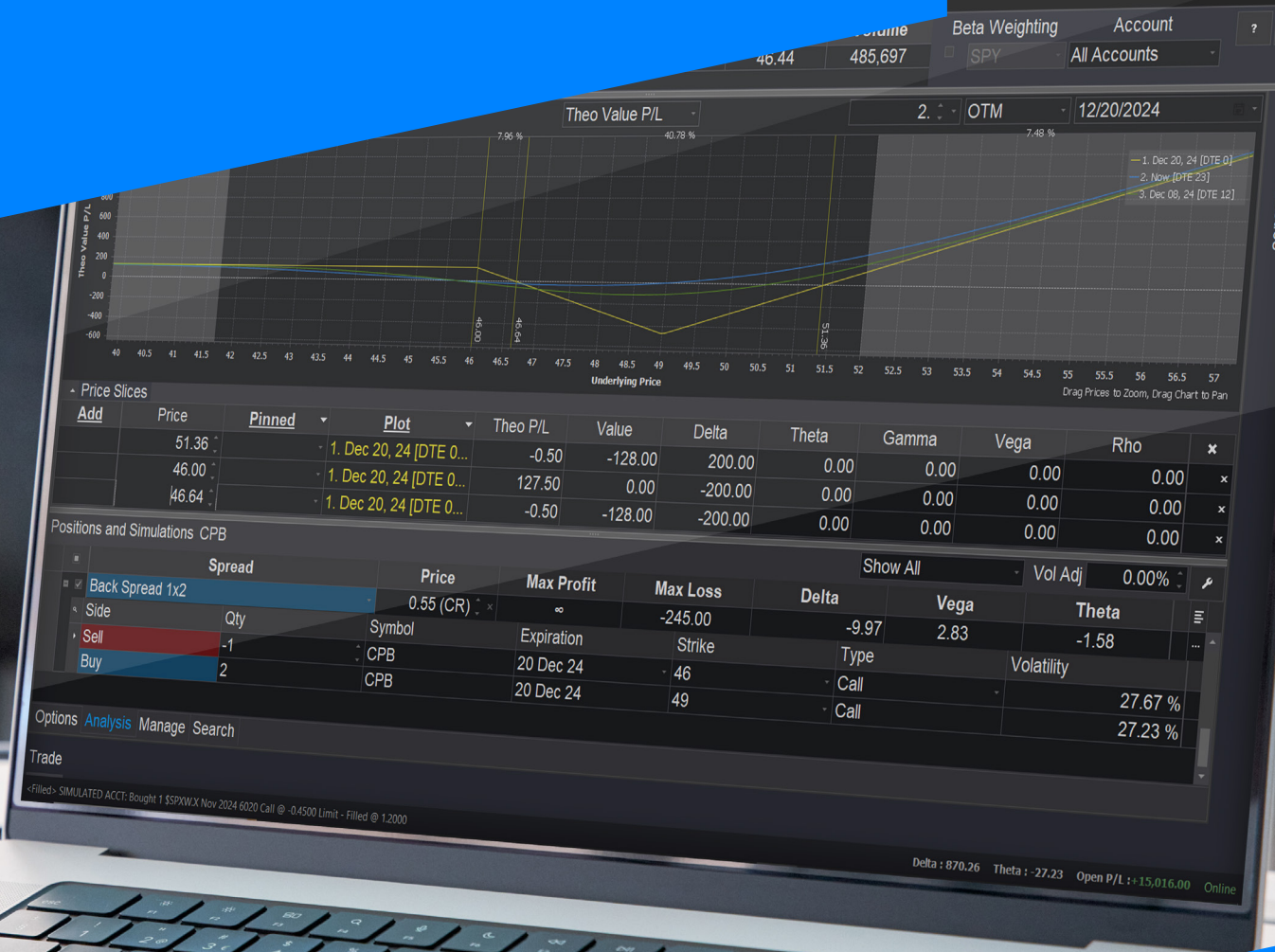


Trading Big Market Moves with Ratio Back Spreads





What is a ratio back spread?

A ratio back spread is an advanced options strategy that involves selling a smaller number of options at one strike price while buying a larger number of options at a different strike price, all with the same expiration date. This strategy gets its name from the ratio of short to long options, typically 1:2 or 1:3, creating a unique risk-reward profile that can benefit traders in specific market conditions.

