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Straddles and Strangles

Straddles & Strangles
Common Characteristics

- Simultaneous purchase of a call and a put.
- Anticipating a substantial move in either direction.
- Benefit from an increase in volatility.
- Higher break even because of the two premiums being purchased.

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When To Apply

- Earnings reports.
- Product launches.
- Law suits or legal rulings.
- Patent and product approvals
- Macroeconomic announcements.

Straddles

- Buy a call and buy a put.
- Same underlying security.
- Same expiration.
- Same strike.

Straddle Example

- Investor expects that the stock will be volatile.
- XYZ is trading at $40.00 a share.
- 6-month $40.00 call is asking $3.10.
- 6-month $40.00 put is asking $2.90.

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Straddle Cost

- Buy $40.00 call at $3.10.
- Buy $40.00 put at $2.90.
- Net cost is $6.00.
- $6.00 = maximum risk.

Straddle Break Even

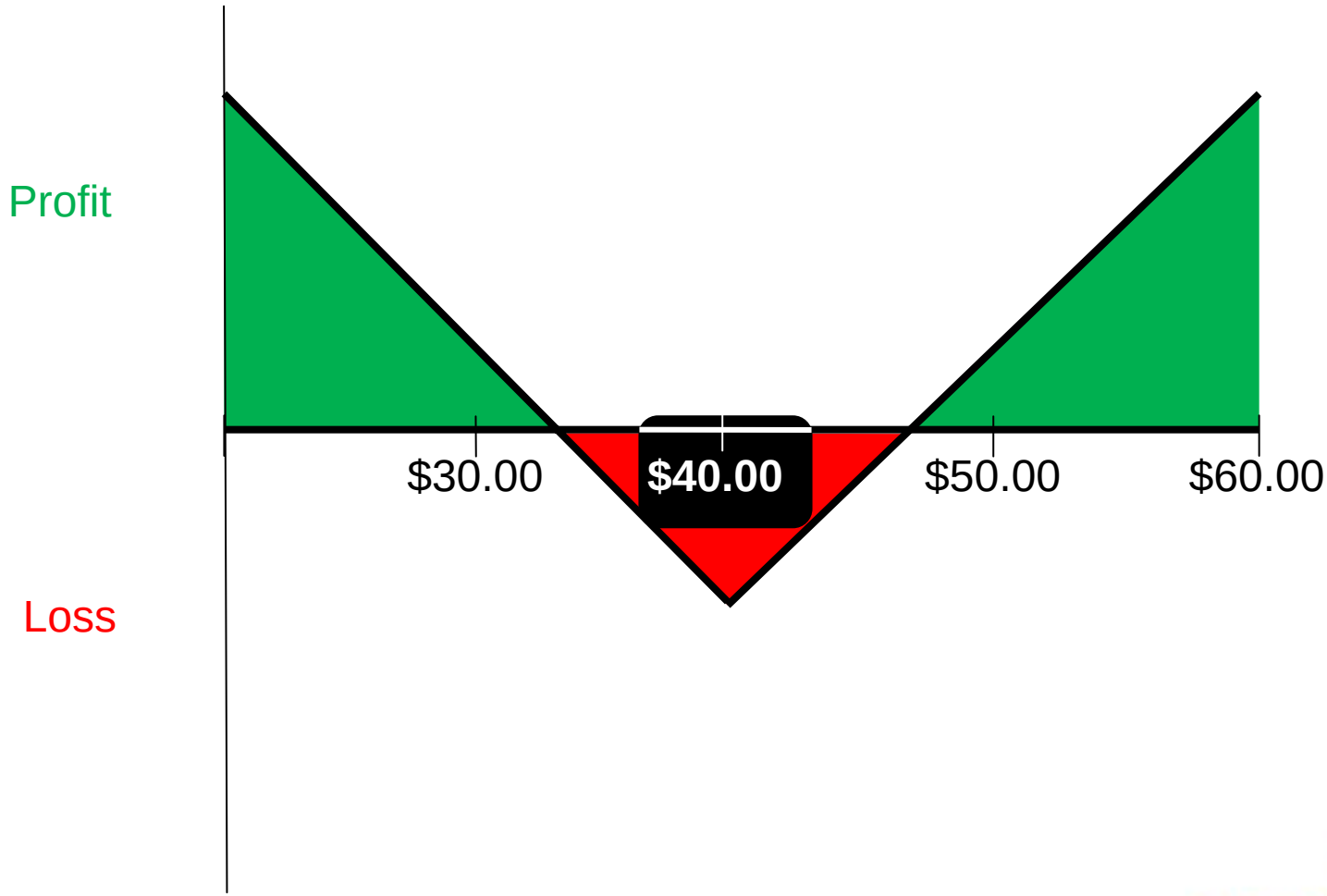
Upside break even on expiration

- 40 strike + $6.00 = $46.00

Downside break even on expiration

- 40 strike – $6.00 = $34.00

Straddle Risk Graph



Straddle Profit and Loss

Stock Price	$40.00 Call P/L	$40.00 Put P/L	Net Profit P/L
$60.00	$16.90	-$2.90	$14.00
$50.00	$6.90	-$2.90	$4.00
$45.00	$1.90	-$2.90	-$1.00
$40.00	-$3.10	-$2.90	-$6.00
$35.00	-$3.10	$2.10	-$1.00
$30.00	-$3.10	$7.10	$4.00
$20.00	-$3.10	$17.10	$14.00

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Strangles

- Buy a call and buy a put.
- Same underlying security.
- Same expiration.
- Different strike prices.

Strangle Example

- Investor expects that the stock will be volatile.
- Stock XYZ is trading at $40.00 a share.
- 6-month $42.50 call is asking $1.55.
- 6-month $37.50 put is asking $1.45.

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Strangle Cost

- Buy $42.50 call at $1.55.
- Buy $37.50 put at $1.45.
- Net cost is $3.00.
- $3.00 = maximum risk

