

## VERTICAL SPREADS

### **Spread Prices**

During the life of a vertical call spread, the spread will trade between its minimum and maximum values (between 0 and the difference between the two strikes). In the case of a vertical call spread, the spread will trade closer to zero when the stock trades closer to or lower than the lower strike price. The spread will trade closer to maximum value when the stock trades closer to or higher than the higher strike price.

For example, let's refer back to the August 35 – 40 call spread chart on a previous page. In the column marked "August 35 – 40 call spread closing price", you can see that with the stock at \$35.00, the spread is worthless. As the stock price climbs toward 40, the call closing price increases until finally it reaches its maximum. Remember, this maximum gain occurs at expiration. Before that time, the spread will trade with a premium.

Starting from a stock price of  $37\frac{1}{2}$ , a price located directly between the two strikes, (using our example of the August 35 – 40 call spread) we can see the approximate value of the spread is roughly  $\$2\frac{1}{2}$  dollars. This is because the August 35 calls and the August 40 calls are equidistant from the current stock price of \$37.50. Being equidistant from the stock, both the August 35 and 40 calls will have almost the same amount of extrinsic value in them. Thus, in the spread, the extrinsic values of the two options cancel themselves out since you are long one call and short the other. This would leave each option value consisting of only intrinsic value. With the stock at \$37.50 the value of the August 35 – 40 call spread will be \$2.50. The August 35 calls will have \$2.50 in intrinsic value while the August 40 calls will have \$0 in intrinsic value. The difference gives you a spread with a value of \$2.50.

A general rule of thumb is: if the stock price is located evenly between the two strike prices, the vertical spread should be worth roughly half of the value of the distance between the two strikes. This will be true for vertical put spreads as well as call spreads. From this rule, we can roughly estimate the vertical spread's price per different stock prices.

For vertical call spreads, if the spread is worth roughly half of the difference between the two strikes with the stock price directly between the two strikes, then as the stock falls to lower strike and beyond, the spread's value will decrease and move closer to \$0. Time left until expiration and volatility will dictate how close and how quickly it will approach \$0. On the other side, as the stock climbs



toward and above the upper strike, the spread's value will increase toward its maximum value described by the difference between the two strikes.

For vertical put spreads, as the stock price decreases toward the lower strike price, the spread will increase in value and approach its maximum value as defined by the difference between the two strikes. As the stock price increases toward the higher strike, the spread will decrease in value and will approach \$0. Again, time until expiration and volatility will determine how quickly and how close the spread will approach \$0.

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