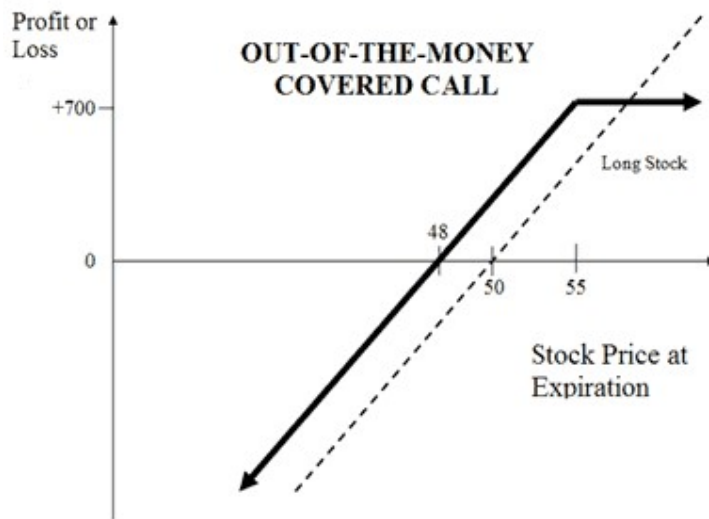


Covered Call Option Trading Strategy Explained

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Covered Call Options Strategy

Strategy Level	Advance
Instruments Traded	Call + Underlying
Number of Positions	2
Market View	Bullish
Risk Profile	Unlimited
Reward Profile	Limited
Breakeven Point	Purchase Price of Underlying- Premium Recieved

A Covered Call is a basic option trading strategy frequently used by traders to protect their huge share holdings. It is a strategy in which you own shares of a company and Sell OTM Call Option of the company in similar proportion. The Call Option would not get exercised unless the stock price increases. Till then you will earn the Premium. This a unlimited risk and limited reward strategy.

Let's assume you own TCS Shares and your view is that its price will rise in the near future. You will Sell OTM Call Option of TCS at a price, where you target to sell your shares. You will receive premium amount for selling the Call option and the premium is your income.

When to use Covered Call strategy?

The covered call option strategy works well when you have a mildly Bullish market view and you expect the price of your holdings to moderately rise in future.

Example

Suppose you are holding 100 shares of ABC company trading at Rs 50 in May. You are bullish on your holdings but are also worried about the downside i.e losses if there is fall in the price. In such a scenario, you can implement a Covered Call option strategy by selling a June 55 Call of Lot Size 100 at Over The Money (OTM) available at a premium of Rs 2. Since you are selling an option, you will receive Rs 2 X 100= Rs 200.

ABC Stock Price	Rs 50
Short Call Option Strike Price	Rs 55
Option Lot Size	100
Premium Received	Rs 200
Break Even Point (Purchase Price of Underlying - Premium Received)	Rs 48

Your total investments in the trade will be the cost of holding 100 shares minus the premium received i.e.

Cost of holdings (Rs 50 X 100= Rs 5000) - Premium Received (Rs 200)= Rs 4800

Now let's discuss about the possible scenarios:

Scenario 1: Stock price of ABC rises to Rs 57.

Here the strike price on expiry (Rs 57) is greater than the strike price of sold Call Option (Rs 55). The Call Option in such a case would be assigned and you will sell the holding shares and make a profit of (Rs 57- Rs 55) X 100= Rs 200. Your total profit, after adding Rs 200 from the premium received on selling the Call Option, would be Rs 400.