Strangle Break Even

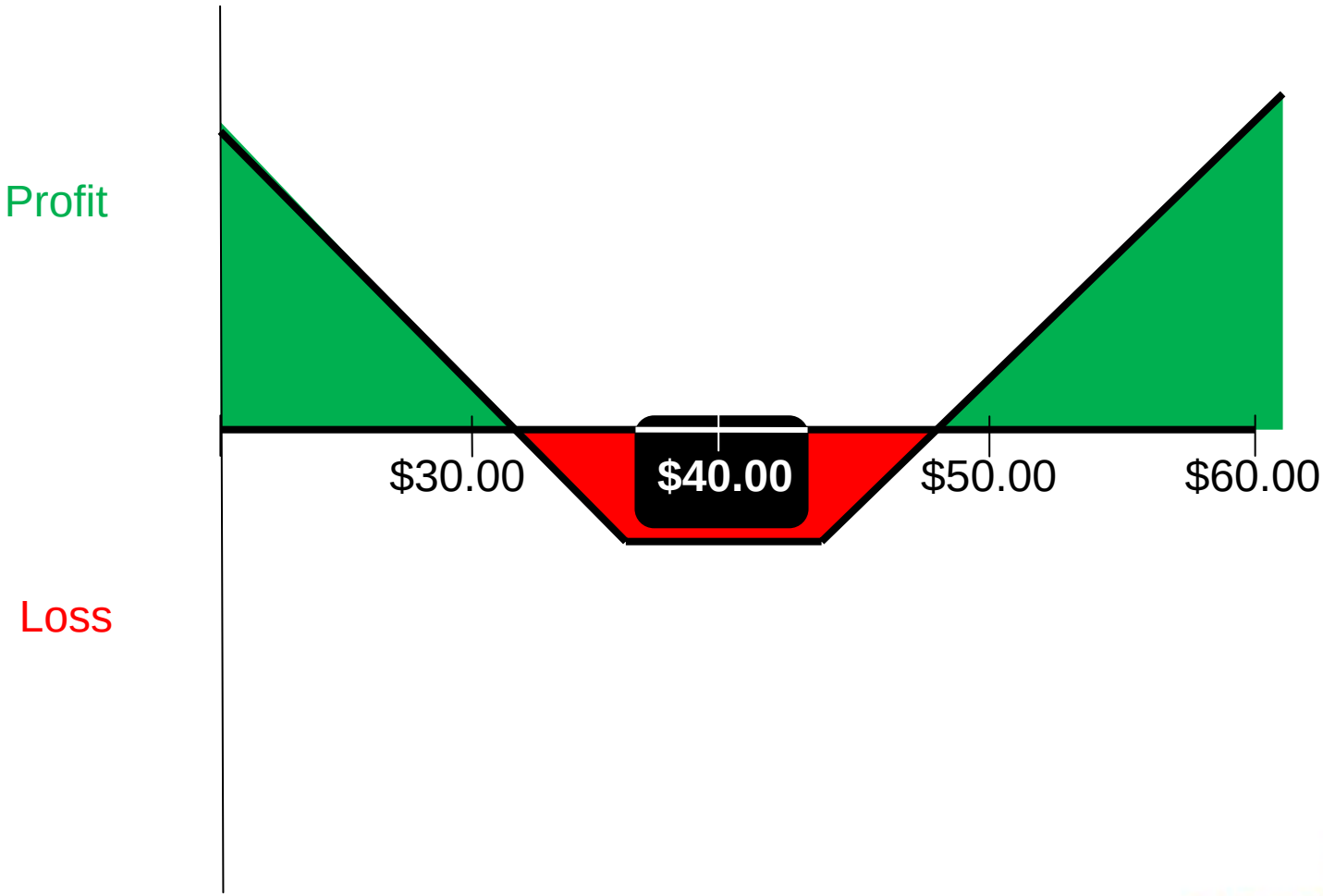
Upside break even on expiration

- 42.50 strike + $3.00 = $45.50

Downside break even on expiration

- 37.50 strike – $3.00 = $34.50

Strangle Risk Graph



Strangle Profit and Loss

Stock Price	$42.50 Call P/L	$37.50 Put P/L	Net Profit P/L
$50.00	$5.95	-$1.45	$4.50
$45.00	$0.95	-$1.45	-$0.50
$42.50	-$1.55	-$1.45	-$3.00
$40.00	-$1.55	-$1.45	-$3.00
$37.50	-$1.55	-$1.45	-$3.00
$35.00	-$1.55	$1.05	-$0.50
$30.00	-$1.55	$6.05	$4.50

Considerations

- A straddle at or close to the money will require less of a move to profit.
- Strangles are less expensive.
- Strangles allow for an adjustment in directional bias.
- The underlying must have the potential move in price sufficient to compensate for the cost of the position.

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Short Straddles and Strangles

- Involves the simultaneous sale of a call and a put on the same underlying.
- With the same expiration month.
- Anticipate little to no move in the underlying security.
- Profit from a decrease in implied volatility and time depreciation.

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When To Apply

- Objective is to generate income through the depreciation of the options premium.
- Underlying security is expected to remain with in a close price range.
- Implied volatility is high and is expected to drop.

Short Straddles

- Sell a call and sell a put.
- Same underlying security.
- Same expiration.
- Same strike.

Short Straddle Example

- Investor expects that the stock will stay with in a close price range.
- Stock XYZ is trading at $30.00 a share.
- 1-month $30.00-strike call is bidding $1.00.
- 1-month $30.00-strike put is bidding $0.90.

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Short Straddle Credit

- Sell $30.00 call at $1.00.
- Sell $30.00 put at $0.90.
- Net credit is $1.90.
- Maximum risk is unidentified.

