Bear call spread (credit call spread or vertical spread)

SITUATION
An investor enters into a bear call spread when he buys a call option and simultaneously sells another call option on the same stock having the same expiry but with a lower strike price.

This type of strategy is similar to buying call options to protect a short sale of shares but instead of selling the stock short, you sell in-the-money call options. The risk of loss with this strategy is limited since you hold call options to protect the sale of your in-the-money call options in the event the stock rises significantly. An investor who expects a stock to fall moderately will see the benefits of this option strategy. It enables him to set the gain and loss limits, avoid an initial outlay and take advantage of a drop in the stock down to the lower strike price. On the other hand, a margin is required to cover the potential loss.

OBJECTIVE
To collect premium revenue as an option writer but reduce the risks associated with "naked" option writing.

STRATEGY
An investor feels that the current market price of QRS shares is likely to fall from its present price of $17.50 per share. He also believes that QRS options are overvalued. To profit from this forecast, the investor decides to write 10 QRS JUN 17.50 calls at a premium of $2.50 per share for an income of $2,500.00. To hedge the possibility that the shares of QRS might rise in value, the investor purchases 10 QRS JUN 20.00 calls at a premium of $1.00 per share. The net premium received is $1,500.00.

- Buy 10 QRS JUN 20.00 calls at $1.00
- Sell 10 QRS JUN 17.50 calls at $2.50
- Net credit: $1.50

RESULTS
If the investor is wrong and the price of the stock underlying his short call should rise, the investor will have a "stop loss" position, since he holds another call to "buy back" the same stock.

Scenario 1: QRS' stock price is below $17.50.
At expiration, both call series expired unexercised. In this case, he keeps the original $1,500.00 received from this strategy. Thus, the investor's maximum profit of $1,500.00 is simply the difference in the premiums of the two "legs" of the strategy (i.e. $2.50 – $1.00 = $1.50) multiplied by the 1,000 shares underlying the 10 options.

See other side >>

Scenario 2: QRS' stock price is between $17.50 and $20.00.
At expiration, the investor would be assigned on his JUN 17.50 calls and would thereby be obliged to sell 1,000 shares of QRS at $17.50. To obtain these shares, he would have to purchase them in the market at the going price, which is higher. It is to be noted that the investor's break-even point for this transaction is $19.00 ($17.50 + the $1.50 received from the strategy), so the strategy is profitable as long as the shares stay below $19.00. Above that price, the investor's original revenues do not offset the losses on QRS JUN 17.50 calls being exercised.

Scenario 3: QRS' stock price rises above $20.00.
If the stock rises above $20.00, both options are in-the-money. The investor would be assigned on his short JUN 17.50 call position and would be obliged to sell the shares at $17.50. He would then exercise his JUN 20.00 calls and thereby purchase 1,000 shares of QRS at $20.00. The net loss would therefore be limited to the difference between the strike prices (20.00 – 17.50) and the $1.50 premium, i.e. $2.50 – $1.50 = $1.00 per share.