Scenario 2: Stock price of ABC falls to Rs 40

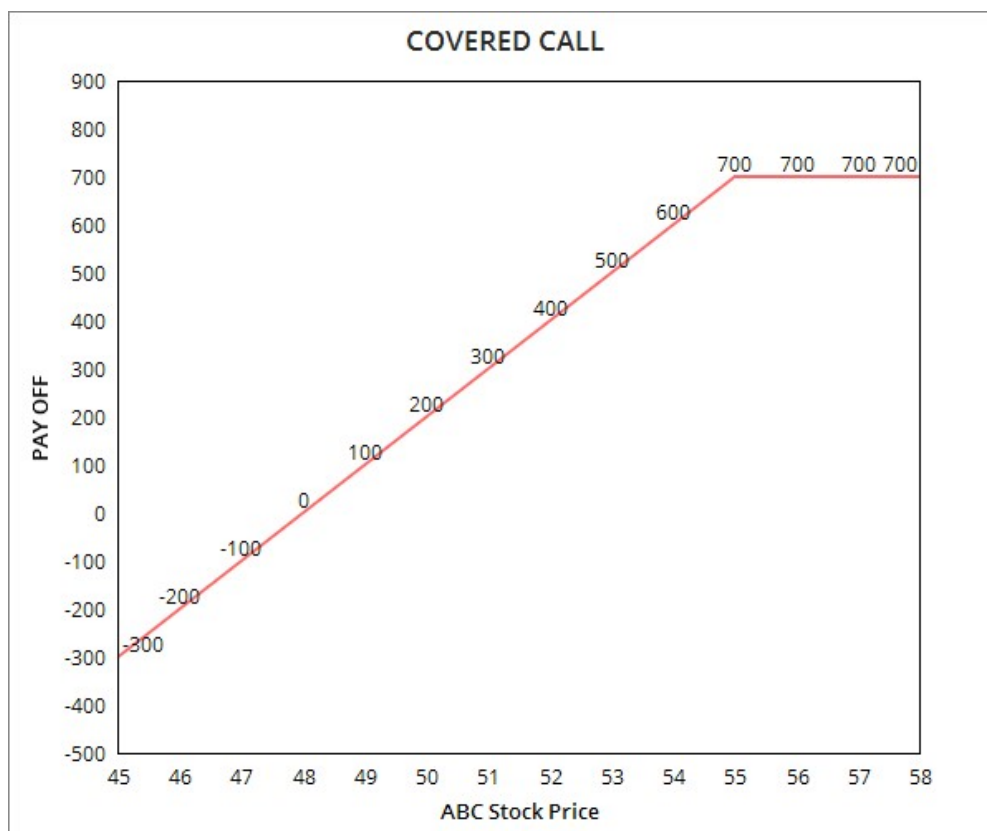
Your holding will lose (Rs 50-Rs 40= Rs 10) X 100= Rs 1000 in value. Since you would not be selling the shares, this loss would only be in the paper. Moreover, the loss will get reduced if you factor in Rs 200 premium received on selling the call option. So, the total loss on paper would be Rs 800.

Covered Call Option Strategy Payoff Schedule

Stock Price on Expiry	Net Payoff(Rs) [(Stock Price - BEP) x 100] BEP=48 MAX PROFIT= 700
45	-300
46	-200
47	-100
48	-0
49	100
50	200
51	300
52	400
53	500
54	600
55	700

Covered Call Option Strategy Payoff Schedule

Stock Price on Expiry	Net Payoff(Rs) [(Stock Price - BEP) x 100] BEP=48 MAX PROFIT= 700
56	700
57	700
58	700



Market View - Bullish

When you are expecting a moderate rise in the price of the underlying or less volatility.

Actions

- Buy Underlying
- Sell OTM Call Option

Let's assume you own TCS Shares and your view is that its price will rise in the near future. You will Sell OTM Call Option of TCS at a price, where you target to sell your shares. You will receive premium amount for selling the Call option and the premium is your income.

Breakeven Point

Purchase Price of Underlying- Premium Received

Risk Profile of Covered Call

Unlimited

Maximum loss is unlimited and depends on by how much the price of the underlying falls. Loss happens when price of underlying goes below the purchase price of underlying.

Loss = (Purchase Price of Underlying - Price of Underlying) + Premium Received

Reward Profile of Covered Call

Limited

You earn premium for selling a call. Maximum profit happens when purchase price of underlying moves above the strike price of Call Option.