Short Straddle Break Even

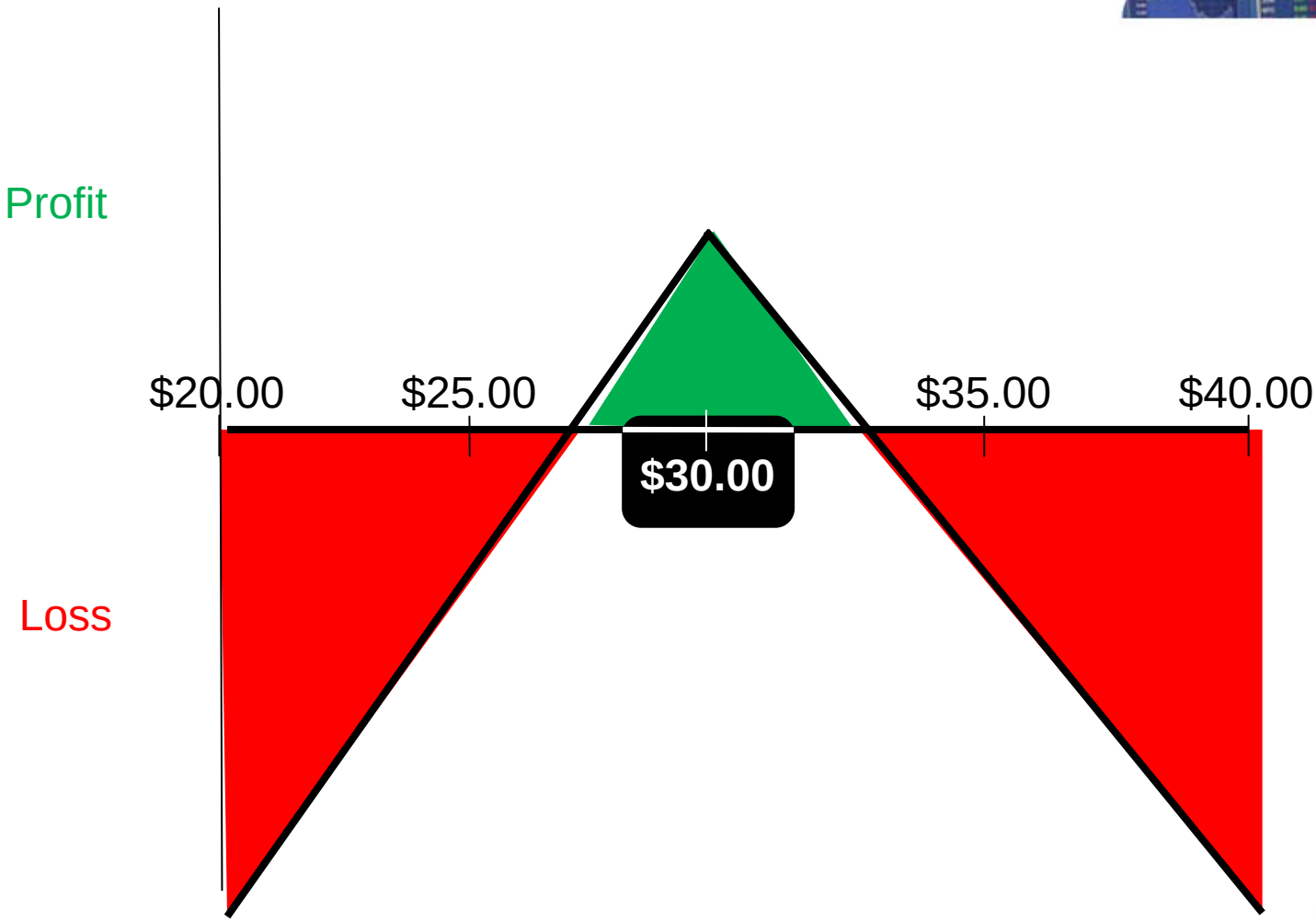
Upside break even on expiration

- 30 strike + $1.90 = $31.90

Downside break even on expiration

- 30 strike - $1.90 = $28.10

Short Straddle Risk Graph



Short Straddle Profit and Loss

Stock Price	$30.00 Call P/L	$30.00 Put P/L	Net Profit P/L
$35.00	-$4.00	$0.90	-$3.10
$31.90	-$0.90	$0.90	$0.00
$31.00	$0.00	$0.90	$0.90
$30.00	$1.00	$0.90	$1.90
$29.00	$1.00	-$0.10	$0.90
$28.10	$1.00	-$1.00	$0.00
$25.00	$1.00	-$4.10	-$3.10

Short Strangles

- Sell a call and sell a put.
- Same underlying security.
- Same expiration.
- Different strike.

Short Strangle Example

- Investor expects that the stock will stay within a close price range.
- Stock XYZ is trading at $30.00 a share.
- 1-month $32.00 call is bidding $0.60.
- 1-month $28.00 put is bidding $0.50.

Short Strangle Credit

- Sell $32.00 call at $0.60.
- Sell $28.00 put at $0.50.
- Net credit is $1.10.
- Maximum risk is unidentified.

