Ultimate Guide to Credit Spreads

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How to trade credit spreads for consistent monthly income

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About the Author

Hey there I'm Lance owner of ThetaTraderz.com,

In a former life I was a licensed financial planner and insurance salesman. In my first few years after college, my hope was that I would be able to teach others about money and investing.

The sad truth is that most of my time was spent looking for new clients, often recommending accounts with large fees that benefitted myself and the company I worked for.

However, I still had a passion for teaching and this led to a career change as I've been a high school science teacher for the last 14 years.

My long-term plan is to eventually live on a teacher pension and part of a Roth IRA, with the rest of the IRA going to my children **tax free** when I pass.

I also have a YouTube channel that helps other teachers invest their money and have help a few other teachers set up their Roth IRA and helped them create a budget. Of course they're not just for teachers you can watch these informative videos too... FREE! (If you check it out be sure to subscribe for future videos)

Check out the link below for the InvestingTeacher YouTube Channel:

tinyurl.com/theinvestingteacher

For this guide I assume you know the definitions of a put, a call, selling and buying them, and have option clearance to sell spreads. If you need additional help in these areas see the video playlists below.

If you're new to investing... check out this video ⬇

https://www.youtube.com/watch?v=Wzg3f5Q8s5E&list=PLIDTDuCeyww8QcqrcOlQdd-lsyrLkRuAd

New to options?

https://www.youtube.com/playlist?list=PLIDTDuCeyww_uS4i1X-DN-Ef-447BFHzP

Why sell options presentation:

tinyurl.com/investingteacher

Cash secured puts and covered calls ebook (also gives a summary of the thetatraderz system)

Thetatraderz How to earn 4% a month selling cash secured puts on High IV Positions

The "Ultimate Guide to Credit Spreads" is the perfect book for anyone looking to increase their income through option credit spreads. With this book, you'll learn the fundamentals of trading credit spreads and how to maximize your profits.

I will warn you though, this isn't a get rich quick scheme. It requires steady work and discipline and if you follow this guide it will teach you a way to earn between 2-4% returns each month (approximately 24-48% yearly).

Ultimately I will not only give you the strategy, I will give you examples of positions that both made me money, and even how I was able to mitigate my losses.

Kind of like teaching science, I'll show you my lab work!

One other side note: If you are new to investing, my options coaching and alert service ThetaTraderz will help shorten the learning curve as I provide in depth one on one coaching.

Plus, you will receive two recommendations a day on trades I'm personally looking at, a private discord community with like-minded individuals, and have access to my personal credit spread trades in real time!

For a 7 day free trial go to thetatraderz.com

What is a credit spread?

A credit spread is when you simultaneously sell an option closer to the current price and buy an option further away from the current price.

Example #1: if a stock is $100 a share, you can sell a put at 95 and buy a put at 90 which is called a put credit spread. This is a good strategy if you believe a stock will increase in price.

Example #2: sell a call at 105 and buy a call at 110 which is called a call credit spread. This is a good strategy if you believe a stock will decrease in price.

If you combine both a put credit spread and a call credit spread on the same stock this is called an iron condor; those are useful when you don't think a stock will rise or fall in price much.

In the above examples you receive a net credit in your brokerage account since the sold option has a large premium than the bought option.

Let's say in the previous example you sell a put at 95 that pays .50 and you buy the put at 90 that costs .20. Your net credit is .50 minus .20 leaving you with .30 credit. Of course, since options deal with 100 shares you would receive .30 X 100 or $30 in credit.

This sounds great and all but there's got to be a catch right? Well yes, there's no such thing as free money. The "cost" to do the spread is the difference between the strikes on the spread. In our examples above we went only 5 wide meaning the cost is $500 minus the $30 credit received = $470.

Your brokerage will hold this amount as theoretically you could lose this much money if the stock closed below 90 (ex #1 from above) at expiration.

As you'll see, I teach you how to setup your trades where this rarely happens. Furthermore, I'll show you how to protect your account by possibly getting out of trades earlier than this max loss situation.

Pros and Cons to credit spreads over cash secured puts and calls

One of the things I believe in is diversification, so I personally use both credit spread and cash secured puts in my trading strategy. Depending on the stock and expiration date one strategy could be more beneficial than the other.