Max Profit= [Call Strike Price - Stock Price Paid] + Premium Received

Max Profit Scenario of Covered Call

Underlying rises to the level of the higher strike or above.

Max Loss Scenario of Covered Call

Underlying below the premium received

Advantage of Covered Call

It helps you generate income from your holdings. Also allows you to benefit from 3 movements of your stocks: rise, sideways and marginal fall.

Disadvantage of Covered Call

Unlimited risk for limited reward.

Option Calendar Spreads

Trading Option Calendar Spreads

Being long a calendar spread consists of a selling an option in a near-term expiration month and buying an option in a longer-term expiration month. The options are both calls or puts, have the same strike price and the same contract. There are always exceptions to this.

One reason to buy a calendar spread -- also referred to as a horizontal spread and a time spread -- is because of its low-risk and profit potential from the passage of time. This may be due to known events, such as an economic report or an election, that you feel will not move the market as much as anticipated.

Let's look at an example.

How an option calendar spread works – an example

A trader believes that the market will be very quiet and stable until after September expiration, when she believes that the market will rally tremendously.

She could just buy a December call. The December call premium, however, will be expensive due to the amount of time left in that option.

She can offset some of that premium by selling a shorter-term call. This is referred to as buying the calendar spread: Sell 1 September 2440 call and buy 1 December 2440 call for a net premium of 33.75.

In the best-case scenario, the market stays stable until after September expiration.

Let's look at a few possibilities.

Exploring the possible outcomes in September

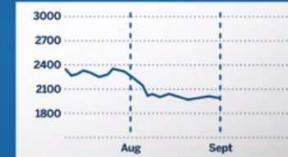
It's now September and the underlying futures have fallen dramatically to 2000. The trader's short call expires worthless – allowing her to keep the premium collected from the short leg of the spread. She still is long the December call, but the value has decreased due to the market drop.

Her maximum loss is only 33.75 – the initial cost of the spread. Had she purchased the December call only, the loss would have been 70.50.

September

Underlying Future = 2000

	SEP-DEC SPREAD	SHORT SEP 2440 CALL	LONG DEC 2440 CALL
COST	33.75	36.75	70.50
VALUE	0.00	0.00	0.00
PNL	-33.75	36.75	-70.50



Far OTM calls may be theoretically worthless, values shown are approximate

Conversely, if the market rose to 3000 before September expiration, her short September call would be worth 560.00, and her long December call would be trading close to parity at 560.00. The spread is worth zero, and she is out the premium of 33.75. In this case, had she purchased the December call only, it would have been very profitable.

September

Underlying Future = 3000

	SEP-DEC SPREAD	SHORT SEP 2440 CALL	LONG DEC 2440 CALL
COST	33.75	36.75	70.50
VALUE	0.00	-560.00	560.00
PNL	-33.75	-523.25	489.50



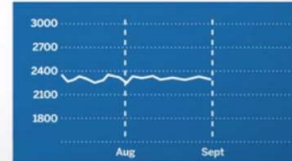
Deep ITM options will trade approximately at parity (intrinsic value)

Say we're at September expiration, and the futures prices have not moved. In this case, the September call expires worthless. The December call is at the money with three months remaining. It still would be worth about 50.00 – minus the spread cost of 33.75, netting the trader a profit of 16.25 if she sold the December call, thus closing out her position.

September

Underlying Future = 2400

	SEP-DEC SPREAD	SHORT SEP 2440 CALL	LONG DEC 2440 CALL
COST	33.75	36.75	70.50
VALUE	50.00	0.00	50.00
PNL	-16.25	36.75	-20.50



Possible outcomes at December expiration

Following her initial instinct, she keeps the December call, hoping for a rally. Come December, let's look at the different scenarios.

If the underlying future dropped to 2000, the December call expires worthless. She would net lose the 33.75 from the spread versus losing the 70.50 premium had she bought the December call alone.

