

DIAGONAL SPREADS

101



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Intro + Foundation

Introduction to Diagonal Spreads

- Diagonals are extremely flexible since you can tweak so many components
- At times known as **Poor-Mans Covered Call**
- Diagonal = hybrid between **calendar** and **vertical** spreads
- Profits from **time decay**, **directional movement**, and potentially **volatility expansion**
- Involves selling a short-dated option and buying a longer-dated option at a *different* strike

Where Diagonals Fit In Your Portfolio?

- Since diagonals are very flexible it depends what you want to use them for (this makes it complex)
- Do you want to use them as a long-investment?
- Do you want to use them as a hedge or defense?
- Maybe you want a double diagonal and use them for non-directional trades?

How Diagonals Work

- **Sell** a short-term option to collect premium
- **Buy** a longer-dated option for directional exposure
- Typically a **net debit** trade (you pay to enter)
- Best suited for **directional trades with time decay working in your favor**

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Diagonal vs Calendar vs Vertical

- **Calendar:** same strike, different expiration
- **Vertical:** same expiration, different strike
- **Diagonal:** different strike **AND** different expiration

Types of Diagonals

- **Call Diagonal:** bullish bias
- **Put Diagonal:** bearish bias
- Can use the inverse as well such as selling OTM Call Diagonals for a bearish bias

Setup, Execution, & Adjustments

Step 1: Ticker Selection

- Plan how you want to use your diagonal (income strategy, theta, a hedge, etc)
- Use liquid tickers: SPY, SPX, QQQ, IWM, TSLA, MSFT, UBER, ROKU, SHOP, ZM, NVDA, PYPL, ETC.
- Avoid earnings week

- **Step 2: Liquidity**

- Ensure both legs have **tight bid/ask spreads**
- Open interest and volume should be decent on both expirations
- Choose tickers with narrow spreads and reliable price action

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Step 3: Expiration Selection

- Common Stocks: 10-17, 17-23, 23-31, 31-38, 38-45
- SPX / SPY Ideas: 10-13, 15-17, 17-20, 23-27, 31-34
- Wider separation increases theta, but creates more risk
- More time = more flexibility to roll or adjust

Step 4: Choosing the Strike Prices

- **Directional intent defines the strike**
 - Start with an ATM calendar
 - Start skewing the direction (What do you want?)
 - Then shift the diagonal left or right
- Create a **gentle slope** between strikes to collect premium

Step 5: Debit Paid

- Think about the type of diagonal you are creating
- Is it more like an ATM Vertical? Then be comfortable with most of the loss
- Is it more like selling OTM vertical? Then the risk will be great with a minimal reward
- Are you looking to campaign it - selling weekly options against it each week?

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Step 6: IV Considerations

- Diagonals benefit from **IV increase**, especially on the back leg (since you are BUYING an option)
- Rising IV helps your long leg retain value
- Avoid selling short legs with extremely high IV unless expecting a crush

Risks, Adjustments, Profit Taking

Profit Target:

- Use vertical profit target concepts depending on your diagonal setup
- Example an ATM diagonal you might aim for 15-20% of the risk or 40-50% if you had more decay
- OTM diagonal you are looking for decay to kick in, but don't want it to overshoot

Closing the Diagonal

- You can close the whole spread or **roll the short leg** to extend the trade if you are doing a **campaign diagonal**
- Best to close **before short leg expires**, especially if price is nearing the long leg's strike
- **Close as a full-diagonal!**

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Rolling the Short Leg

- Roll up/down/out for more credit or to reset directional exposure
- When rolling - this can be often confusing and only do this if you are more advanced!
- You can always close the spread and reset it

Taking a Loss

- Managing the losses - use the same principle as the profit taking spots.
- If it's a risk 1 to make 1 (1:1 risk to reward) then you should be comfortable with most of the loss
- If its different, then you have to tweak
- Diagonals are directional - don't let them turn into prayers

Managing Assignment Risk

- ⚠ Stocks with **short in-the-money options** near expiration have **assignment risk!**
- **Roll or close** before expiration to avoid assignment
- Cash-settled indices like SPX you don't have to worry until expiration

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Capital Allocation

- Defined-risk trades — easy to cap downside
- Spread your trades across **multiple tickers or sectors**
- Spread them on different days
- Don't load up on short-dated diagonals in the same direction — diversify time and direction

When to Be Cautious with Diagonals

- In extremely high IV environments
- When IV extremely skewed (short leg IV > long leg IV)
- On choppy, directionless markets unless you're ATM or planning to scalp premium