Pros to credit spreads

- One of the benefits of a credit spread is that in most cases it costs less to implement - if a stock is at 100 and you sell a put at 95, the cash secured put would cost $9,500. However, if you bought the 90 call as a hedge it would cost you only $500 minus premium received.
- Going with the first point, many blue chip/high quality stocks are hundreds of dollars. Credit spreads allow you to trade these stocks even if you have a relatively small account. This leaves you with more options (sorry bad pun) in which you can trade high value stocks and ETF's!
- Diversification is important, by choosing to sell credit spreads you can have many different positions in a variety of sectors since it uses considerably less buying power. With cash secured puts you might be limited in the number of positions you can take.
- The max profit or loss is predetermined. You know going into the trade what your max loss and profit can be before entering the trade.
- Usually a higher % return - If you sold a 95 put for .5 you would receive $50 putting up $9500, or a .5% return. By buying the 90 put for .20 leaving a net credit of .3 you would receive $30 putting up $500, or 6%! This is a much higher % gain than the cash secured put.

Cons to credit spreads

- Tougher to manage - When a position goes in the money on your bought call you are in a max loss situation and it is much tougher to roll the position than a cash secured put.
- Cannot wheel - In a cash secured put if the position goes below your strike price you can just let it get assigned and sell covered calls. With credit spreads the only way you could do this is to sell back your bought option and then take shares from the sold option. This would also use up a lot more buying power.
- More likely to take riskier trades - I have seen and tried to help many people that take on too much risk in their credit spreads and would have been better off if they simply sold a put on the stock instead of selling a lot of contracts on the same position.

How to setup a credit spread

There are many different strategies in where to place your strike prices using credit spreads, for example you could place a trade with a high delta which initially provides more income but is also more risky and is likely to end in between your strikes or worse end up as a max loss situation.

ThetaTraderz philosophy: Look for trades that are low-risk high-probability, and can provide consistent income in any market conditions. So how do I do this?

The goal is to find trades with at least an 85% chance of success, and many times I can find even better than that. A delta of .16 means there is approximately an 84% chance the spread will expire worthless, and it is 1 standard deviation from the possible price at expiration.

If you are very confident in your technical analysis this could bring in around 5-15% returns in a month. This in my opinion is incredibly aggressive, so I typically look between .05 and .10 delta. These trades return between 3-7% in a month, are less stressful, and they're less likely to expire as a loss.

This is an important note: We are in this for the long haul, and making consistent small returns will keep you in the game longer and provide more confidence in your own trading.

With many trades averaging 3-7% in a month, even if a small % of trades don't work you can still earn 2-5% (much higher returns than buy and hold strategies in most cases).

Another thing to consider is having your strikes at least 10% away from the current ETF price, or at least 15% away from the current stock price. Low delta trades in most cases usually achieve this.

Stocks and ETF's considerations

Here are some considerations for when you are deciding on a stock or ETF to make a credit spread. Note that these are very different from the cash secured put strategy that thetatraderz.com recommends.

- Highly liquid
- Stock price over 50
- Open interest at least 250 for your chosen strike.
- Premium of at least .2 in a monthly put or call credit spread; Premium of at least .4 in a monthly Iron Condor.

How far out in time should your credit spreads be?

- 30-45 DTE is the most common trade since you can go far away in strike prices from the current share price. You can also consider 60 DTE but premiums are likely not much higher than 45 DTE
- 7 DTE if you can receive at least a .15 premium at a .08 delta
- 0 DTE on SPX/SPY is a specific strategy that thetatraderz.com runs. Sign up if interested in alerts

When to buy to close

- Make a target % you want to receive per week or for the whole contract
- When you make this target % consider buying to close
- Simpler method, BTC at 60% profit (if you sell a credit spread for .5 buy to close it at .2). If there is a week left before expiration and your delta is below .1, just let it expire to save commissions.

When to make a stop loss

When entering trades notice the support (where a price doesn't typically go lower) and resistance (where a price typically doesn't go higher) levels.

Your credit spread should be below the support line on a put credit spread and above the resistance line on a call credit spread.

