



PARKWOOD CAPITAL
Empowering your success

The Versatile Diagonal Call Spread

Kerry W. Given, Ph.D. (Dr. Duke)

Parkwood Capital, LLC



Disclosures and Disclaimers

Buying and selling stocks and options involves risks and may not be suitable for all investors. Prior to buying or selling an option, the investor must receive a copy of the booklet, Characteristics and Risks of Standardized Options, from your broker or from The Options Clearing Corporation, 1 North Wacker Drive, Suite 500, Chicago, IL 60606.

The information in this presentation is presented for educational purposes only. It should not be construed as a recommendation or solicitation to buy or sell options. Many examples of options trades are presented in this presentation as illustrations of the principles being taught in this course. These examples are not recommendations or solicitations to buy or sell any stock or option.

To simplify the calculations, commission costs have not been included in the examples in this presentation. Commission costs will affect the outcome of any stock or options trade and must be considered prior to entering the transaction.

No representation is being made that any account will or is likely to achieve profits or losses similar to those discussed in this presentation. The past performance of any trading system or methodology is not necessarily indicative of future results.

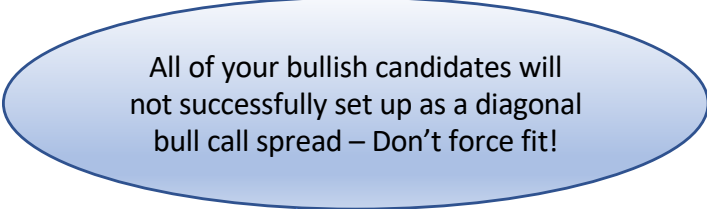
Introduction

- A diagonal spread is formed when I buy an option in one expiration and sell another option at a different strike and in a different expiration. Any vertical spread may be diagonalized.
- In this webinar, we will focus on the diagonalized bull call spread.
- Diagonal spreads are more forgiving than vertical spreads – a sideways move works very well.
- As we roll the short call out each week or month, we lower the cost basis of the long call, increase the potential gains, and also lower our risk.
- The diagonalized bull call spread will profit for stock price moves higher, sideways or even slightly lower.

Diagonal Bull Call Spreads

General Process

- Select a stock with a neutral to bullish outlook.
- Buy an ITM call one month to several months out in time.
- Sell an ATM or slightly OTM call in the front month or week.
- Experiment with different strikes and expirations to find:
 - An initial debit that is equal to or less than the spread width ★
 - Ensure the lower break-even gives you adequate downside protection ★
- As expiration approaches: roll out to the next week.
- Continue to reduce the cost basis via this process.
- Set a stop loss as you would with a vertical spread:
 - Use support levels from the price chart, or
 - Set a stop loss just below the break-even price.



All of your bullish candidates will not successfully set up as a diagonal bull call spread – Don't force fit!

Diagonal Bull Call Spreads ***Managing the Trade***

- If the stock price moves sideways to modestly higher:
 - As we near expiration, we roll the short call out to the next week or month for a credit.
 - If the credit to roll is too small, roll farther out in time.
 - As our short call option moves farther ITM, our credit to roll becomes smaller.
- If the stock price moves strongly higher:
 - We can roll out to next week or month and up one strike to expand our spread and expand our potential profit.
 - But this roll will be for a debit, increasing our cost basis. We are putting more capital at risk to increase the maximum potential profit.
- For modest downward moves that don't trip our stop loss:
 - We can roll out to next week or month and down one strike to bring in a credit and compensate for a portion of the loss.
 - Keep track of your cost basis in the long call and compare to the market price.
 - Sometimes closing the position is best.

Your Broker's Screen May Be Misleading

- Your broker's screen will often display an incorrect P/L for a diagonal spread.
- My broker showed my SWKS diagonal call spread position as follows:
 - May 90 call purchased at \$13.01 and now trading at \$7.25 for a loss of \$5.76
 - May 97.50 call sold at \$1.50 and now trading at \$1.05 for a net gain of \$0.45
 - Therefore, the position looks like it is losing \$531 per contract.
- But I had generated the following credits:
 - Sold AprWk2 100 call +\$238
 - Rolled out to Apr 100 call +\$131
 - Rolled out to AprWk4 100 call +\$37
 - Rolled out to MayWk1 100 call +\$87
 - Rolled out to MayWk2 97.50 call +\$165
 - Rolled out to May \$97.50 call +\$150
 - Therefore, the cost basis was \$493 (\$1301 purchase price less the \$808 in credits from the rolls)

When trading a diagonal call spread, compare the cost basis in the long call to its current market price. As long as those two numbers are close, you are good to continue.
In this case, I owned a May \$90 call selling for \$7.25, but my cost basis was \$4.93.