Why traders choose ratio back spreads

Traders often turn to ratio back spreads when they anticipate significant market movements but want to limit their risk exposure. This strategy particularly appeals to traders who want to capitalize on rising implied volatility while maintaining a controlled risk profile. The ability to enter the position with minimal cost, or sometimes even a credit, makes it especially attractive when traders have strong directional views but want to manage their capital efficiently.

The strategy tends to work well in markets where technical analysis suggests a breakout from consolidation patterns or when fundamental catalysts might trigger substantial price movements. Events like earnings announcements, FDA approvals in biotech stocks, or major economic developments often create the ideal environment for ratio back spreads.

Benefits of trading ratio back spreads

Ratio back spreads offer several compelling advantages for sophisticated options traders.

1 Asymmetric risk-reward profile

When properly structured, these spreads can provide substantial profit potential with limited risk.

2 Low or no-cost entry

The position can often be entered for little to no cost, and in some cases, traders can even receive a small credit, effectively getting paid to enter a position with significant upside potential.

3 Flexibility in volatile markets

As market volatility increases, the additional long options in the ratio spread can appreciate rapidly, potentially leading to profits. This characteristic makes ratio back spreads particularly valuable during market uncertainty or ahead of known volatile events.

4 Defined risk

Ratio back spreads have a clear maximum loss, which occurs when the underlying asset price sits between the strike prices at expiration. This predictability allows for precise risk management and position sizing.

Understanding the risks

While ratio back spreads offer attractive benefits, they come with specific risks that traders must understand and manage.

1 Maximum loss in the “dead zone”

The most significant risk is the potential for maximum loss when the underlying asset price remains between the selected strike prices at expiration. This “dead zone” can result in the loss of premium paid for the extra long options while the short option provides insufficient offset.

2 Assignment risk

The short option in the spread can be assigned any time before expiration, particularly with American-style options. For example, in a call ratio back spread, if the stock price rises above your short strike price, you might face early assignment, especially if there's an upcoming dividend payment.

3 Impact of early assignment

Early assignment can disrupt the spread's intended risk profile and create unexpected margin requirements or stock positions. While the long options in the spread provide some protection, managing an assignment requires quick action and can result in additional transaction costs. Traders should monitor their positions closely when short options become in-the-money and consider closing or rolling the spread to avoid assignment.

4 Time decay risk

Time decay presents another challenge, particularly affecting the long options in the position. As expiration approaches, the rate of time decay accelerates, potentially eroding the value of the long options faster than the benefit received from the short option. This time decay risk makes position timing and management crucial for success.

5 Execution and liquidity risks

Traders also face execution risk, especially in less liquid options markets. Executing multiple legs of the trade at favorable prices can be challenging, and wide bid-ask spreads can impact the strategy's profitability. Additionally, margin requirements for the short options must be carefully considered, as they can tie up trading capital.

Types of ratio back spreads

Call ratio back spread

A call ratio back spread is typically used when expecting a large upward price movement.

a) Structure

- Sell one call option at a lower strike price.
- Buy two or three call options at a higher strike price.

b) Profit and risk

- **Maximum profit:** Unlimited on upward price movement and limited to the credit received if the price moves downward.
- **Maximum risk:** The difference between the strike prices minus the premium collected.

c) Breakeven prices

- **Downward breakeven:** Strike price of the short call plus the credit received.
- **Upward breakeven:** Strike price of the short call plus two times the difference between the strike prices, minus the initial credit.