December

Underlying Future = 2000

	SEP-DEC SPREAD	SHORT SEP 2440 CALL	LONG DEC 2440 CALL
COST	33.75	36.75	70.50
VALUE	0.00	0.00	0.00
PNL	-33.75	36.75	-70.50

EXPIRED



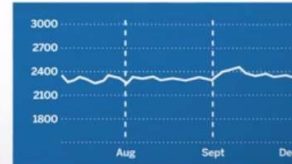
This also would be the case if the futures didn't move and stayed around 2400. She would lose 33.75 on the spread versus the 70.50 had she bought the December call alone.

December

Underlying Future = 2400

	SEP-DEC SPREAD	SHORT SEP 2440 CALL	LONG DEC 2440 CALL
COST	33.75	36.75	70.50
VALUE	0.00	0.00	0.00
PNL	-33.75	36.75	-70.50

EXPIRED



We had said the best-case scenario would be the market stabilizing until after the September expiration. If futures rose to 3000, the December call would be worth 560, Less the spread cost of 33.75, this nets her a gain of 526.75.

December

Underlying Future = 3000

	SEP-DEC SPREAD	SHORT SEP 2440 CALL	LONG DEC 2440 CALL
COST	33.75	36.75	70.50
VALUE	560.00	0.00	560.00
PNL	526.75	36.75	489.50

EXPIRED



Conclusion

As we've seen, the trader can design a spread position that minimizes her loss potential while leaving open the possibility of tremendous profit.

Options Strategies

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Key words: Options spreads, Combinations , Synthetic options, Bull spread, Bear spread, Butterfly, Calendar spreads, Diagonal spreads, Straddle, Strangle, Strip, Strap



There are only two types of options, puts and calls, and a lot of options strategies that can be used on the market. Nevertheless in order to find more attractive scenarios and develop complex strategies the simple but important concepts should be understood as the key factors that determine trader's potential risks and rewards. The article is designed to help build a foundation for making options payoffs by providing a primer on a basic concept of grouping options strategies.

We divide strategies into 4 groups:

1. Simple
2. Spread
3. Combination
4. Synthetic

Each group consists of different sub strategies, for example Married Put, Collar, Butterfly and other funny names. For simplicity reasons we will not dig into every sub strategy because they are too many and it is easy to get stuck in different payoffs.

1. Simple strategy consists of a simple call or a put option. Small investors are bombarded with different advice about options. Therefore before starting with complex payoffs a simple option technique can be very advantageous.

The four basic and well known sub strategies here are:

- Buy call
- Sell call
- Buy put
- Sell put

Call buying is the most popular bullish option strategy while long put position expresses bearishness.

We will not explore different ways to use these strategies and their payoffs in the article.

Indeed, with the reams of literature on call and put buying, is there anything new to say on the subject? Instead, we move on to the next strategy, spread.

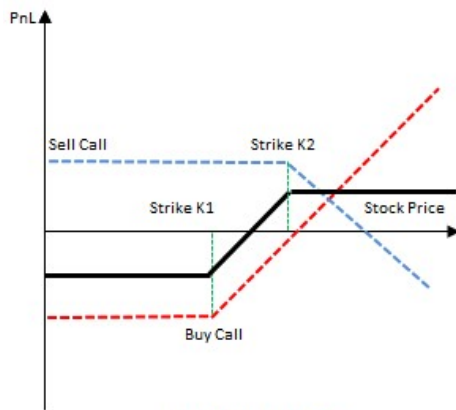
2. Spread is a position in two or more options of the same type, i.e. it can be two puts, three calls etc.

