

18. Protective call.

It's a hedging strategy where the trader, who has an existing short position in the underlying security, buys call options to guard against a rise in the price of that security. Construction for Protective Call is given as follows;

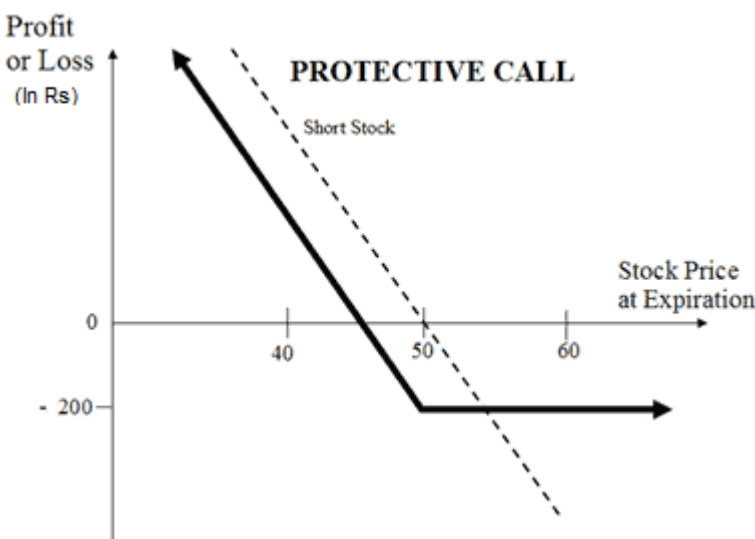
Short 100 shares; Buy 1 ATM Call.

A protective call strategy is usually employed when the trader is still bearish on the underlying but wary of uncertainties in the near term. The call option is thus purchased to protect unrealized gains on the existing short position in the underlying.

Example

An options trader is short 100 shares of XYZ stock trading at Rs.50 in June. On This price he implements a protective call strategy by purchasing an APR 50 call option trading at Rs.200 to insure his short position against a sudden move to the upside. Maximum loss occurs when the stock price is Rs.50 or higher at expiration. Even if the stock rallies to Rs.70 on expiration, his max loss is capped at Rs.200. Let's see how this works out. At Rs.70, his short stock position will suffer a loss of Rs.2000. However, his SEP 50 call will have an intrinsic value of Rs.2000 and can be sold for that amount. Including the initial Rs.200 paid to buy the call option, his net loss will be $\text{Rs.2000} - \text{Rs.2000} + \text{Rs.200} = \text{Rs.200}$. There is no limit to the profits attainable should the stock price head south. Suppose the stock price crashes to Rs.30, his short position will gain Rs.2000. Excluding the Rs.200 paid for the protective call, his net profit is Rs.1800.

Protective Call Payoff Diagram:



Unlimited Profit Potential

The protective call is also known as a synthetic long put as its risk/reward profile is the same that of a long put's. Like the long put strategy, there is no limit to the maximum profit attainable using this strategy. The formula for calculating profit is given below:

- Maximum Profit = Unlimited
- Profit Achieved When Price of Underlying < Sale Price of Underlying - Premium Paid
- Profit = Sale Price of Underlying - Price of Underlying - Premium Paid

Limited Risk

Maximum loss for this strategy is limited and is equal to the premium paid for buying the call option. The formula for calculating maximum loss is given below:

- Max Loss = Premium Paid + Call Strike Price - Sale Price of Underlying + Commissions Paid
- Max Loss Occurs When Price of Underlying \leq Strike Price of Long Put

Breakeven Point(s)

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

- Breakeven Point = Sale Price of Underlying + Premium Paid

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