Institute of Trading and Portfolio Management

Professional Options Trading Masterclass Video Series

POTM

Video 12

Option Spreads 1 - Bull Call Spread

Bull Call Spread

Quick Explanation

Buying a Call Option and Selling a Higher Strike Call Option where both contracts have the same time to expiration.

The Bull Call Spread is one of the most useful Options Trading Strategies for Retail Traders because it is relatively simple, requiring just two transactions to implement and the risk is limited to premium paid. It is primarily used when the outlook on an underlying Stock is Bullish, and the expectation is that the Stock will increase in price to a certain range in the time frame of the contracts traded, but no higher than a certain level. It's often considered a cheaper alternative to the Long Call Options Strategy, because it involves Writing Calls to offset some of the cost of Buying Calls. The trade-off with doing this is that the potential $ profits are capped on the upside (limited). The main reason why you would use this Strategy is to try and profit from a Stock increasing in price. You would typically use it when you expected the price of an asset to increase by a certain amount, but not dramatically (as the profit potential is limited). The strategy is basically designed to reduce the upfront costs of buying Calls so that less capital investment is required, and it can also reduce the effect of time decay.

- **Directional Bet**
- **Bullish Strategy**
- **Simple**
- **Two Transactions**
- **Debit**
- **Max Risk (Limited)**
- **Max Gain (Limited)**

When to Use the Strategy

Buying a Call Option and Selling a Higher Strike Call Option where both contracts have the same time to expiration.

The main reason you would use a Bull Call Spread is because you are Bullish the underlying Stock and you expect it to rise in price but not above a certain level by the time of expiration of the two Call Option contracts you have bought and sold. The point of this is to get a marginal benefit of being Long the Call Option versus simply owning Stock and to reduce the upfront cost of the Long Call Option Contract by writing a higher Strike Call to the one you have bought. There will be a net Debit (premium) paid over the two transactions because the Long Call Option you have bought is nearer the Money than the one you have sold and is therefore more “expensive” / higher priced. However, the cost of a Bull Call Spread is lower than simply being Long a Call. You are paying for the Lower Strike Call (Debit) and receiving a Credit for writing the higher Strike Call. The net effect is still a net Debit but the cost is reduced. The trade-off here versus paying more for a simple Long Call Option Strategy is that your upside is capped. So, you need to be confident of the Call Option Strike that you sell that the Stock will not rally more than that Strike price by the time of expiration in order to maximise your gain. If the underlying stock rallies above the Strike you have sold, the Calls you have Sold will be In The Money (ITM) as to will your lower Strike Calls, but your Profit would be lower than if you had been just Long the Stock. It could then be argued that the Marginal benefit of putting the strategy on over simply buying Stock diminishes. However, it is still true that the downside of putting the Bull Call Spread on versus simply buying Stock still has a marginal benefit because the downside is limited to the net premium you pay for the spread. So, if the underlying stock falls and both contracts expire worthless you have only lost the premium you have paid for the spread (limited Downside), whereas if you were Long Stock, this may have required more capital and you could have lost a lot more. This is why the Bull Call Spread is ranked high in usefulness for Retail Traders. The $ upside may be limited but the $ risk is also limited. Additionally, it is a simple strategy and it is a Directional Bet. So, the Bull Call Spread Strategy has high usefulness in the specific situations that it can be used for.

How to Use the Strategy

There are two main ways to use the strategy. We can buy an At The Money (ATM) Call and sell a higher Strike Call or we could buy an Out of the Money (OTM) Call and Sell a Higher Strike Call. In both scenarios there needs to be a marginal benefit in doing so over simply being Long Stock. The marginal benefit comes from a Risk Reward analysis of the specific fundamentals you are looking to expose yourself too and capital considerations. If you are expecting a moderate rise by the time of expiration of both contracts in the underlying Stock then it would better to either own Stock or buy an ATM Call and Sell a higher Strike Call. You must believe that the Strike you sell will be the price that the Stock will go to but no higher than that price. If you expect an explosive rise in the Stock price by the time of expiration of both contracts you may be better off (but not always) buying an OTM Call (say 3-5%) and selling a higher Strike that you believe even though you expect the Stock to rally aggressively, the Stock

will settle as close to the higher Strike as possible by expiration but no higher. The biggest decision you need to make therefore when putting on the Bull Call Spread is the Strike that you choose for the Calls that you write.