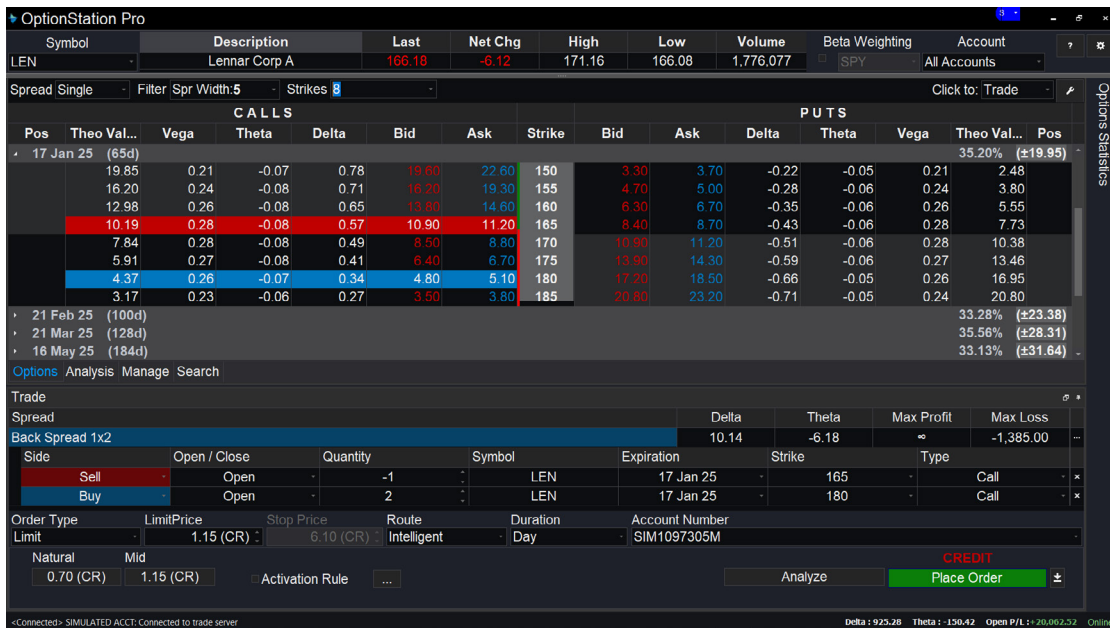
Watch the Webinar – “Ratio Back Spreads: Trading Explosive Price Swings with Options”. Discover how this technique may strengthen your trading approach and gain actionable insights to help you confidently apply it in various conditions.

Trade example: Call ratio back spread

Lennar Corporation (LEN) appeared in the RadarScreen® filter on the ratio back spread workspace. The company will release an earnings report in 30 days. The implied volatility is relatively low, and there is a weekly uptrend that should accelerate with a positive earnings report.



We will use the January 17 calls since they will still have over 30 days before expiration after the earnings event, reducing the effect of time decay on the spread.



Breakeven analysis

The two breakeven prices are:

- \$166.15: Calculated as the short 165 strike plus the premium received.
- \$193.85: Calculated as the short 165 strike plus twice the 15-point spread minus the premium received.



Maximum loss

A maximum loss of \$1,385 will occur if the underlying stock is at the long strike of 180 at expiration.

Profit potential before expiration

The trade may not be held until its expiration. If the earnings report results in a significant price movement, the position may be closed for a profit when it has more than 30 days to expire.

Post-earnings breakeven points

Adjusting the plot to the day after the earnings release, the price slices on the risk profile in the trade analysis show that before the time value erodes, the updated breakeven prices are at:

- \$149.06 and \$182.22.
- These breakeven points require a smaller price movement to profit than if held to expiry.



Trade management

The position can be closed manually or managed with an activation rule. For example, you can attach an exit order that triggers when a certain profit or loss has been achieved. This approach demonstrates how to adapt the trade to market conditions and capitalize on price movement following an anticipated earnings event.

Put ratio back spread

A put ratio back spread is most effective when expecting substantial downward price movement.

a) Structure

- Sell one put option at a higher strike price.
- Buy two or three put options at a lower strike price.

b) Profit and risk

- **Maximum profit:** Unlimited to zero on downward movement and limited to the credit received on upward movement.
- **Maximum risk:** the difference between the strikes minus the premium collected.

c) Breakeven prices

- **Upward breakeven:** The short put's strike price minus the credit received.
- **Downward breakeven:** The short put's strike price minus two times the difference between the strike prices plus the initial credit.

Trade example: Put ratio back spread

Adobe Inc. (ADBE) appeared in the RadarScreen filter on the ratio back spread workspace. The company will release an earnings report in 28 days. The price is in a sideways channel and is nearing an open gap that may cause it to drop due to a lack of buying pressure. There is a chance that the price may fall again from a disappointing earnings report, as it did last quarter.



The put ratio back spread will be created using options that expire in 65 days. This will allow for action in the trade after the earnings release while the options have more than 30 days to expire, reducing the effect of time decay on the long options.