Choosing the Expirations

AMGN Diagonal Call Spread on 11/03/23 with AMGN at \$269.86

Two Fundamental Objectives:

1. The initial debit should be equal to or less than the spread width.
2. Avoid having an upper break-even.

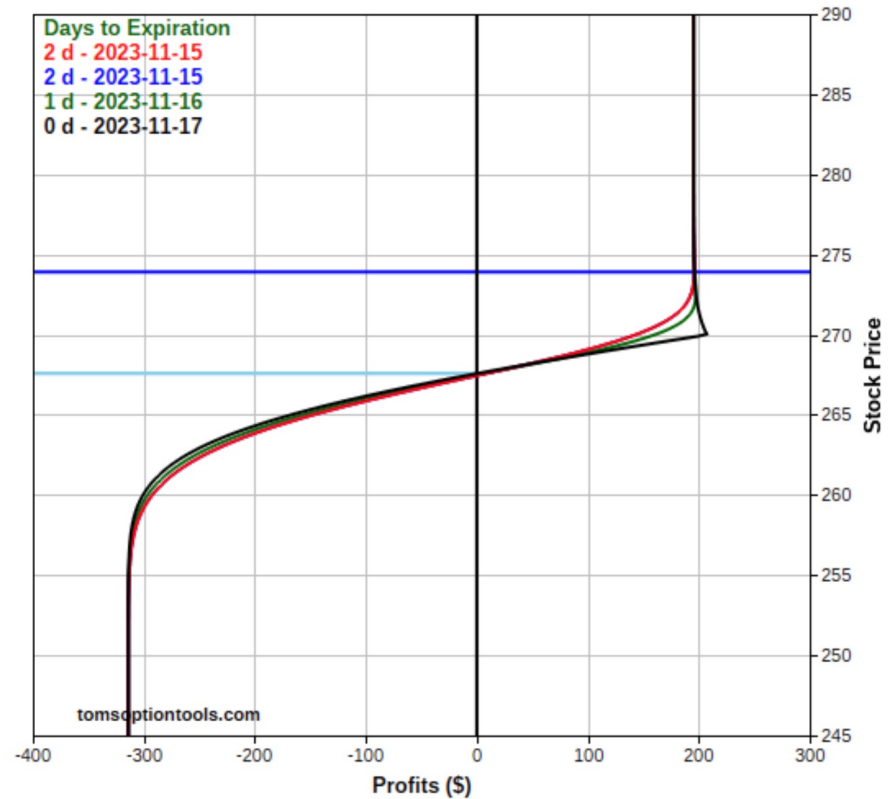
<u>Buy 265 Call</u>	<u>Sell 270 Call</u>	<u>Debit</u>	<u>LBE</u>	<u>UBE</u>
12/8	11/10	\$600	\$266.40	\$281.36
12/1	11/10	\$535	\$266.58	\$289.63
11/24	11/10	\$465	\$266.85	N/A
11/17	11/10	\$428	\$267.46	N/A

As the expiration of the long call is brought in closer:

- The debit decreases
- The upper break-even moves higher and eventually disappears
- In this case, I entered the Nov(11/10)/Nov(11/24) 265/270 diagonal call spread for a debit of \$447.
- I have rolled the Nov(11/10) 270 call out to Nov(11/17) and the cost basis is \$314.

The Diagonal Call Spread

Current Example with AMGN



11/03/23: I bought the AMGN Nov(11/3)/Nov(11/24) 265/270 diagonal call spread for a debit of \$447. I rolled the 11/10 call out to 11/17 and lowered the cost basis to \$314. The trade currently stands at a net gain of \$196 per spread or +62%.

Conservative Diagonal Call Spreads

- Always enter your diagonal call spread for a debit that is less than the spread width.
- With conservative stocks with lower implied volatility options, this is more difficult.
- If the initial debit is somewhat larger than the spread, estimate the weekly credit to roll the short call.

