

VERTICAL SPREADS

Cost Relationship between Corresponding Put Spreads and Call Spreads

We have demonstrated that vertical spreads have intrinsic value, and that we can roughly determine their value by comparing stock price to strike prices. There is another relationship that can help investors determine value. That is the relationship that exists between corresponding vertical spreads.

When we use the term corresponding we mean the same month, the same strikes in the same stock. The only difference is between calls and puts. For example, the XYZ Sept. 30 – 35 vertical call spreads' corresponding spread would be the XYZ Sept. 30 – 35 vertical put spread. Similarly, the ABC June 70 – 80 put spreads' corresponding spread would be the ABC June 70 – 80 call spread.

The importance of understanding the relationship of corresponding vertical spreads is that the sum of a vertical call spread and its corresponding vertical put spread is going to be equal to the difference between the two strikes.

If the April 30 – 35 call spread trades at \$2.00, then the April 30 – 35 put spread will be worth \$3.00. Let's review this. The difference of the two strikes is \$5.00 and the cost of the call spread is \$2.00. That means the cost of the put spread will be \$3.00. The chart below is a floor trader's pricing sheet that shows where individual options are trading and what they are worth based on each trader's individual inputs.

From this we can calculate the price of any spread. Pick any vertical spread. Now, calculate the value of a vertical call spread or a vertical put spread. Once you've done that, calculate the value of its corresponding vertical spread. Add the two spreads together and see if that sum is equal to the difference between the two strikes. Perform the calculations several times on different vertical spreads. Try it on \$5, \$10 and even \$15 spreads.



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|------------------------------|---------|---------|------------|------------------------|
| QCOM Trading Sheets | | | | Tuesday 6/1/04 |
| Stock Price = \$65.50 | | | | Volatility = 30 |
| CALLS | | | | |
| Strike | June 04 | July 04 | October 04 | January 05 |
| 55 | 10.50 | 10.70 | 11.70 | 12.80 |
| 60 | 5.74 | 6.38 | 8.09 | 9.48 |
| 65 | 2.04 | 3.13 | 5.22 | 6.79 |
| 70 | .39 | 1.21 | 3.17 | 4.73 |
| 75 | .03 | .38 | 1.82 | 3.20 |

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|------------------------------|---------|---------|------------|------------------------|
| QCOM Trading Sheets | | | | Tuesday 6/1/04 |
| Stock Price = \$65.50 | | | | Volatility = 30 |
| PUTS | | | | |
| Strike | June 04 | July 04 | October 04 | January 05 |
| 55 | \$0 | .12 | .95 | 1.84 |
| 60 | \$.18 | .74 | 2.25 | 3.44 |
| 65 | \$1.48 | 2.47 | 4.37 | 5.71 |
| 70 | \$4.84 | 5.56 | 7.31 | 8.63 |
| 75 | \$9.51 | 9.75 | 10.90 | 12.00 |

It is not necessary to understand the rationale for why this works at this time. It will be covered in a future Options University release. For now, it is important to understand that these spreads are related and the price of one can help you calculate the price of the other.

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