

### 11. Collar Backspread.

This strategy involves selling a number of call options and buying more call options of the same underlying stock and expiration date at a higher strike price. It is an unlimited profit, limited risk options trading strategy in which options trader thinks that the underlying stock will experience significant upside movement in the near term.

#### Call Backspread Construction

Sell 1 ITM Call

Buy 2 OTM Calls

A 2:1 call backspread is implemented by selling a number of calls at a lower strike and buying twice the number of calls at a higher strike.

#### Example:

Suppose XYZ stock is trading at Rs.43 in June. An option trader suppose executes a 2:1 call backspread by selling a JUL 40 call for Rs.400 and buying two JUL 45 calls for Rs.200 each. The net debit/credit taken to enter the trade is zero.

On expiration in July, if XYZ stock is trading at Rs.45, both the JUL calls expire worthless while the short JUL 40 call expires in the money with Rs.500 in intrinsic value. Buying back this call to close the position will result in the maximum loss of Rs.500 for the options trader.

If XYZ stock rallies and is trading at Rs.50 on expiration in July, all the options will expire in the money. The short JUL 40 call is worth Rs.1000 and needs to be bought back to close the position. Since the two JUL 45 call bought is now worth Rs.500 each, their combined value of Rs.1000 is just enough to offset the losses from the written call. Therefore, he achieves breakeven at Rs.50.

Beyond Rs.50 though, there will be no limit to the gains possible. For example, at Rs.60, each long JUL 45 call will be worth Rs.1500 while his single short JUL 40 call is only worth Rs.2000, resulting in a profit of Rs.1000.

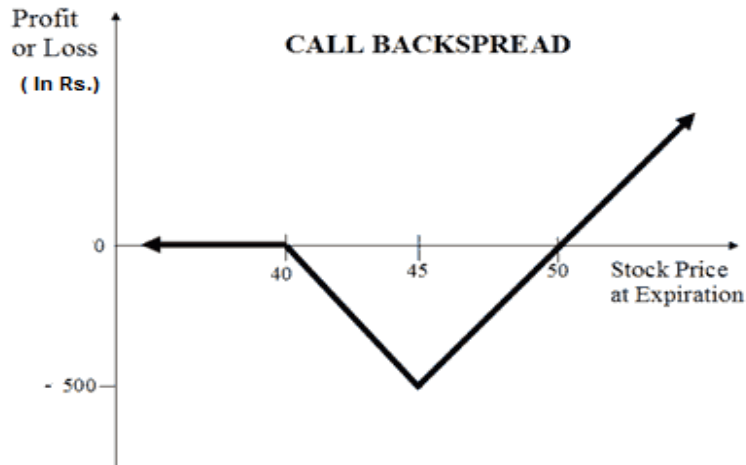
If the stock price had dropped to Rs.40 or below at expiration, all the options involved will expire worthless. Since the net debit to put on this trade is zero, there is no resulting loss.

#### Breakeven Point(s)

There are 2 break-even points for the call backspread position. The breakeven points can be calculated using the following formulae.

- Upper Breakeven Point = Strike Price of Long Call + Points of Maximum Loss
- Lower Breakeven Point = Strike Price of Short Call

## Call Backspread Payoff Diagram:



### Unlimited Profit Potential

The call back spread profits when the stock price makes a strong move to the upside beyond the upper breakeven point. There is no limit to the maximum possible profit.

- Maximum Profit = Unlimited
- Profit Achieved When Price of Underlying  $\geq 2 \times$  Strike Price of Long Call - Strike Price of Short Call +/- Net Premium Paid/Received
- Profit = Price of Underlying - Strike Price of Long Call - Max Loss

### Limited Risk

Maximum loss for the call back spread is limited and is taken when the underlying stock price at expiration is at the strike price of the long calls purchased. At this price, both the long calls expire worthless while the short call expires in the money. Maximum loss is equal to the intrinsic value of the short call plus or minus any debit or credit taken when putting on the spread.

The formula for calculating maximum loss is given below:

- Max Loss = Strike Price of Long Call - Strike Price of Short Call +/- Net Premium Paid/Received + Commissions Paid
- Max Loss Occurs When Strike Price of Long Call

For any query related to above topic kindly contact us on [knowledge@grovalue.in](mailto:knowledge@grovalue.in).