## SITUATION

An investor enters into a bull 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 higher strike price.

This strategy is similar to covered call writing but, instead of holding the shares, you have an in-the-money or at-the-money call option. There is less risk with this type of strategy because the worst case scenario is that the call option held will be worthless at expiry. Therefore, even if the stock drops substantially, the maximum loss will never exceed the net premium paid for the option position. An investor who expects a stock to rise moderately and wants to take advantage of it will see the benefits of this option strategy.

## OBJECTIVE

To reduce the purchase price of the call option bought while profiting from bullish views to a certain limit.

## STRATEGY

An investor feels that the current market price of QRS shares is likely to increase from its present price of $50.00 per share. To profit from his prediction, the investor decides to buy 10 QRS OCT 50 calls at a premium of $2.25 for an amount of $2,250.00. He also sells 10 QRS OCT 55 calls at a premium of $1.00. His net outlay is $1,250.00. The strike price of the written call determines the bullishness of the strategy.

• Buy 10 QRS OCT 50 calls at $2.25
• Sell 10 QRS OCT 55 calls at $1.00
• Net debit: $1.25

## RESULTS

The sale of the QRS OCT 55 calls reduces the cost of buying the OCT 50 calls. It also limits the strategy's potential gains should it be profitable at expiration.

**Scenario 1: QRS' stock price rises above $55.00.**
At expiration, the investor exercises his OCT 50 calls and thereby purchases 1,000 shares of QRS at $50.00. He is also assigned on his short OCT 55 call position and therefore sells the shares at $55.00, locking-in a $5.00 gain. The net gain (considering the $1.25 per share outlay for the options) would therefore be $3.75 ($5.00 – $1.25). He realizes the maximum profit from this strategy, since the price of the stock is higher than the strike price of the option sold.

**Scenario 2: QRS' stock price is between $50.00 and $55.00.**
At expiration, the investor exercises his OCT 50 calls and thereby purchases 1,000 shares of QRS at $50.00. He then sells them in the market for the going price. It is to be noted that the investor break-even point for this transaction is $51.25 ($50.00 + the $1.25 cost of the transaction), but to reduce his loss, he would still exercise his option if the stock is trading between $50.00 and $51.25.

**Scenario 3: QRS' stock price is below $50.00.**
At expiration, the investor lets his options expire worthless. His net loss would be the cost of the transaction, or $1.25 per share.