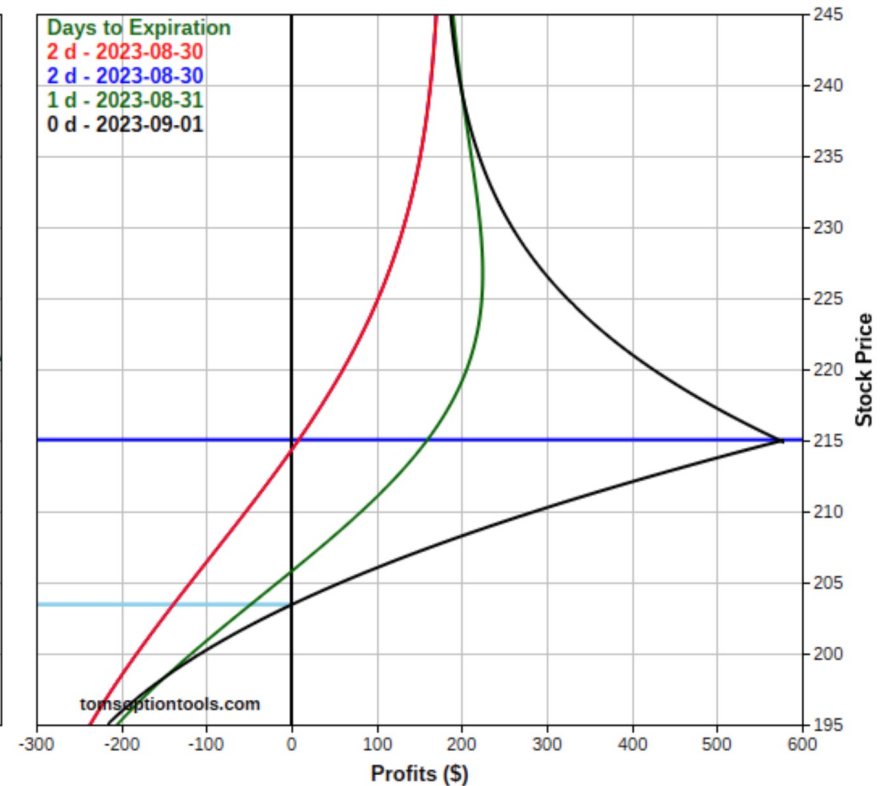
Aggressive Diagonal Spreads

Playing the Earnings Announcement

- Playing earnings announcements with any trade is a speculative trade. Size the trade appropriately.
- This is a bullish trade, although a sideways price move will be very profitable.
- In this situation you are selling a high volatility call and greatly reducing the cost of the long call.
- Trade Setup:
 - Sell the option expiration containing the earnings announcement, e.g., the announcement is on Wednesday after the close. I would sell Friday's ATM or OTM call.
 - Buy the following week's ITM call.
- Critical criteria:
 - The entry debit should be equal to or lower than the spread width. This protects you against a huge bullish price move after the announcement.
 - The lower break-even should be at or below the lower price range predicted by the ATM straddle. Also compare with recent support levels on the price chart.
- After the earnings announcement:
 - Close if you have a good profit.
 - If you remain bullish on this stock, you may roll the short call out to next week to increase the gains.