Vertical spreads as a subgroup are characterized by different strikes:

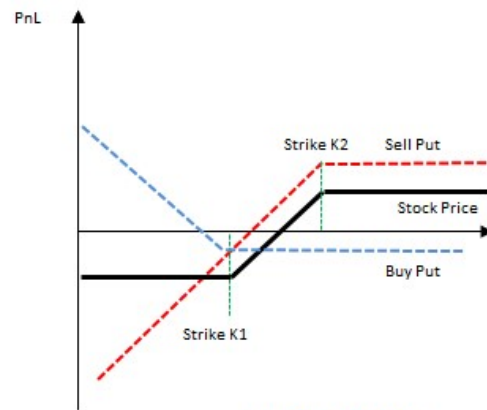
- Bull spread

with Calls: Long call option with Strike K1, Short call option with a higher strike K2.

with Puts: Long Put with lower Strike K1, Short put with higher strike K2.



Bull Spread (Calls)

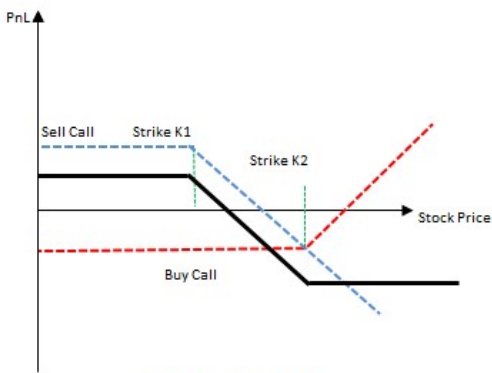


Bull Spread (Puts)

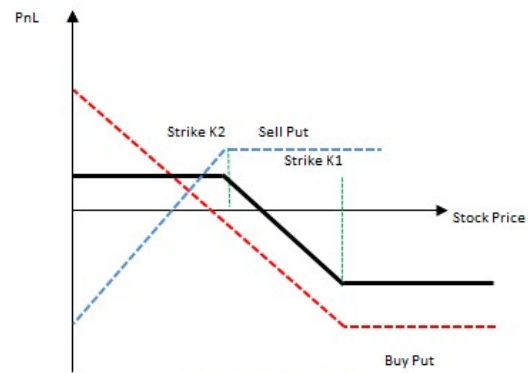
- Bear spread

with Calls: Long call with Strike K2, short call with lower strike K1.

with Puts: Long put with Strike K1, short put with lower strike K2.



Bear Spread (Calls)

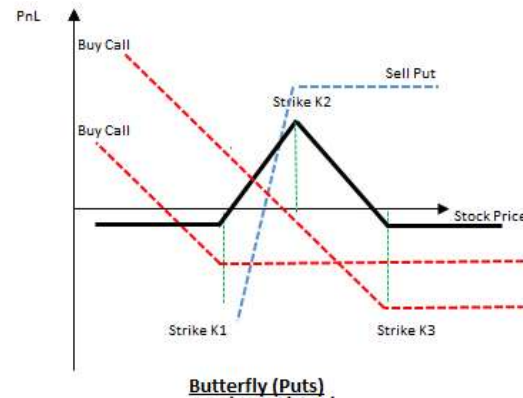
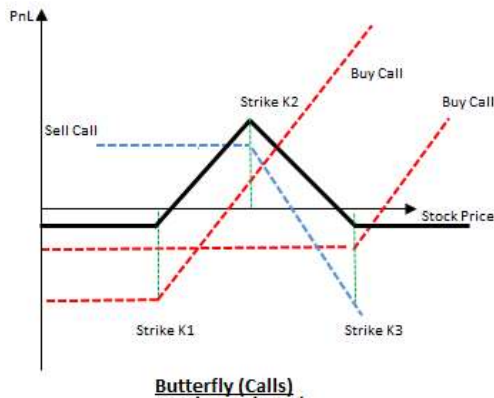


Bear Spread (Puts)

- Butterfly – combination of call and bear spreads.

with Calls: Long call with Strike K1, Long call with strike K3, Short two calls with middle strike K2.

with Puts: Long Put with Strike K1, Long put with Strike K3, short two puts with average strike K2.

