Creative writing on options trading strategies db4

Business, Strategy

Introduction

Hedging refers to an investment strategy that employs financial instruments with the aim of cushioning oneself from the incurrence of losses on other investments. Hedges can be formulated by using a number of financial instruments; these include: options, swaps, future contracts, derivatives, among others. Hedging strategies are diverse in nature. The spread strategy is commonly applied in the markets. This involves the use of more than one option of a similar class or category on the same underlying stock. There are a number of spreads that could be employed by the company in accordance with the volatility. These include the following:

Bull spread

In this strategy, it combines a long call with a short call at a higher strike price, and a short put and a long put at a lower strike price. The call strike ought to be above while the put strike ought to be lower than the current level of the underlying stock. Bull spread also assumes that the underlying stock is the same for both calls and the expiration date for the calls is the same. The strategy involves the initiation of the position at even which would lead to the cost of spread being offset by the income from the put spread.

Butterfly spread

The strategy involves two short calls usually at the middle strike and two long calls each at the lower and higher strike. It requires the lower and higher strike to be equidistant from the middle strike. The strategy also works on the assumption that the underlying stock and the expiration date for all the calls is the same. The strategy would be profitable if the

underlying stock achieves a certain predetermined price target at the end of the expiration date of the options.

Ratio spread

In this strategy, the bull and naked calls are combined. It involves one long call and two short calls with the same expiration date. However, the strike should be higher. The ratio spread essentially entails the purchase of a several options with the resale of the same underlying stocks and the same expiration date at a different strike price that would be higher than the initial strike price. It would be pursued if the seller believes the underlying stock would be subjected to little volatility. The strategy would be profitable if the underlying stock value arises up to the strike price of the two short calls, but does not exceed those prices.

Bear spread

This strategy involves a short call at a lower strike price to the long call. It works on the assumption that then underlying stock for both the stock and the expiration dates are the same. It contrast the bull spread in the positioning of its call options. The bear's positioning of calls ensures it generates a net cash inflow at the onset. The short call in the bear suffices for income generation while the long call suffices for the limitation of the risks inherent in the options. The strategy profits if the initial premium revenues generated from the initial cash inflows are retained before the expiration date arrives. It would perform better if the underlying stock remains below the strike price up to the expiration date.

Conclusion

Hedging essentially requires the sellers and buyers to accurately predict the likely outcomes and enter into favorable contracts. It should be appreciated that the main motivation for hedging lies in the cushion effects it avails in the event a loss occurs in one financial instrument.

References

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