11.3 BULL CALL SPREAD STRATEGY

Explainer Video

This strategy is used when we are bullish on the underlying asset. This strategy has limited profit and loss potential. We have to pay a net premium to enter into this trade.

STEPS TO FORM AN BULL CALL SPREAD STRATEGY

BUY

We buy a call option with strike price being lower than the levels that we expect the underlying asset price to reach.

SELL

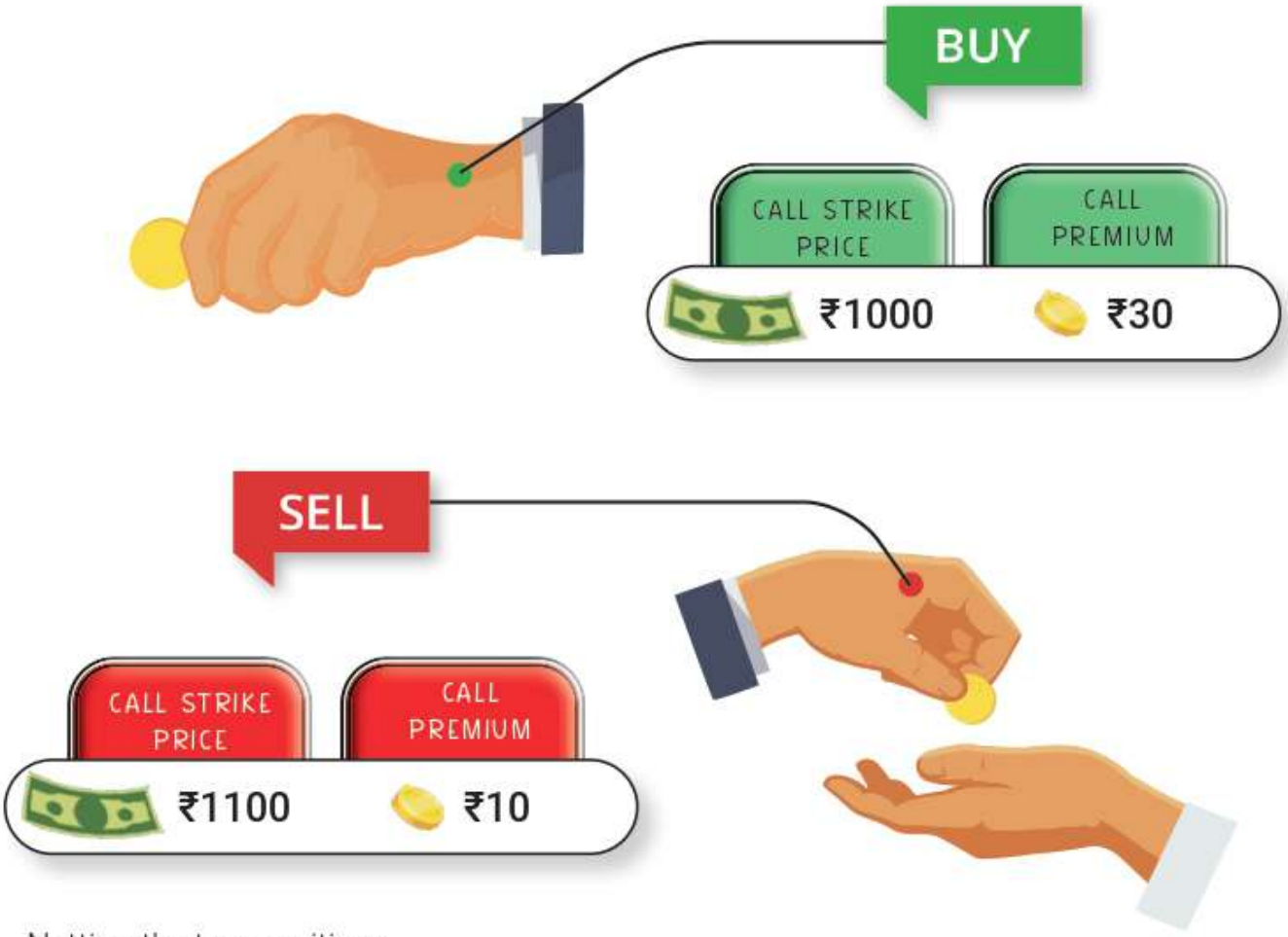
We will sell a call option with a strike price that is higher than the strike price of the option that we have purchased.

MAXIMUM LOSS = PREMIUM PAID ON OPTION 1 - PREMIUM RECEIVED ON OPTION 2

BREAKEVEN POINT = LOWER STRIKE + NET PREMIUM

MAXIMUM PROFIT = DIFFERENCE IN STRIKE – NET PREMIUM

For instance, we buy a call option at ₹1000 at a premium of ₹30 and we sell another call option at ₹1100 for a premium of ₹10.



Netting the two positions.

