14. Bear Call Spread.

Today we will be discussing Bear call spread strategy which is Bearish strategy. In upcoming session we will continue with bearish strategies. This option trading strategy is employed when the options trader thinks that the price of the underlying asset will go down moderately in the near term. The bear call spread option strategy is also known as the bear call credit spread as a credit is received upon entering the trade.

Bear Call spread construction

Buy 1 OTM Call; Sell 1 ITM Call

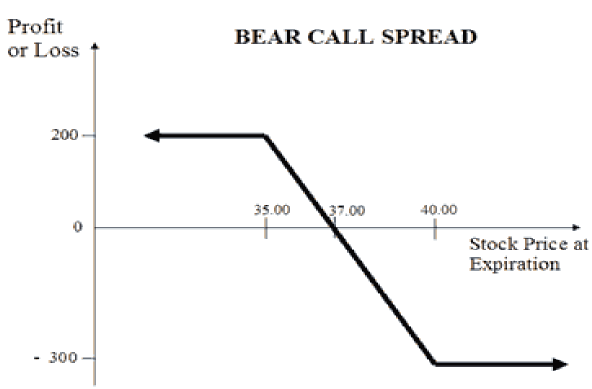
Bear call spreads can be implemented by buying call options of a certain strike price and selling the same number of call options of lower strike price on the same underlying security expiring in the same month.

Example:

Suppose XYZ stock is trading at Rs.37 in Apr. An options trader bearish on XYZ decides to enter a bear call spread position by buying a May 40 call for Rs.100 and selling a May 35 call for Rs.300 at the same time, giving him a net Rs.200 credit for entering this trade. The price of XYZ stock subsequently drops to Rs.34 at expiration. As both options expire worthless, the options trader gets to keep the entire credit of Rs.200 as profit.

If the stock had rallied to Rs.42 instead, both calls will expire in-the-money with the May 40 call bought having Rs.200 in intrinsic value and the May 35 call sold having Rs.700 in intrinsic value. The spread would then have a net value of Rs.500 (the difference in strike price). Since the trader have to buy back the spread for Rs.500, this means that he will have a net loss of Rs.300 after deducting the Rs.200 credit he earned when he put on the spread position.

Bear Call Spread Payoff Diagram:



Limited Downside Profit:

The maximum gain attainable using the bear call spread options strategy is the credit received upon entering the trade. To reach the maximum profit, the stock price needs to close below the strike price of the lower striking call sold at expiration date where both options would expire worthless.

The formula for calculating maximum profit is given below:

- Max Profit = Net Premium Received - Commissions Paid
- Max Profit Achieved When Price of Underlying <= Strike Price of Short Call

Limited Upside Risk:

If the stock price rise above the strike price of the higher strike call at the expiration date, then the bear call spread strategy suffers a maximum loss equals to the difference in strike price between the two options minus the original credit taken in when entering the position.

The formula for calculating maximum loss is given below:

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

Breakeven Point:

The underlying price at which break-even is achieved for the bear call spread position can be calculated using the following formula.

- Breakeven Point = Strike Price of Short Call + Net Premium Received

For more details or any queries kindly contact us on knowledge@grovalue.in