Track these points before entering the trade, and set an alert on your brokerage when a position hits the support or resistance. On thetatraderz.com you will be given these prices.

A good rule of thumb is to set your stop loss at 3 times the premium received. For example if you make a put credit spread at .4 you will then set a stop limit order for 1.2. This would result in a 1.2-.4 or $80 loss in the position; which is a lot better than hitting your max loss of $500 on a 5 width spread.

When to roll

At ThetaTraderz we do not recommend rolling spreads! You deal with additional commissions, potential slippage on bid ask spread, and you may need to take your position out a long period in time. In most cases it's best to cut your losers and move on to the next trade.

Should you decide to rolling your position, only do so if you can receive a net credit on the roll while lowering the price on a put credit spread or at a higher price on a call credit spread. Ideally the new strike prices are below a longer term support level or higher than a longer term resistance level.

Lastly, if the position your rolling is during an earnings release consider just taking the stop loss.

Money Management and Trade size

- Have a minimum of 3 different stocks and 2 different ETF's or Indexes
- You can also just trade at least 3 different ETF's or Indexes. All of the following have large open interest and volume SPY/SPX, IWM, TNA, RUT, QQQ/NDX, sector ETF such as XLE, XLF
- Take the amount of funds you will be trading with, divide by 5 for the minimum number of different positions . Then divide by 5 again when doing 5 width spreads (which I usually recommend, if you are doing 10 width spreads divide by 10)
- For example if you are trading $10,000, divide by 5 = $2000 per stock/etf. 2000/5 is 4 contracts you can sell using 5 width spreads, or 2000/10 is 2 contracts you can sell using 10 width spreads.

Example of a winning trade

On 9/17/2021 IWM was trading at 221.73, with support at 212. I placed a put credit spread at 205/202 expiring 10/15 for a credit of .3. On 9/30/2021 - I was able to buy to close the spread at .1, earning .30 minus the buy back of .10 left $20 profit in 12 trading days. With a 3 width spread $300 in margin was used to setup the trade. After commissions of $2.4 the net return was 17.6/300 or 5.8% in 13 days.

Trades like the one shown happen frequently!

Sample portfolio

Here is a sample portfolio similar to what I usually have. Add more contracts of each depending on your account size.

SPY at 450, sell a 400 put and buy a 395 put for .25 premium expiring in 30 DTE

IWM at 210, sell a 180 put and buy a 175 put, also sell a 240 call and buy a 245 call for .48 premium expiring 30 DTE

XLE at 60, sell a 50 put and buy a 45 put, also sell a 70 call and buy a 75 call for .52 premium expiring 45 DTE

TSLA at 1000, sell a 850 put and buy a 845 put for .15 premium expiring 7 DTE. (I have done this type of trade many times with success)

AAPL at 150, sell a 140 put and buy a 135 put, also sell a 160 call and buy a 165 call for .42 expiring in 30 DTE.

List of ETF's and Stocks

Here is a sample list of stocks and ETF's I have sold credit spreads on, use this watchlist as a starting point. I also recommend adding your own stocks to your watchlist.

Stocks:

* TSLA
* AMZN
* V
* MA
* AAPL
* JPM
* JNJ
* BYND
* MSFT
* META
* NVDA
* UPST
* WMT
* CSCO
* ADBE
* CHWY
* MCD
* PYPL
* UNH

ETF's or Indexes:

* SPY (S&P 500 ETF)
* QQQ (Nasdaq ETF)
* IWM (Russell 2000 ETF)
* SPX (S&P 500 Index)
* NDQ (Nasdaq Index)
* RUT (Russell 2000 Index)
* XLE (Energy Sector ETF)
* XLF (Financial Sector ETF)
* TAN (Solar Energy ETF)

Other ETF's to consider are leveraged ETF's such as SOXL which is a leveraged ETF that tracks semi-conductors, and TNA a leverage ETF that tracks small cap stocks in the Russell 2000.

The End!!!

Thanks for taking the time to read the Ultimate Guide to Credit Spreads. I hope you found this guide useful in your investing journey.

Remember investing is a journey. Using the strategies I teach you allow the numbers to work in your favor overtime.

Come check out our amazing group at ThetaTraderz.com!