

Professional Options Trading Masterclass Video Series

POTM

Video 18

Ladder Spreads 1 – Bull Call Ladder Spread

Bull Call Ladder Spread

Quick Explanation

Buy 1X At The Money or Slightly Out of The Money Call Option and Write 2X higher Strike Calls (with differing Strikes) for the same expiration.

The Bull Call Ladder Spread Strategy as the name suggests is a Bullish Directional Strategy. It is very similar to the Bull Call Spread in which the aim is to profit from a move higher in the underlying Stock price by owning Call Options but at the same time doing this in a less costlier way than simply owning Call options, by writing a higher Strike Call Option at a Strike price that you believe the Stock will not go higher than by the time of expiration of the 2X Call Option contracts. The only difference between the Bull Call Spread and the Bull Call Ladder Spread is the amount of transactions that are required to establish the trade, the ratio by which Call Options are written and the cost of doing so. In the Bull Call Spread the amount of transactions is 2X i.e. Buy 1X Call Option and Sell 1X higher Strike Call Option with the same expiration. With the Bull Call Ladder Spread, there are 3X transactions. Buy 1X Call Option and Sell 2X Higher Strike Calls at different Strikes. The Strategy can be put on for a small Debit or even a Credit.

- **Directional Bet**
- **Bullish Strategy**
- **Simple**
- **Three Transactions**
- **Debit or Credit**
- **Max Risk (Medium-Unlimited)**
- **Max Gain (Limited)**

When to Use the Strategy

Buy 1X At The Money or Slightly Out of The Money Call Option and Write 2X higher Strike Calls (with differing Strikes) for the same expiration.

Putting on a Bull Call Ladder Spread versus establishing a Bull Call Spread, a Long Call Option or simply owning Stock is essentially a trade off between upfront cost (Debit or Credit) and forgone profit opportunity. It is a useful strategy incrementally for Retail Traders because if you can get it on at good prices and you have a very high degree of certainty that the underlying Stock will not rise by expiration above a certain price, it will be a lower priced strategy (Debit or Credit) than simply buying a Bull Call Spread (Debit) or owning an outright Long Call Option position (Debit). The only problem is if the underlying Stock does go higher than both the higher Strikes of the Calls you have written, you will still make money (if the underlying stock doesn't rally too much), but less than simply owning a Bull Call Spread or a Long Call Option or simply owning Stock. If the underlying Stock does rally too much you can actually lose money on the trade. So even though the profits here are limited the risk is theoretically unlimited. Though, only unlimited in the sense that it would have to be in extraordinary circumstances that you lose a lot of money on the trade, which is why we rank this strategy as High as it can be used in many circumstances for incremental added portfolio value by Retail Traders as the cost of the strategy is low or even beneficial in the receipt of a Credit. You can also always buy back one or both Call Options you have written if you believe the Stock is going to rally higher than the Strikes you have written by expiration. So, there is a degree of flexibility here.

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 2X higher Strike Calls at differing Strikes or we could buy a slightly Out of the Money (OTM) Call and Sell 2X Higher Strike Calls at differing Strikes. In both scenarios there needs to be a Marginal Benefit in doing so over simply putting on a Bull Call Spread, a Long Call or simply owning Stock. The marginal benefit comes from a Risk Reward analysis of the specific fundamentals you are looking to expose yourself to and capital considerations. The Capital consideration is fairly straight forward as it would be a lot lower capital (margin) requirement to put on a Long Call, Bull Call Spread or Bull Call Ladder Spread than to simply own Stock. The opportunity cost of doing so is where the real value add to your portfolio (or not) arises i.e. the risk reward versus other Options Strategies. If you are expecting a moderate rise in the underlying Stock by the time of expiration of both legs of the trade then it would be better to either own Stock or buy an At The Money (ATM) Call and Sell a higher Strike Call as a Bull Call Spread or buy an At The Money Call and writing 2X differing higher Strikes thus establishing a Bull Call Ladder Spread rather than buying an Out of The Money Call and writing a higher Strike Call establishing a Bull Call Spread or an Out of the Money Call and establishing a Bull Call Ladder