With the Bull Call Spread you are making money in two ways. You are making profit on the Calls you are going Long as the underlying Stock Price goes up. But you are also making money on the Calls you have written due to time decay. The ideal scenario is that the price of the underlying security goes up to around the strike price of the written options contracts, because this is where the maximum profit is. If the underlying security continues to go up in price beyond that point, then the written contracts will move into a losing position. Although this won't cost you anything, because the options you own will continue to increase in price at the same rate. The spread will lose money if the underlying security doesn't increase in price. Although you will profit from the short position, as the contracts you have written will expire worthless, the options you own will also expire worthless. The potential losses are limited though, because you cannot lose any more than the cost of putting the spread on.

You have the chance to make a bigger Return On Investment (ROI) than you would by simply buying Calls, and also you will have reduced losses if the underlying security falls in value. This is a simple Risk Reward strategy and comparison to simply being Long Calls or being Long Stock, which appeals because you know exactly how much you stand to lose at the point of putting the spread on and exactly how much you stand to make. The disadvantages of are limited, which is perhaps why it's such a popular strategy. There are more commissions to pay than if you were simply buying calls, but the benefits mentioned above should more than offset that minor downside. The only other real disadvantage is that your profits are limited and if the price of the underlying security rises beyond the strike price of the short call options you won't make further gains.

Another use for a Bull Call Spread could be to Hedge a Short Stock Position. By Buying an ATM or slightly OTM Call Option and selling a higher Strike Call this would lower the cost of a simple Long Call Hedge against a Short Stock Position. However again the $ upside would be capped but at least if there is a Short squeeze in the Stock that was unexpected you would save losing money on your Short Stock position and will have increased ammunition to Short more into a technical squeeze (Fundamentals don't change) if it made sense to do so. As the $ downside on a Short Stock position is theoretically unlimited, this is another reason why this Directional bet has high usefulness for Retail Traders as it can act as an effective hedge on Short Stock positions and add significant value to your overall portfolio.

Break Even

Leg A = Buy ATM or OTM Call Option, Leg B = Write Higher Strike Call Option

Break-even point is when Price of Underlying Security = Strike Price Leg A + (Price of Options Leg A – Price of Options Leg B)

Profit Calculations (Maximum Upside)

Maximum profit is limited

Maximum profit is made when **Price of Underlying Security > or = Strike Price Leg B**

Maximum profit per option owned is **(Strike Price Leg B – Strike Price Leg A) – (Price of Option Leg A – Price of Option Leg B)**

Risk Calculations (Maximum Downside)

Maximum loss is limited

Maximum loss is made when **Price of Underlying Security < or = Strike Price Leg A**

Maximum loss per option owned is **Price of Option Leg A – Price of Option Leg B**

Strategy Example

Here we have provided an example of the Bull Call Spread strategy, showing how it would be used and a few potential outcomes at the point of expiration. Please be aware this example is purely to provide a rough overview of how it can work and it doesn't necessarily use exact prices. For the purposes of this example we have ignored the commission costs.

- Company X stock is trading at $50, and you expect it to increase in price but by no higher than $53.
- At The Money (ATM) Calls on Company X stock (Strike Price $50) are trading at $2 and Out of The Money (OTM) calls on Company X stock (strike price $53) are trading at $0.50.
- You buy 1 Call contract with a Strike price of $50 and Expiration Date of Feb' 22nd (4 weeks from now) at a cost of $200 (One contract = 100 shares). This is Leg A.
- You write 1 Call contract with a Strike Price of $53 and Expiration Date of Feb 22nd for a credit of $50 (One contract = 100 shares). This is Leg B.

- You have created a Bull Call spread for a net debit of $150.

If Company X stock increases to $53 by expiration

The options you bought in Leg A will be In The Money and worth approximately $3 each for a total of $300. The ones you wrote in Leg B will be at the money and worthless. Taking into account your initial investment of $150, you have made a total profit of around $150.

If Company X stock rose even higher than $53, your profits wouldn't increase above the $150, because the short position would start to cost you money.

If Company X stock increases to $52 by expiration

The options you bought in Leg A will be In The Money and worth approximately $2 each for a total of $200. The ones you wrote in Leg B will be out of the money and worthless. Taking into account your initial investment of $150, you have made a total profit of around $50.

If Company X Stock stays at $50 or falls, by expiration date Feb 22nd.

Your contracts would both expire worthless, and you would lose your initial investment. You will have no further returns to come and no further liabilities, but you have lost your initial $150 investment. No matter how far Company X Stock fell, your loss would still be limited to the initial $150 investment.

Remember: You can close your positions at any time prior to expiration if you want to take your profits at a particular point, or cut your losses. Also, you can increase the profit potential of the spread by writing the options in Leg B with a higher strike price.