Playing the Earnings Announcement

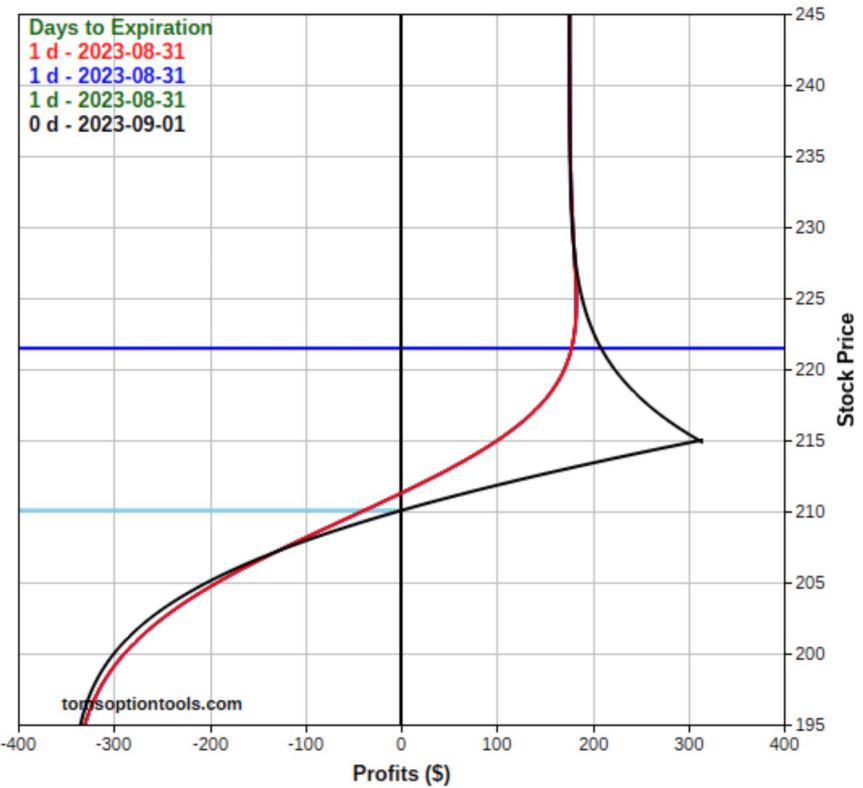
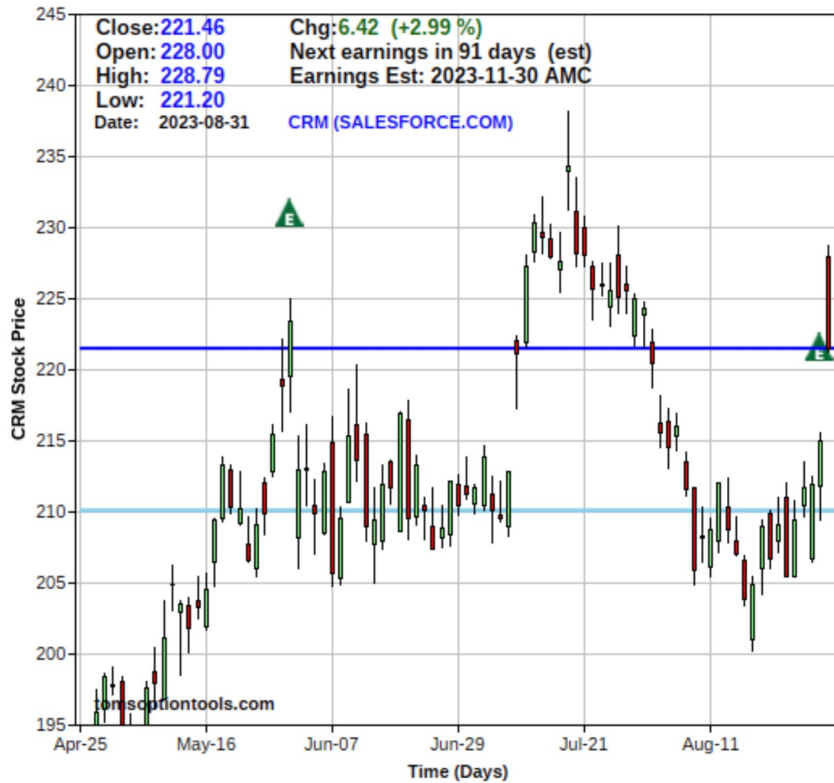
Recent Example with CRM



8/30/23: CRM Sep(9/1)/Sep(9/8) 210/215 diagonal call spread entered at a debit of \$345. The trade has no upper break-even and the lower break-even is at \$203.45.

Playing the Earnings Announcement

Recent Example with CRM



8/31/23: CRM Sep(9/1)/Sep(9/8) 210/215 diagonal call spread was closed for a credit of \$520, for a net gain of \$175 per spread or +51%.

Diagonal Spreads Summary

- If the trader's prediction is sideways or higher, the diagonal bull call spread is a good choice.
- As the stock price moves up, you can buy back the short call and sell the next expiration call at the same strike for a credit, further reducing the cost basis of your long call.
- If the stock price moves up rapidly, the credit for rolling at the same strike will diminish, forcing you to close the trade early. If the initial entry debit was less than the spread width, you will be closing for a gain.
- Monitor the cost basis of the long call as you make decisions to roll out or close the trade. The cost basis is the maximum loss at any point in time.
- The diagonal call spread may also be used to speculate on a stock's earnings announcement, but this is a speculative trade with no opportunity for adjustment. Size the position appropriately.

Interested in Learning More?

Parkwood Capital offers private stock and options coaching, group courses, four subscription trading services and a weekly newsletter. The QR code below will open our website.
Click the Free Downloads tab and click presentations to download a copy of these slides.



www.ParkwoodCapitalLLC.com

Email: DrDukeOptions@gmail.com

630-291-1230