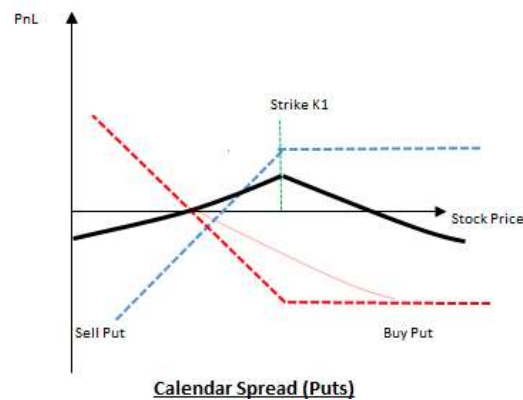
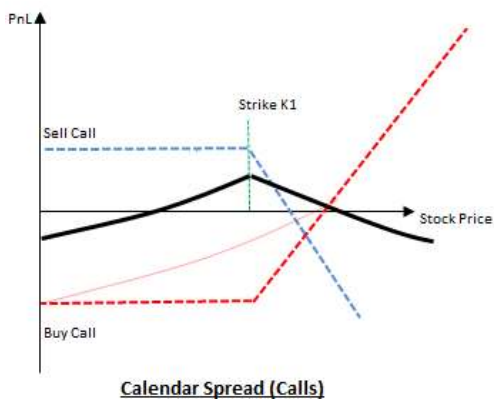


Horizontal or Calendar spreads characterized by different dates:

- Calendar spread

with Calls: Long call with a more distant expiration than short call option, the strike is the same K1.

with Puts: Long put with a more distant expiration than short put option, the strike is the same K1.

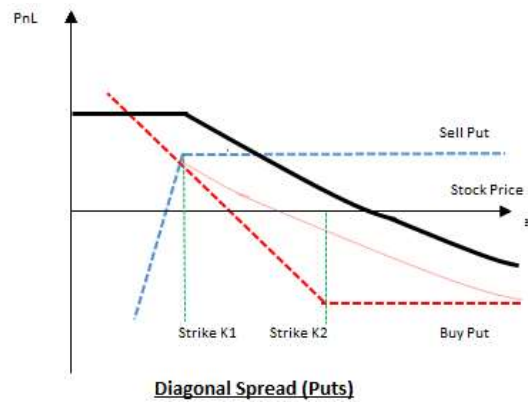
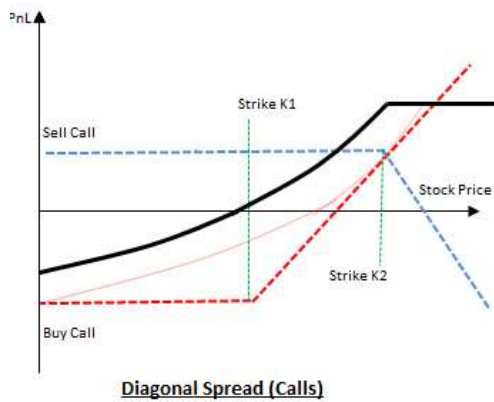


Diagonal spreads characterized by different dates and strikes:

- Diagonal spread

With calls: Long call and short call with different expiry and strikes.

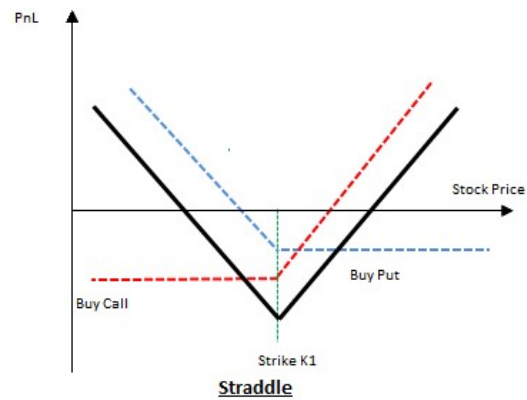
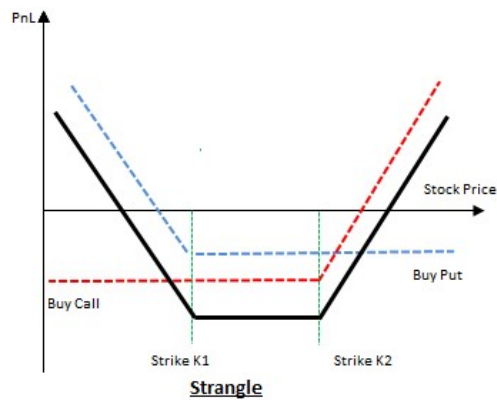
With Puts: Long put and short put with different expiry and strikes.



