Protecting Downside Risk with the Bear Put Option Strategy

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I’m John Rowland, CMT

- Barchart’s Senior Market Strategist
- Head of Trading Education
- Chartered Market Technician
- 35+ years of Trading Experience

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What is a Bear Put Spread?

- The Bear Put strategy is used when there is an expectation of downward price movement in an underlying asset, such as a stock. This vertical debit spread occurs when a trader simultaneously purchases a higher strike put and sells a lower strike put with the same expiration date. Since the higher strike put costs more than the lower strike put, the trade requires a capital outlay which is why it's referred to as a debit spread.
- The potential profits and losses of the Bear Put Spread strategy depend on the difference between the stock price and the strike prices.
- Selling the lower strike put limits the profit potential. But the premium received works to partially offset the cost of the higher strike put which mitigates the potential loss.

Advantages of Bear Put Spreads

- The capital outlay is less than buying a single put outright.
- The strategy's risk is limited and significantly less than the upside risk of a "SHORT" position.
- The strategy's potential profit could offset most of the loss incurred from owning the underlying asset during a price decline.

How to Calculate Potential Profits and Losses

- Maximum loss is limited to the price paid for the higher strike minus the credit received for the lower strike; in the worst-case scenario, if the underlying asset's price rises above the higher strike price, both puts expire worthless, and only the initial outlay is lost.
- Breakeven is achieved if, at expiration, the underlying price falls below the higher strike by the amount of the initial debit outlay.
- The maximum profit would be the difference between the two strike prices minus the initial debit outlay.

Strike Selection

- Choosing both in-the-money strikes (ITM) will create a strategy with a higher probability, smaller max profit, and greater max loss.
- Choosing both out-of-the-money strikes (OTM) will create a strategy with a lower probability, larger max profit, and smaller max loss.
- Choosing the higher first leg strike ITM and the lower second leg strike OTM equal distance from the current price will create a strategy of relatively equal probability and slightly larger max loss to max profit.
- Each strategy has its pros and cons based on risk versus reward. If the goal is to maximize reward to offset price decline from ownership, choose a lower strike price that the trader believes the underlying will not go below by expiration.

Additional Risks of the Bear Put Spread

- Expiration risk would occur if the position is held through expiration where the underlying asset is below the higher strike but is not at or below the lower strike. Such a situation would create a short position which could be restrictive based on the trader’s account or the availability to borrow shares to be shorted.
- If the trader owns the asset, the Put will act as a “cover,” and there could be a tax liability.
- Best practice would be to close both legs before expiration.

Takeaways

This limited protective directional options strategy rewards the trader who correctly identifies a downward directional price movement. Strike price selection will determine the risk-to-reward profile.

Investors looking to employ this strategy to help offset the loss from a price decline of the underlying asset will optimize reward to risk by choosing a higher strike ITM with a lower strike OTM below where the trader believes the stock price will finish at expiration.

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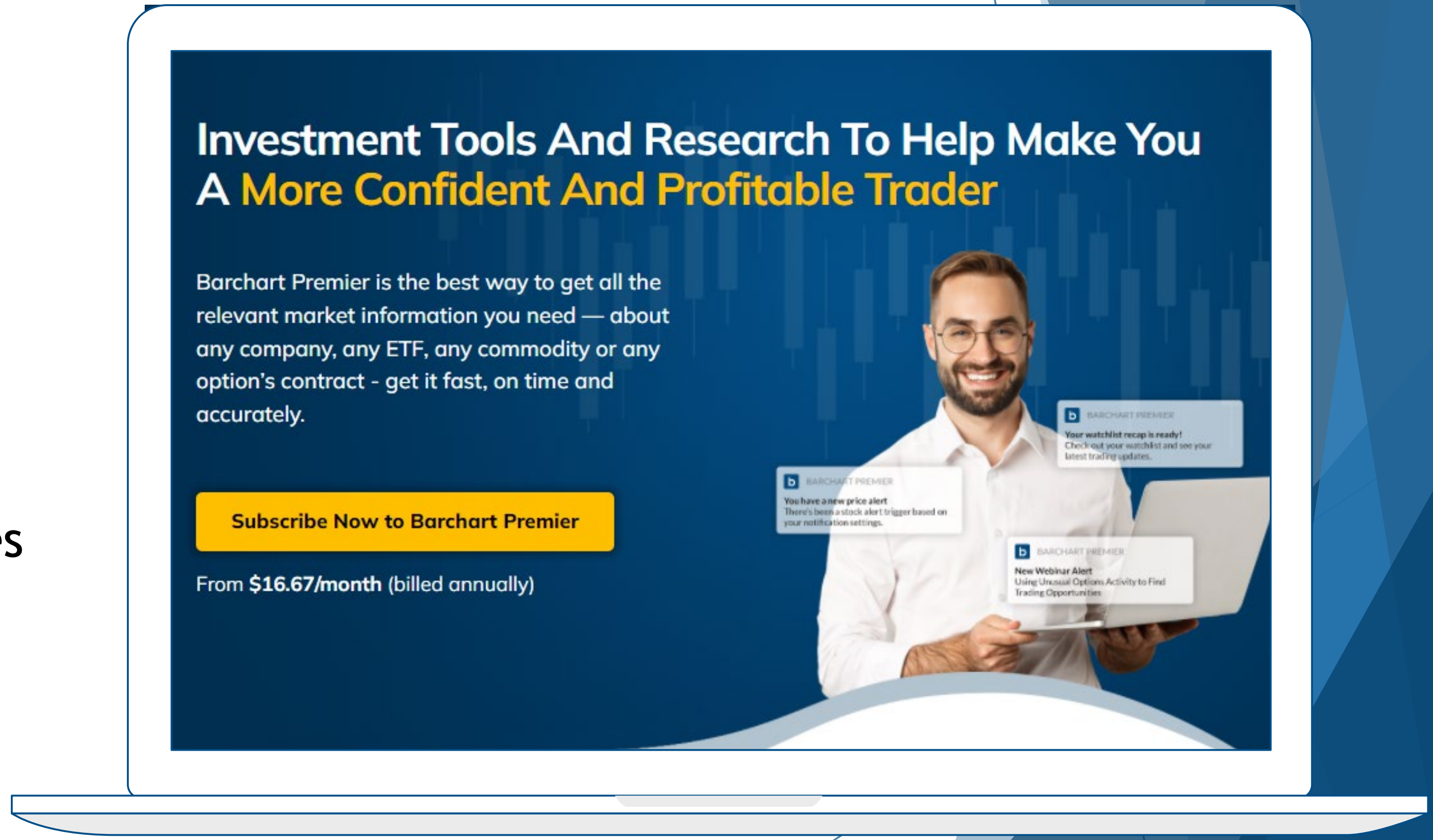

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