

Payoff Diagrams

If you can't draw the payoff, you don't know the trade.

Every payoff diagram answers two questions: the floor, and how far price must move to beat it.

TERMS

Payoff diagram: A picture of a trade: stock price at expiration on one axis, dollar result on the other.

Breakeven: The stock price where the position first nets zero, not a profit yet.

Defined risk: The maximum loss is known and capped before you enter the trade.

Hockey stick: The payoff shape: flat floor, a kink at the strike, then a rising line.

Kink: The bend in the line right at the strike price, where the right starts to matter.

BEFORE YOU ACT, CHECK

- ☐ Where's the flat floor, and what max loss does it show?
- ☐ Where's the kink, and does it sit at the strike?
- ☐ Which way does the line rise: right for a call, left for a put?
- ☐ Have I found breakeven before entering?

QUICK RECALL

1. What is the breakeven of a long call at expiration?
Strike price plus the premium paid. The call buyer only nets positive once the stock clears both.
2. What does a defined-risk payoff mean?
The maximum loss is known and capped before you enter. The floor on the diagram shows that worst case up front.

NUMBERS

Long call breakeven	strike + premium paid	\$50 call, \$2 premium: breakeven = \$52.
Long put breakeven	strike - premium paid	\$50 put, \$2 premium: breakeven = \$48.
Worked example (put)	same formulas, plain numbers	\$60 put for \$3.50: breakeven \$56.50, max loss \$350 per contract.

THE TRAP

"The diagram shows what the stock will do."

A payoff diagram shows the shape of a position at expiration, not a forecast. It answers two things: the worst case, and how far the stock must move to beat it. It never predicts the outcome.

CARRY FORWARD

- Long call: flat floor at minus premium, kink at strike, rises to the right. Breakeven = strike + premium.
- Long put: flat floor at minus premium, kink at strike, rises to the left. Breakeven = strike - premium.
- Both are defined-risk: the floor tells you the max loss before you enter.

Next: Module 1.7 Max Loss, Max Gain, and Stating Risk
First: naming the worst case out loud before every trade.

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