Short Strangle Break Even

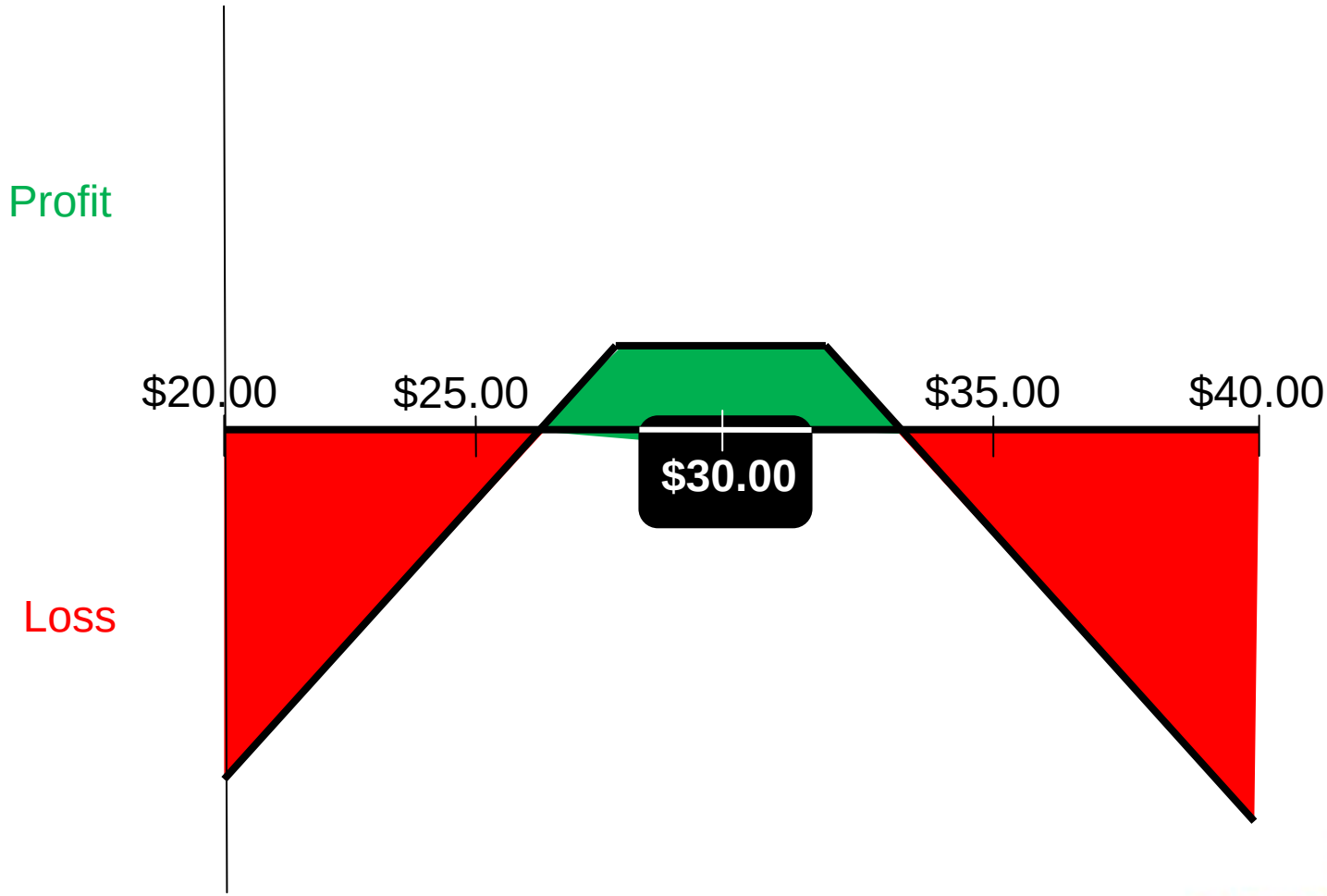
Upside break even on expiration

- 32 strike + $1.10 = $33.10

Downside break even on expiration

- 28 strike – $1.10 = $26.90

Short Strangle Risk Graph



Short Strangle Profit and Loss

Stock Price	$32.00 Call P/L	$28.00 Put P/L	Net Profit P/L
$40.00	-$7.40	$0.50	-$6.90
$33.10	-$0.50	$0.50	$0.00
$33.00	-$0.40	$0.50	$0.10
$30.00	$0.60	$0.50	$1.10
$27.00	$0.60	-$0.50	$0.10
$26.90	$0.60	-$0.60	$0.00
$20.00	$0.60	-$7.50	-$6.90

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