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Option Strategies to Hedge Downside Risk

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Using Options to Hedge Downside Risk

Different Strategies

Credit Call Spread
Put Spread
Double Bear Spread
Calendar Spread
Ratio Spread

Strategy set up would depend on your outlook

Ideally you have a model with probabilities

It is important for option strategy and strike selection

Ex:

70% Stock goes up 10%

20% Stock is flat

10% Stock is down 20%

EV: 70% X 10% + 20% X 0 + 10% X - 20% = 5%

Credit Call Spread

Limited Risk and Reward

Offers some downside cushion

Brings in a credit

2 legs to the strategy

Debit Put Spread

Limited Risk and Reward

Offers some downside cushion

Debit Cost

2 legs to the strategy

Double Bear Spread

Combination of a credit call spread and debit put spread

You buy a downside put spread and finance some of the cost with a credit call spread

4 legs to the strategy

Bearish Calendar Spread

Buy an option with a longer dated expiration and sell an option with a shorter dated expiration on the same strike

In a bearish calendar spread the strike price is below the spot price and you are long vega so your outlook would be that IV will increase in the future

Ratio Spread

This can be set up in different ways depending on your outlook

You would have different quantities of options on different option contracts.

Most common ratio is 1 by 2