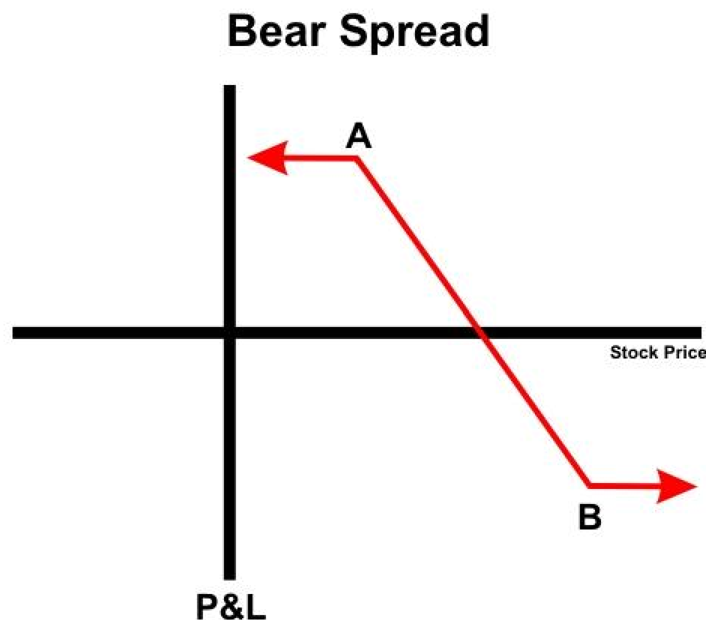
A bear spread, however, is used when, you the investor, feels a stock is likely to trade down. Remember, "bearish" means that one's outlook on the future movement of the stock is negative. To take advantage of this expected downward movement, the investor would put on a bear spread. This can be done in either of two ways.

First, the investor can do it using puts. The purchase of a vertical put spread (bear put spread) can be accomplished by purchasing a put with a higher priced strike and selling a put with a lower priced strike.

The second way an investor can construct a bear spread is by using calls, specifically, by selling a vertical call spread (bear call spread). You do this by selling a call with a lower strike price and purchasing a call with a higher strike price.

So if you think that a stock is likely to decrease in value, you sell a vertical call spread (bear call spread) or purchase a vertical put spread (bear put spread). Let's take a look at the P&L diagram for a Bear Spread below.



Finally, there are two fundamentals that are universal to all vertical spreads. These fundamentals are critical to understanding the foundation of the vertical spread strategy: (1) you can determine a vertical spread's maximum value by taking note of the difference between the two strikes and (2) vertical spreads have intrinsic value.

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