Spread by writing 2X higher strike calls. This is because your view is that the stock is not going to move much higher, so why buy an Out of the Money Call and lower your chances of maximizing profitability? It doesn't make any sense to do so. As with the Bull Call Spread really the most important thing for a Bull Call Ladder Spread to add incremental value to your portfolio and hence to maximize "usefulness" and profitability, you must believe with the Bull Call Ladder Spread that the Strike of the lower Strike Call 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 and selling the 2X higher Strikes that you believe the underlying Stock will not rally beyond in the case of the lower Strike Call you sell. It is the same principle as before when you expected a moderate rise in the stock, except now you're expecting an aggressive rally in the stock. The point is, regardless of your view on how aggressive or moderate the rally will be, profit is maximized when the underlying stock settles at or as close to the Strike price of the lower Strike Call you sell by the time of expiration. The biggest decision you need to make therefore when putting on the Bull Call Ladder Spread is the Strikes that you choose for the Calls that you write. The lower Strike Call needs to be the level that you genuinely believe the Stock can not rally beyond and the second higher Strike Call you sell must be even higher than this.

With the Bull Call Ladder 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 Lower Strike written Call options contract, because this is where the maximum profit is. If the underlying security continues to go up in price beyond that point, then the Lower Strike written Call contract will move into a losing position. If the underlying Stock price continues to go even higher beyond the higher Strike Call Option contract you have written, both Call Option Contracts you have written will be losing Money. Remember you have only bought 1X ATM or slightly OTM Call Option at the Lower Strike level and sold 2X Call Options at 2X Higher Strikes. You will still make money by the time of expiration if the underlying Stock settles below the lower Strike Calls you have Written and if it settles between the 2X Strikes you have written. However, if the underlying Stock settles at the time of expiration above both the Strikes you have written your profit will diminish quickly and you could end up losing money because the options you own will NOT continue to increase in price at the same rate as the 2X Call Options contracts you are short. Additionally, 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 problem you have here is Gap Risk. If the market is closed and a materially positive announcement occurs like a Revenue or profit guidance increase from the company or a merger or takeover of the company and the stock opens say 30% higher than the higher Strike you have sold you are going to be in a big hole. Remember though in continuous markets, even if materially positive news comes out, in terms of risk of losing money due to an aggressive rally in the Stock, there is always the flexibility of buying one or both of the Call Option legs you have written back, if you believe the Stock price will settle higher than the lower Strike or higher than both Strikes you have sold. So, there is some degree of flexibility here. If you buy one of them back you will be left with a Bull Call Spread. If you buy both back you will be left with a Long Call position.

With the Bull Call Ladder Spread you have the chance to make a bigger Return On Investment (ROI) than you would by simply buying Calls or a Bull Call Spread, 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 having a Bull Call Spread, 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. However, you cannot know exactly how much you stand to make or lose if the Stock rallies aggressively through both Strikes of the Call Options you have written, although you will have the ability to know roughly, so it's a moot point.

The disadvantages are limited. There are more commissions to pay than if you were simply buying a Bull Call Spread or going Long Calls. Another disadvantage is that your profits are limited and if the price of the underlying security rises beyond the strike prices of Calls you have written, you won't make further gains and you could end up losing money if it rallies aggressively higher. Lastly this strategy does require a larger amount of margin in your Options trading account versus establishing a Bull Call Spread because you are writing 2X as many Calls as you are buying.

Another use for a Bull Call Ladder Spread could be to Hedge a Short Stock Position. By Buying an ATM or slightly OTM Call Option and selling 2X higher Strike Calls..., this would lower the cost of a simple Long Call Hedge or Bull Call Spread against a Short Stock Position and you may even get a Credit for doing so i.e. you get paid to get a Hedge! 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 Stock 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 low cost hedge on Short Stock positions and can add significant value to your overall portfolio.

Strategy Example

Due to the complex nature of the 3X transactions and the variability in the Debit / Credit payment, breakeven, profit / loss calculations it is better to use an example than to use a formulaic process in explaining how the Strategy works.

The first thing you need to do before you use this strategy is to determine what strikes you are going to use. You should probably simply buy at the money calls for the long leg of the spread, but you need to put some thought into the strikes for the two short legs. It is best to write one batch of options with a strike equal to approximately what price you think the underlying security will rise to, but not exceed, and write another batch of options with the next highest strike.

