VETICAL SPREADS

Time Decay and Volatility Trading Opportunities

When vertical spreads are mentioned, they quite often come with monickers such as “bull” and “bear”. This lends most to think of vertical spreads as directional plays which is true. However, vertical spreads can be used to take advantage of two other potential trading opportunities – time decay and volatility movement.

If you are looking for a fully hedged way to take advantage of time decay, a vertical spread can be an excellent tool. Knowing a little about them now, you will recall that a vertical spread has a limited profit potential but also a limited loss scenario for both the buyer and the seller. So, how do we use this covered trade to take advantage of time decay.

At-the-money options have more extrinsic value than their similar month in-the-money or out-of-the-money options. Since it is an option’s extrinsic value that decays away over time, you could set up a vertical spread by selling an at-the-money option and buying either the out-of-the-money option (creating a credit spread) or buying an in-the-money option (creating a debit spread). If the stock holds tight to the out-of-the-money option, the option’s extrinsic value will decay away at a faster rate than either the in-the-money option or the out-of-the-money option due to the fact that the at-the-money option has more total extrinsic value to decay in the same amount of time as the others.

Creating the vertical spread by selling an at-the-money option and buying an out-of-the-money or in-the-money option as a hedge looks like a good idea, but now there are a couple choices. Should you do the put spread or the call spread? Should you buy it or sell it? The decision of what to do from here should first be based on which way you think the stock will move. Although you are playing for time decay and you are assuming an overall lack of movement, you can’t expect the stock not to move at all. So even though you are playing time decay, you still want to form an opinion about in which direction the stock is most likely to move. By doing this, you’ve now give yourself another way of making the trade profitable. You are playing for a lack of movement but now you can still win if you pick the right direction. This scenario presents you with two ways to win and only one to lose.

Now that you have picked which at-the-money strike you are going to sell and you’ve picked your anticipated stock position you still have a decision to make. Do you do the call vertical spread or the put vertical spread? Remember both the vertical call spread and a vertical put spread allow you to participate in either stock direction. For the bulls, you can buy a vertical call spread or sell a vertical if you think that the stock will go up. For the bears, you can buy a vertical put spread or sell a vertical call spread.

For each direction there are two choices to decide from. One is a purchase, one is a sale. The best way to decide which to do, other than your own style or comfort ability is a simple risk/reward analysis.

By selecting an at-the-money option to sell as part of a vertical spread, an investor can execute a time decay play with a hedged position.

Much in the same way that a vertical spread can be used as a time decay play, it can be used as a volatility play. We stated earlier that an at-the-money option has more extrinsic value than any other option in its expiration month. This is due to a number of contributing factors including time but it is in no small way due to volatility. Volatility is a huge component of an option's extrinsic value. An option's dollar sensitivity to movements in implied volatility is known as vega. Obviously, an at-the-money option will have a higher vega (volatility sensitivity) then will an in-the-money or out-of-the-money option in the same month.

As volatility increases, the at-the-money option will increase in price to a greater degree than will an in-the-money or out-of-the-money option in the same month. As volatility increases, the at-the-money option will increase in price to a greater degree then will an in-the-money or out-of-the-money option whose vega's will be less. Conversely, the at-the-money option will lose value at a greater rate than an in-the-money or out-of-the-money option should implied volatility decrease. The question now is how to use the vertical spread to take advantage of anticipated movements in implied volatility. Remember, the vertical spread affords you the luxury of being hedged on either side of the trade – both as a buyer and a seller of the spread.

So, if you think that implied volatility is likely to increase, you can set up a vertical spread by buying an at-the-money option and selling either the in-the-money or out-of-the-money option against it. Conversely, if you feel implied volatility will decrease; you can set up a vertical spread by selling an at-the-money option and buy either an out-of-the-money or an in-the-money option against it.

As to how to set it up, you would follow the same guidelines as you would for setting up a vertical spread to take advantage of time decay. Decide which direction you feel the stock would most likely move. If you feel the stock would most likely rise, you will have to decide between buying a vertical call spread and selling a vertical put spread.

Either way, the spread will have to be constructed with the at-the-money option being long if you feel volatility will increase or short if you feel volatility will decrease. If you feel the stock would most likely fall, you will have to decide between buying a vertical put spread and selling a vertical call spread. Again, either way, the spread will have to be constructed with the short option being the at-the-money.

As you can see, the vertical spread does not have to be used only in directional scenarios. It is very versatile allowing the investor several choices among a diverse group of potential uses. It also affords limited risk, albeit limited profit potential, to both the buyer and the seller.

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