Spreads & Hedging

Defining Your Risk on Both Sides — Lesson Explainer

The Concept

A spread combines two or more options of the same type on the same underlying, at different strikes or expirations, to create a position with a precisely defined maximum gain and maximum loss.

A bull call spread buys a lower-strike call and sells a higher-strike call - cheaper than the call alone, but with upside capped at the higher strike. A bear put spread does the mirror image with puts.

Hedging uses an option to offset risk already present elsewhere in a portfolio. A protective put acts like insurance on stock you own. A collar combines a protective put with a covered call, often structured so the premiums roughly offset.

Illustrative Example: A Bull Call Spread vs. a Single Call

Stock at $100. Single $100 call for $6, versus a spread: buy the $100 call for $6, sell a $110 call for $2 (net cost $4).

Stock at Expiration	Single Call P&L	Bull Spread P&L
$95	-$6 (Max Loss)	-$4 (Max Loss)
$105	-$1	+$1
$115	**+$9**	**+$6 (Max Gain)**
$130	+$24	+$6 (Still Capped)

The spread costs less upfront, has a smaller max loss, and breaks even sooner - but sacrifices unlimited upside for a hard cap at $6 gain, no matter how high the stock eventually goes.

5 Things to Know About Spreads & Hedging

1. Spreads trade unlimited potential for defined risk - both max gain and max loss are known upfront.

2. A spread is cheaper because you're also selling one - the short leg partially offsets the cost.

3. Hedging costs something, by design - a protective put's premium is the price of a floor.

4. A collar can be structured near zero-cost - but that typically means giving up upside.

5. Spreads and hedges reduce risk, they don't eliminate exposure - a loss within range is still possible.

4 Things to Check Before Using a Spread or Hedge

• Confirm both legs match - same expiration, underlying, and contract sizes.

• Know your max gain and max loss upfront - calculate both before placing the trade.

• Weigh the hedge cost against what it protects - size the premium against the real downside.

• Watch both legs into expiration - assignment risk applies to the short leg of a spread too.

Worth knowing:
this explains spreads and hedging using illustrative numbers - it isn't personalized financial advice, and no strategy here is a recommendation to trade. All options strategies carry risk, and defined-risk positions can still result in a loss within their stated range.

Quiz — Answer the questions, then check the key on the next page

1. What is a vertical spread?

A. Buying stock and a call at the same time
B. Buying one option and selling another of the same type and expiration, at a different strike
C. Selling an uncovered call with no other position
D. A type of stock, not an options strategy

2. In the illustrative example, why did the bull call spread cost less than the single call?

A. Because spreads are always free to enter
B. Because the stock price was lower for the spread trade
C. Because the premium collected from selling the higher-strike call offset part of the cost
D. Because the broker waived the commission

3. What is a protective put?

A. Buying a put against stock you own, to put a floor under potential losses
B. Selling a put with no other position
C. A put option that never expires
D. A type of covered call

4. What is a collar, according to this lesson?

A. Two calls bought at the same strike
B. A type of bond, not an options strategy
C. Selling both a call and a put with no stock position
D. A protective put combined with a covered call, often structured so the premiums roughly offset

5. Do spreads and hedges eliminate all risk?

A. Yes, defined-risk strategies guarantee a profit
B. Yes, but only for call spreads specifically
C. No, they reduce and bound risk, but a position can still lose money within its defined range
D. No, spreads always increase total risk compared to a single option

Answer Key

1. What is a vertical spread?

Correct answer: B. Buying one option and selling another of the same type and expiration, at a different strike

A vertical spread combines a long and short option of the same type and expiration at different strikes.

2. In the illustrative example, why did the bull call spread cost less than the single call?

Correct answer: C. Because the premium collected from selling the higher-strike call offset part of the cost

Selling the $110 call for $2 offset part of the $6 cost of the $100 call.

3. What is a protective put?

Correct answer: A. Buying a put against stock you own, to put a floor under potential losses

A protective put means buying a put against stock you own, acting like insurance.

4. What is a collar, according to this lesson?

Correct answer: D. A protective put combined with a covered call, often structured so the premiums roughly offset

A collar combines a protective put with a covered call, trading upside for a cheaper floor.

5. Do spreads and hedges eliminate all risk?

Correct answer: C. No, they reduce and bound risk, but a position can still lose money within its defined range

Spreads and hedges reduce and define risk, but don't eliminate market exposure entirely.