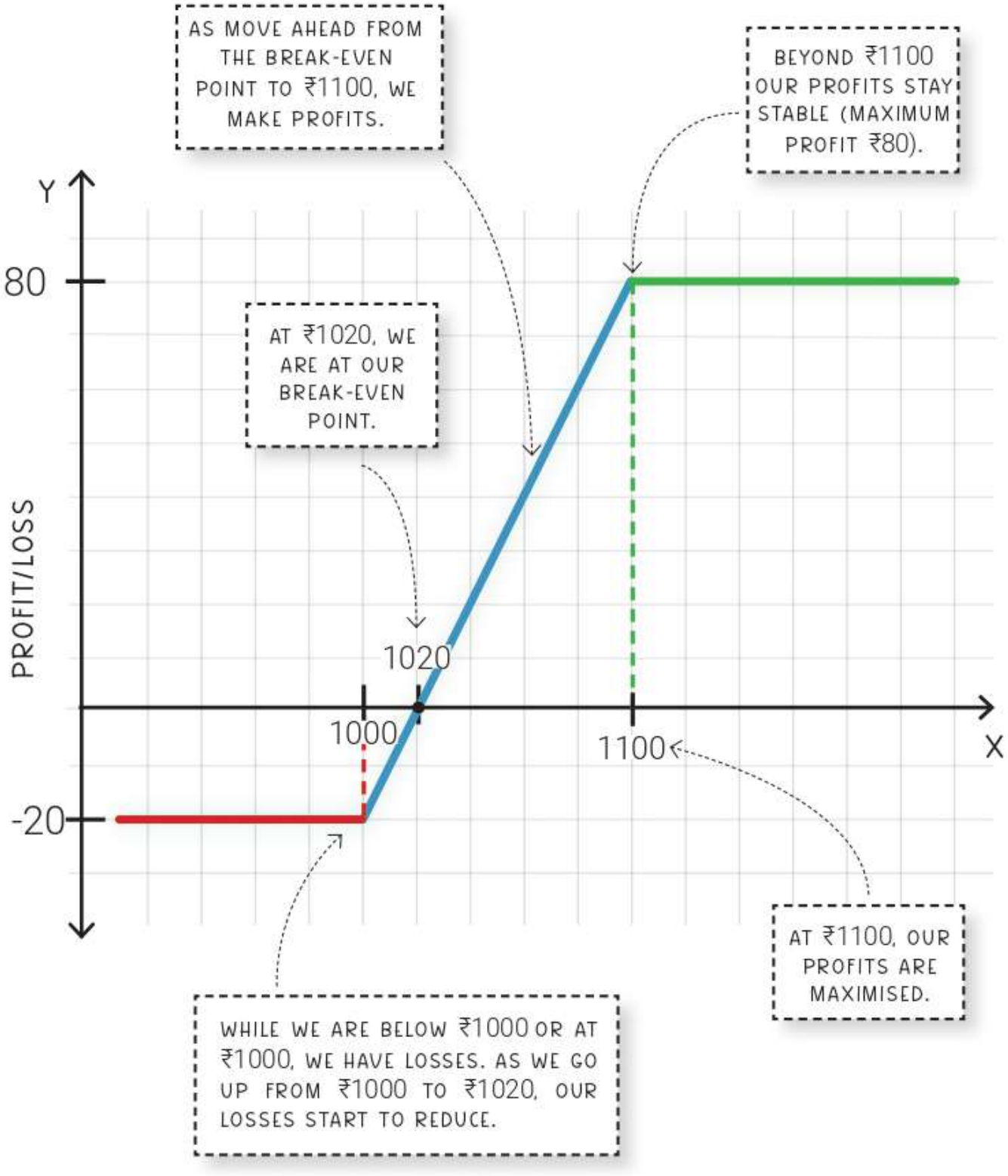
COST OF CREATING THE STRATEGY = ₹30 – ₹10 = ₹20

THIS IS OUR NET INVESTMENT IN THIS STRATEGY.

MAXIMUM LOSS = Net premium
= ₹20

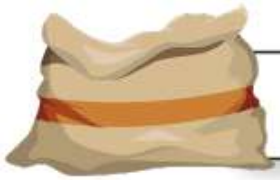
BREAK EVEN POINT = Lower strike price + Net premium cost
= ₹1000 + ₹20 = ₹1020

MAXIMUM PROFIT = Difference in Strike prices - Net Premium
= (₹1100 – ₹1000) – ₹20 = ₹80



As price on expiry moves beyond ₹1100, the payoff on the option that we had sold starts to increase. This happens by the exact same amount as we receive on the call option that we had purchased. This is why we can say that the maximum profits are limited in this strategy.

Let's take another example on this.



LOT SIZE
100 shares

CURRENT MARKET PRICE
₹470

BUY
ITM Call Option

CALL STRIKE PRICE
₹460

CALL PREMIUM
₹25

SELL
OTM Call Option

CALL STRIKE PRICE
₹600

CALL PREMIUM
₹20

Price	Buy Option	Sell Option
Price < ₹460	✗ Exercised	✗ Exercised
Price = ₹500	✓ Exercised	✗ Exercised
Price > ₹600	✓ Exercised	✓ Exercised

NET INVESTMENT/MAXIMUM LOSS = Net premium

= ₹25 – ₹20

= **₹5**

So, while we are below ₹460 or at ₹460, we are in losses. As we go up from ₹460 to ₹465, we start to recover our losses.

BREAK EVEN POINT = Lower strike price + Net premium cost

= ₹460 + ₹5

= **₹465**

As we move beyond ₹465 break-even point to ₹600, we make profits. But at ₹600, again, our profits are capped.

MAXIMUM PROFIT = Difference in Strike prices - Net Premium

= (₹600 – ₹460) – ₹5

= **₹135**

Beyond ₹600, our profits staysame as the profits received from call option bough is offset by the profit from call option sold.