

# Limited Risk Option Strategies

## Straddle and Strangle

Following the meltdown in the share market in 2008, the fear is still ever present that another substantial sell off could occur. Many believe however that the share market sell off to date has been so extreme that the next likely big move is higher. We have already witnessed how sharply share prices can fall when panic grips the market. Yet even bear market rallies can see explosive upside moves which can be breathtaking to witness. So which side of the market do we take?

Both the *Straddle* and *Strangle* strategies can help to give you a “foot in both camps” to take advantage of either scenario. The *Straddle* and *Strangle* take no view as to the direction the share price will take, and so start off as a neutral strategy. A large move is what is needed, the direction is not important.

The worst outcome for both strategies is for a sideways trading market with little directional movement taking place for the duration of the trade. This outcome is certainly possible, however given where we have come from there is still a very good chance that we could witness large directional moves in the months ahead.

### ***Straddle in a nutshell:***

**Step 1**

*Buy at the money call option.*

**Step 2**

*Buy at the money put option.*

**Step 3**

*Wait for share price breakout in either direction. If none occurs close spread after a predetermined time.*



## ***Strangle in a nutshell:***

**Step 1**

*Buy out of the money call option.*

**Step 2**

*Buy out of the money put option.*

**Step 3**

*Wait for breakout in either direction in the share price. If none occurs close spread after a pre-determined time.*



<b>Straddle/Strangle</b>	
<b><i>Description</i></b>	<p><u>Straddle:</u> Buy same strike price at the money call and put options.</p> <p><u>Strangle:</u> Buy out of the money call and put options.</p>
<b><i>Market View</i></b>	Expect a significant breakout of the current trading range but are unsure of likely direction.
<b><i>Profit Potential</i></b>	Unlimited in either direction.
<b><i>Risk Characteristics</i></b>	Limited to the combined premiums paid for the put and call options.
<b><i>Effects of Time Decay</i></b>	Negative – time decay works against both of these strategies.
<b><i>Best Time to Implement</i></b>	When the market has been trading in a well-entrenched trading range and option premiums are relatively underpriced. Alternatively strategies can be instituted before potentially market moving events such as company reports or when entering periods of potential volatility.
<b><i>Best Strike Prices to Use</i></b>	<p><u>Straddle:</u> Buy at the money puts and calls.</p> <p><u>Strangle:</u> Buy options 1-3 strikes out of the money (use previous support/resistance levels as a guide).</p>
<b><i>Time to Expiry</i></b>	Use options that have three months or more to expiry to mitigate time decay. Shorter duration options can be used for a specific volatility event such as before a company announcement or major economic news release.

### **Don't have to pick the market direction**

One of the best features of this strategy is the fact that you don't have to try to pick a direction that the market needs to move in. You are effectively only betting that there will be a reasonably large move in either direction in the share price over the time period that you have chosen. This can take a lot of the stress out of trading.

### **Unlimited Profit Potential**

You have the potential for unlimited profit on either side of the market.

### **Limited Risk**

The maximum risk is limited to the net amount paid for the spread. A sideways non-volatile non-directional market environment is the least desired outcome.

### **Initiate before Specific Company News or Economic Releases**

This is an excellent strategy to institute before specific company announcements such as profit reports, or before the release of potentially market moving local or international economic statistics, such as *Employment* and *Retail Sales* figures.

### **Increase in Volatility Favours this Strategy**

Most investors or traders tend to be frightened of volatility and for good reason. However this is one strategy where volatility works in your favour. As well as benefiting from large directional share price movements, an increase in volatility in the share will also often cause option premiums for both calls and puts to rise substantially, which is beneficial for this strategy.

### **Flexibility**

Should a break occur in one direction you can elect to close the other side of the trade, or look to hold in case of a pull back. At any time you can decide to close part or all of your trade, depending on your level of bullishness or bearishness. For example one favoured follow up strategy is to close half your position when the total premium paid doubles in value, leaving the remainder of your position to take advantage of further gains.

### **Be Positioned in the Market**

Having a position established in the market before a move occurs holds a big advantage. Quite often the biggest market moves originate overseas, particularly from the United States. For example if the US *Dow Jones Industrial Average* is down very heavily, you would expect our market to open the next day sharply lower. If you didn't already have a position in the market it can almost be too late. However if you are holding a *Strangle* or *Straddle*, you know that you have a guaranteed position in the market to take advantage of the move.

### **Timing not as Important**

Due to the nature of this strategy timing is not as important as in other strategies. Quite often you will implement the *Strangle* and *Straddle* in markets that have been trading in a range. Longer dated options are chosen to give you sufficient time for a break to occur in either direction.

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