New York Securities Pty Ltd

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Generating Income through the Options Market - The Bear Call Spread

The bear call spread is a strategy that can be used to generate income when an investor has a short or long term neutral to moderately bearish view on a stock or index. The spread defines both the profit the investor receives if the strategy is successful and the maximum loss on the trade. It is commonly referred to as a ‘credit call spread‘.

In order to execute the bear call spread the investor will generally sell an out-of-the-money call option (meaning above the current share price or index level) and buy a deeper out-of-the-money call option (the protection). Both call options reflect the same underlying stock or index and the same expiration date.

The premium received for selling the out-of-the-money call option will exceed the price paid for the deeper out-of-the-money call option and the investor will receive the difference between the two as a premium or ‘income’. The maximum loss on the trade is defined by the difference between the two strike prices of the call options ‘the spread’ minus the premium received. Margins are payable on the position.

The bear call spread is executed as follows;

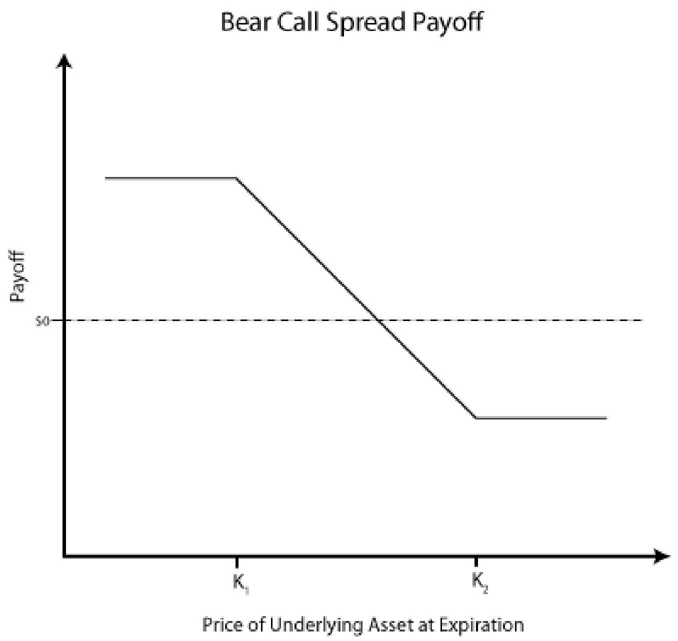
Stock XYZ is currently trading at $47, the investor has a view the stock XYZ will hold its price or fall moderately over the coming month. Additionally the investor is highly confident the stock will not rise above $49.00.

As such the investor sells 10 contracts of XYZ JAN $49.00 call option ($K_1$) for $0.40 and buys 10 contracts of XYZ JAN $49.50 call option ($K_2$) for $0.30. **Note:** Writing the spread at $49.00 has given the investor a $2 buffer between the current share price and the sold leg of the spread.

The income the investor derives from selling the spread is 10 (10 contracts) x $0.10 ($0.40-$0.30) x 1000 (1,000 shares per contract) **=$1,000** (excluding brokerage), representing a 20% return on the trade if successful.

The maximum loss from the trade is $0.50 ($49.50 -$49.00) x 10 (10 contracts) x 1000(1,000 shares per contract) minus the premium received of $1,000 **= $4,000** (excluding brokerage),

The breakeven point is the strike price of the sold call (in this example $49.00) plus the premium received ($0.10), being a XYZ share Price of $49.10



Four possible Scenarios will occur;

1) The XYZ share price trades sideways for the month of January and at expiry closes below $49.00. Both the $49.00 and the $49.50 XYZ JAN call options expire worthless and the investor retains the premium for the month.
2) The XYZ share price falls moderately closing well below the $49.00 XYZ JAN call option on expiry. As such both the $49.00 and the $49.50 XYZ call option expire worthless and the investor retains the premium for the month.
3) The XYZ share price rises above the $49.00 and $49.50 call option on expiry. Both XYZ call options will be valued intrinsically in relation to the share price and the maximum loss for the spread is realised.
4) The XYZ share price finishes in-between the $49.00 and $49.50 XYZ JAN call option on expiry. Both XYZ call options will be valued intrinsically in relation to the share price (i.e. if the share price is $49.25 the intrinsic value of the $49.50 call option is zero and the intrinsic value of the$49.00 call option will be $0.25), and the investor closes out the trade at the best possible price minimising the loss on the trade.

<u>Alternative action prior to expiry</u>

1) If the investors view on the share price or index changes significantly prior to the option expiry date, the investor can close out the position on the market by buying back the spread. The closing transaction relieves the investor of the exposure on the spread and the margin requirements. Additionally the investor can 'leg out' the position to reflect their view of the underlying share price or index level i.e. close out (buy) the sold leg to profit from a rise in the underlying share price or index level.
2) If the share price or index level falls modestly to a level where the theoretical value of the call options are near worthless, the investor may decide to close out (buy) the sold call option consequently removing the exposure and the margin requirements of the spread.

<u>Other risks to consider</u>

Selling a call option gives you the obligation (if assigned) to sell stock at the strike price of the call option. Once the share price rises near or above the sold call before or on expiry, the investor should determine if they are willing to accept the risk of being assigned and the costs associated with a stock transaction. Bearing in mind the investor has the right but not the obligation to buy the same stock at the strike price of the brought call option (the protection) to limit the loss of the trade.

Overall, The bear call spread or 'credit call spread' is an effective strategy that can be used to generate income on a regular basis from a neutral to moderately bearish view on a share price or index level. A spread constructed of out-of-the-money options produces a 'buffer' between the current share price or index level and the price of the sold call option allowing for volatility in the underlying share price or index. Additionally the ability to 'leg out' once the spread trade has been implemented gives the investor flexibility for a change in view in the underlying.

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For more information on this strategy please call New York Securities Pty Ltd on (08) 9363 1700 to speak to an Accredited Derivatives Advisor.

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