190 S. LaSalle Suite 3000 Chicago, IL 60603 1-888-TRADE01 1-888-872-3301 (tel:1-888-872-3301) ctaylor@optionpit.com

When Being Neutral Is The Best Trading Policy

JANUARY 22, 2022 (HTTPS://OPTIONPIT.COM/WHEN-BEING-NEUTRAL-IS-THE-BEST-TRADING-POLICY/) BY MARK SEBASTIAN (HTTPS://OPTIONPIT.COM/AUTHOR/MARK-SEBASTIAN-2/)

Hey Traders,

You have almost certainly heard of delta … the option Greek that tells you how much the price of an option will move with a $1 change in the underlying.

But my Big Money Flow members have heard me talk a lot about trades that are *delta neutral*.

Trading delta neutral involves active trade management … but it is something many Big Money traders engage in.

Why? How does it benefit them?

What the heck is delta neutral, anyways?

Let's take a look.

Neutral Party

Before we dig into neutralizing delta, let's go over a quick review of what delta actually is.

Simply put, an option's delta tells you how much the price of an option will move for every $1 change in the underlying.

Call options have deltas between 0.00 and 1.00, while put deltas range from -1.00 to 0.00.

Typically, at-the-money options have deltas near 0.5, or -.50. The farther in-the-money you go, the delta moves closer to 1.00 (or -1.00).

c...	cMIDIV	cBID	cASK	STRIKE	pBID	pASK	pM...	p...
0.80	43.50	14.25	14.60	DIS Feb18 125.00	1.91	1.97	43.60	0.20
0.71	40.95	10.40	10.65	DIS Feb18 130.00	2.95	3.05	40.74	0.29
0.59	38.28	6.95	7.25	DIS Feb18 135.00	4.55	4.70	38.43	0.41
0.45	36.43	4.35	4.50	DIS Feb18 140.00	6.85	7.00	36.41	0.55
0.31	35.20	2.51	2.57	DIS Feb18 145.00	9.90	10.15	35.06	0.69
0.20	34.62	1.34	1.39	DIS Feb18 150.00	13.75	13.95	34.41	0.80

So if you have a call option on DIS with a delta of 0.50, if DIS share price rises $1, the value of your option should increase by $0.50.

If you have a DIS put option with a delta of -0.50, then your put option will lose $0.50 if DIS rallies $1, but will gain value if DIS falls.

Now, delta represents directional risk – because your position will gain or lose value depending on the direction of the underlying.

Trading delta neutral is when you want to reduce your directional risk by adding an opposing position that brings the total delta closer to zero.

This is something that is often done by professional traders, like market makers or institutional investors. It requires active management of your positions, because an option's delta is constantly changing.

How does this actually work?

Say you are long 10 contracts of DIS calls with a delta of 0.50. To calculate the overall delta exposure, you would multiply the delta 0.50 * 100 (shares per contract) * 10 (number of contracts).

This would give you an overall delta of 500. So for every $1 DIS moves, your position would gain (or lose) $500.

But say you want to reduce your directional risk (we will talk about some of the reasons why you may want to do this in a minute), and make your position delta neutral.

How do you do this?

Well, since the position has positive delta, you can hedge with positions that will have negative delta. For example, you could buy long puts (or open a long put spread), short calls (or even a short call spread), or short stock. Shares of an underlying always have a delta of 1, so buying long stock will increase your delta by 1, while shorting stock will decrease your delta by 1.

In this case, with a delta of +500, you could short 500 DIS shares to bring your total position to delta neutral.

Let's say your original position was puts, and your original delta was -500. In this case, you could buy long stock, or buy calls or short puts to bring in positive delta, and move your overall delta risk closer to 0.

So, we have established that being delta neutral reduces your directional risk.

But why would you want to do this?

Well, traders such as market makers and other institutional investors may have different goals with their trading. For example, market makers may want to profit from buying cheap options and selling more expensive options, so their goal is not so much to profit off of price changes in the underlying. Therefore reducing their directional risk is in line with their goals.

If you can hedge out the directionality of an option, then you are limiting your risk exposure to other factors in the options pricing model, such as time decay (theta) and volatility (vega).

So for example, let's say you think volatility in DIS will go up, but you don't want directional exposure to the stock. By trading delta neutral, you can profit from increasing volatility without taking on a bunch of directional risk.

Alternatively, delta-neutral hedging can help protect your portfolio against price fluctuations in a stock. So if you are bullish on a stock in the long-term, but concerned about near-term price action, a delta neutral strategy is one way to help protect against downside.

The downside to this of course is that you are limiting your profit potential by neutralizing your delta … but you are also limiting your potential losses, so there is a trade-off in both directions.

Let's take a look at a real-world example.

Here is a Big Money trade on DraftKings (Ticker: DKNG) that crossed the tape on Friday, as DKNG was trading around $20.10 …

TIME	SYMBOL	OPTION	▼ QTY	PRICE
11:06:08.345	DKNG	DKNG Apr14 20.00 P	27,000	3.18
11:06:08.345	DKNG	DKNG Apr14 25.00 C	27,000	1.61

This trader purchased 27,000 contracts of the April 20-strike put for $3.18, and sold the same number of 25-strike call contracts for $1.61.

This trade is known as a risk reversal, and what they did here was essentially create a synthetic short.

Does this mean they are bearish? No.

Instead, this seems to be someone who wants to get long, and who is collaring that position to reduce their risk.

This trade had a -0.78 delta, and this trader now holds 27,000 contracts.

What does that make the total delta exposure here?

-0.78 * 100 * 27,000 = -2,106,000

So to make this position delta neutral, you would need to buy 2,106,000 DKNG shares.

And wouldn't you know it …

TIME	SYMBOL	▼ Q...	PRICE
11:06:08.492	DKNG	2,106,000	20.1000

At the same time this trade went through, a block of 2,106,000 DKNG shares crossed the tape, too!

Now this trader is able to hold their long DKNG shares, but if DKNG happens to struggle in the near-term (which, if you take a look at its recent chart, is not out of the question …) …

This trader won't be losing $2,106,000 of value for every dollar DKNG drops (although the sold calls do limit potential upside).

Like I mentioned, delta hedging does take a lot of hands-on management to successfully pull off, since deltas are dynamic and change throughout the trading day.

But knowing how to watch and manage your own portfolio's delta is a crucial skill to maintaining your portfolio's "health" and making sure you aren't taking on more directional risk than you can handle.

Your Only Option,

Mark Sebastian

- **PIT REPORT (HTTPS://OPTIONPIT.COM/CATEGORY/PUBLIC/)**

This site uses Akismet to reduce spam. Learn how your comment data is processed (https://akismet.com/privacy/).

[clickfunnels_clickpop id="6q03uc7ijutj15oz" subdomain="options"]Your Content[/clickfunnels_clickpop]

More Information

- Privacy Policy (https://optionpit.com/privacy-policy/)
- Disclaimer (https://optionpit.com/disclaimer/)
- Terms and Conditions (https://optionpit.com/terms-and-conditions/)
- Contact Us (/contact-us/)
- Refund policy (https://optionpit.com/refund-policy/)

Learn to Trade Options & Become Your Own Money Manager.

An educational site dedicated to helping individual investors and traders learn the skills they need to succeed in today's complex financial markets.