OptionStation Pro														
Symbol	Description	Last	Net Chg	High	Low	Volume	Beta Weighting	Account						
ADBE	Adobe Inc	538.00	11.58	539.92	520.59	2,019,535	SPY	All Accounts						
Spread Single - Filter Spr Width:5 - Strikes 8 - Click to: Trade														
CALLS							PUTS							
Pos	Theo Val...	Vega	Theta	Delta	Bid	Ask	Strike	Bid	Ask	Delta	Theta	Vega	Theo Val...	Pos
13 Dec 24 (30d)	Weekly												42.08%	(±52.13)
20 Dec 24 (37d)	Weekly												40.35%	(±55.51)
27 Dec 24 (44d)	Weekly												38.17%	(±57.26)
17 Jan 25 (65d)													35.50%	(±64.76)
	38.33	0.85	-0.27	0.64	43.70	44.40	520	21.05	21.45	-0.36	-0.20	0.85	16.34	
	35.38	0.87	-0.27	0.61	40.85	41.70	525	23.15	23.60	-0.38	-0.21	0.87	18.37	
	32.58	0.88	-0.28	0.59	38.15	38.70	530	25.35	25.90	-0.41	-0.21	0.88	20.55	
	29.93	0.89	-0.28	0.57	35.50	36.00	535	27.75	28.30	-0.43	-0.21	0.89	22.89	
	27.43	0.90	-0.28	0.54	32.95	33.45	540	30.20	30.80	-0.46	-0.21	0.90	25.38	
	25.07	0.91	-0.28	0.52	30.60	31.10	545	32.95	33.45	-0.48	-0.21	0.91	28.02	
	22.87	0.91	-0.28	0.49	28.35	28.90	550	35.70	36.25	-0.51	-0.20	0.91	30.82	
	20.81	0.90	-0.28	0.47	26.25	27.35	555	38.50	39.15	-0.53	-0.20	0.90	33.76	
Trade														
Spread										Delta	Theta	Max Profit	Max Loss	
Back Spread 1x2										-31.03	-20.35	49,360.00	-3,140.00	
Side	Open / Close	Quantity	Symbol	Expiration	Strike	Type								
Sell	Open	-1	ADBE	17 Jan 25	540	Put								
Buy	Open	2	ADBE	17 Jan 25	525	Put								
Order Type	Limit Price	Stop Price	Route	Duration	Account Number									
Limit	16.40	16.40	Intelligent	Day	SIM1097305M									
Natural	Mid	Activation Rule												
17.00	16.25													
Trade														
Delta : 941.15 Theta : -93.41 Open P/L : 23,477.20 Online														

Breakeven analysis

- The put ratio spread is opened for a credit, unlike the call ratio back spread example.
- The breakeven prices are calculated as usual, but the maximum risk is the difference in strikes plus the premium paid. This would be realized if the options expired with the underlying at the long strike.



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Earnings day adjustment

The risk profile improves when we adjust the plot to the day after the earnings release. Instead of breaking even, if ADBE is at \$493.50, the spread theoretically profits \$1,183. It's important to note that this is an estimate, and the real-world results may differ.



Less time decay leads to different break-even prices and profit or loss values. The position should be actively managed and can be exited when sufficient profit is achieved or when nearing the maximum acceptable loss. Attaching a take profit and stop loss order after opening the position can help automate these decisions and enhance risk management.

Position management strategies

Successful ratio back spread trading requires active position management. Before entering the trade, traders should establish clear profit targets and stop-loss levels to maximize potential gains while minimizing risk.

Profit targets

A common approach is to take profits when the position reaches 50-70% of its maximum potential profit, as holding for the last portion of potential profit often exposes the position to unnecessary risk.

Automating exits

A profit target and stop loss order can be placed once the ratio back spread has been entered. An order to exit can be placed and set to trigger by using the activation rule feature. For more information, visit [Placing activation rules on options orders](#) in TradeStation's Options Education Center.

Monitoring implied volatility

Monitoring changes in implied volatility is crucial, as significant changes can affect the position's profitability even if the underlying asset moves in the anticipated direction.

Rolling positions

Traders should also consider rolling positions when approaching expiration to avoid the accelerated time decay of the long options.

These strategies can enable traders to effectively manage ratio back spreads and optimize their outcomes.

Conclusion

Ratio back spreads offer traders a sophisticated way to express directional views while maintaining defined risk parameters. Success with this strategy requires a thorough understanding of options mechanics, careful attention to market conditions, and disciplined position management. While the strategy presents certain risks, its unique characteristics make it a valuable tool in the right market environment.



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