You can use higher strikes if you choose, but these will be a cheaper price, and you won't receive as much credit to offset the upfront cost of the long leg. The advantages of using higher strikes though is that the strategy will require less margin and you can potentially make more profits.

Warning! Do not choose Strikes based on whether you will pay a Debit or receive a net Credit. The Stock wont settle at a particular price at expiration simply because you paid out or received money on the strategy. The Stock doesn't care whether you paid a debit or received a Credit. Choose the Strikes you sell based purely on your view of where the Stock is capped near term NOT based on whether you receive a Credit or not. If it so happens that you receive a net Credit then of course that's a bonus. But if it's a small debit then its still OK!

Remember all three legs should use contracts with the same expiration date.

Let's assume that Company X stock is trading at \$30, and you believe its price will increase up to around \$35, but it will go no higher. You would make the following three transactions.

- Buy At The Money Calls based on Company X stock, with a Strike Price of \$30.
- Write the same number of Calls, with a strike of \$35.
- Write the same number of Calls again, with a strike of \$36.

Now let's look at the sums of money involved in creating this spread. Please note, we haven't accounted for any commission costs.

- At The Money Calls (strike \$30) are trading at \$1. You buy 2X contracts, (1 contract = 100 shares), for a total cost of \$200.
- The Calls with a \$35 strike price are trading at \$.30. You write 2X contracts, (1 contract = 100 shares), and receive a credit of \$60.
- The Calls with a \$36 strike price are trading at \$.20. You write 2X contracts, (1 contract = 100 shares), and receive a further credit of \$40.

The upfront cost of \$200 for buying the options is offset by \$100 because of writing the options with a higher strike. In this example, you have created a Bull Call Ladder Spread for a cost of \$100 (Debit). If you received a Credit you would add this onto your Breakeven and Max Profit calculations.

The spread will start to move towards profit as the underlying security (Company X stock in this example) increases in price. The maximum profit will be if the price of the security increases to at least the lowest strike of the Call options written (\$35 in this case) but no higher than the higher strike of the Call options written (\$36 in this case).

If the underlying security increases in price beyond that point, the position will start to reverse and you can lose money if the price goes too high. If the underlying security fails to increase in price, or even falls in price, the maximum loss is the initial investment (\$100).

Company X stock remains at \$30 by expiry

- The Options in the long leg will be At The Money, and will therefore expire worthless. The ones in both the short legs will be out of the money and will also expire worthless. Therefore, you will eat the loss of your initial investment, \$100.

Company X stock increases to \$33 by expiry

- The Options in the long leg will be in the money, and worth around \$3 each. You implicitly own a total of 200 shares, meaning the Options contracts are worth \$600.
- The Options in both the short legs will be Out of The Money and they will expire worthless

- Your profit will be the \$600, minus your initial \$100 investment, for a total of \$500

Company X stock increases to \$35 by expiry

- The Options in the long leg will be In The Money, and worth around \$5 each. You implicitly own a total of 200 shares, meaning the Options contracts are worth \$1,000.
- The Options with a Strike of \$35 will be At The Money, and will expire worthless.
- The Options with a Strike of \$36 will be Out of The Money, and will expire worthless.
- Your profit will be the \$1,000, less your initial \$100 investment, for a total of \$900.
- This is the maximum profit you can make, and it would be the same if the price of Company X stock is anywhere between \$35 and \$36 at the time of expiration.

Company X stock increases to \$40 by expiry

- The Options in the long leg will be In The Money, and worth around \$10 each. Your total holding will be worth \$2,000
- The Options with a Strike of \$35 will be In The Money, and will give you a liability of around \$5 each, for a total of \$1,000
- The Options with a Strike Price of \$36 will be In The Money, and will give you a liability of around \$4 each, for a total of \$800
- Your profit is the value of the options you own minus your liabilities and your initial investment. This would give you a total of \$100 profit.
- If the price of Company X stock increased above \$40, your position would turn into a losing one. Of course, you could always close your position early if the security looked like it would rise by that much. The issue is you have Gap Risk!