



## Diagonal Spreads

Diagonal spreads utilize aspects from both vertical and horizontal spreads. These strategies use the differing expiration prices of vertical spreads with the differing expiration dates of horizontal spreads. The unification of the two strategies results in a highly variable strategy that balances neutral underlying price expectations with bullish or bearish occurrences thereafter. You can use puts or calls to create diagonal spreads. Diagonal spreads, like both horizontal and vertical spreads, offer limited risk in exchange for limited potential profit.

### Diagonal Bull Calls

Creating a bull call diagonal spread begins with selling an “out the money” call which expires in the short term. The proceeds are used to buy an “at the money” or “in the money” call which expires in a longer term. The long term should be at least twice the length of the short term. Another short term call will be sold every time it expires until the end of the long term call, as long as the new short term call will expire before the long term call expires. Each sale creates cash which reduces the cost of the position. The cost of opening the position is ultimately the difference between strike prices received and paid. If the spread was opened for a debit, which is usually the case, the debit’s value increases the cost. If the spread was opened for credit, the credit’s value decreases the cost. Any credit may be applied against the margin requirements of the position’s opener. Since costs are reduced by the sales of new calls after the first put sold, total costs will not be known until the strategy concludes.

Diagonal bull call spreads should be used if the underlying asset’s short term price will contain very little underlying price movement, and the long term will be slightly bearish. For the length of the short term out the money calls you sold, the price needs to stay below the strike price. The underlying price should only reach “in the money” status only after long term calls expire, allowing you to continuously earn money selling out the money calls without being exercised against. If you are exercised against, you exercise your purchased long term call to prevent heavy losses. The maximum potential earnings are equal to your premiums collected plus the difference in the option’s strike prices. Debits incurred creating the trade are subtracted, and credits incurred creating the trade are added. The profit rises with the amount of out the money calls sold.

The maximum potential loss is the difference between the profits of the sold option minus the cost of the purchased option. If the position is created for a credit, subtract the credit from the result. If the position is created for a debit, add the debit to the result.

Your goal is acquiring the maximum amount of money for the sale of each option without risking the option being exercised. The price needs to stay below the sold option’s exercise price to ensure that happens. Underlying aspects that help boost premium prices on options help you earn profit so long as the option is never in the money for sold options. Implied volatility of underlying assets can be high since that raises the price, as long as that volatility brings underlying prices away from the exercise price.

### Diagonal Bear Puts

Creating a bear put diagonal spread begins with selling an “out the money” put which expires in the short term, and buying an “at the money” or “in the money” put which expires in a longer term. The long term put should be at least twice the length of the short term. Another short term put will be sold every time it expires until the end of the long term put. This only happens if the new short term put will expire before the long term put expires. Each sale creates cash which reduces the cost of the position. The cost of opening the position is ultimately the difference between strike prices received and paid. If the spread was opened for a debit, which is usually the case, the debit’s value increases the cost. If the spread was opened for credit, the credit’s value decreases the cost. Any credit may be applied against the margin

requirements of the position's opener. Since costs are reduced by sales of puts after the first put sold, the total costs will not be known until the strategy concludes.

Diagonal bear put spreads should be used if the underlying asset's short term price will contain very little underlying price movement, and the long term will be slightly bullish. For the length of the short term out the money puts you sold, the price needs to stay below the strike price. The underlying price reaches "in the money" status only after long term puts expire, allowing you to continuously earn money selling out the money puts without being exercised against. If you are exercised against, you exercise your purchased long term put to prevent heavy losses. The maximum potential earnings are equal to your premiums collected plus the difference in the option's strike prices. Debits incurred creating the trade is subtracted, and credits incurred creating the trade is added. The profit rises with the amount of out the money puts sold.

The maximum potential loss is the difference between the profits of the sold option minus the cost of the purchased option. If the position is created for a credit, subtract the credit from the result. If the position is created for a debit, add the debit to the result.

Again in case you forgot: Your goal is acquiring the maximum amount of money for the sale of each option without risking the option being exercised. The price needs to stay above the sold option's exercise price to ensure that happens. Underlying aspects that help boost premium prices on options help you earn profit so long as the sold options are never in the money. Implied volatility of underlying assets can be high since that raises the price, as long as that volatility brings underlying prices away from the exercise price.

### **Time Decay**

Diagonal Bull Call Spreads and Bear Put Spreads are heavily influenced by time decay. Time value erodes the option purchased and the option sold over time. Your first sold short term option will suffer from time decay's value erosion faster than your purchased long term option. Your short term options sold after the first expiration suffer time decay closer to your long term option's time decay.