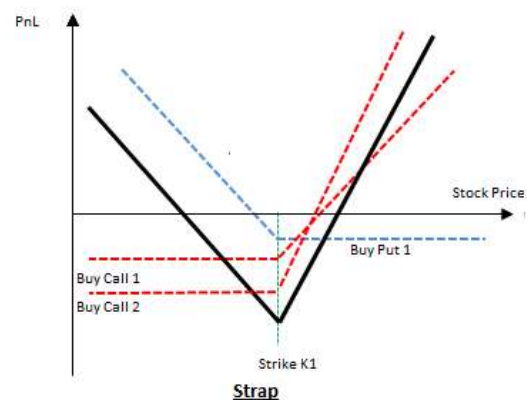
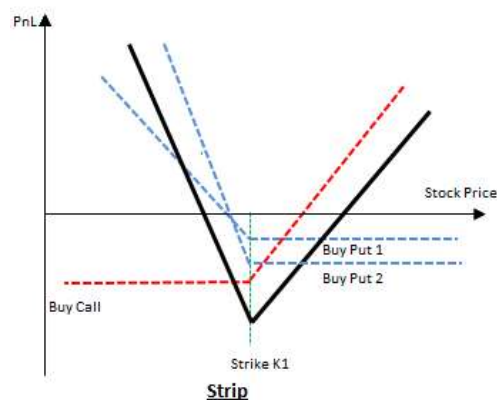
3. Combinations are an option trading strategy that involves positions in calls and puts options simultaneously.

The most popular combinations are two and three legs combinations.

- Straddle – two legs combination that involves long call and put with the same strike and expiry.
- Strangle – two legs combination that involves long put and call with the same expiry but different strikes K1 and K2.



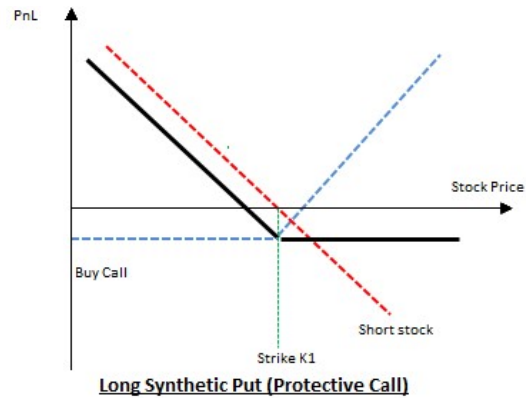
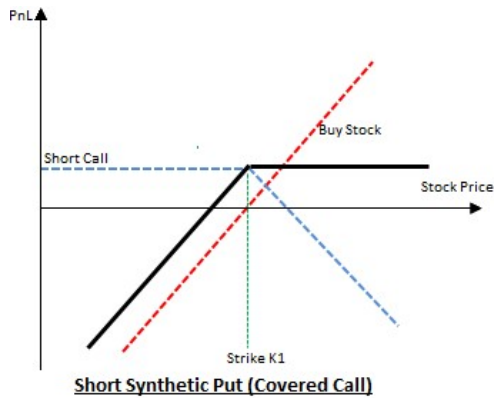
- Strip – three legs combination with long one call and long two puts with the same strike and expiry.
- Strap – three legs combination with long two calls and one put on the same strike and expiry.



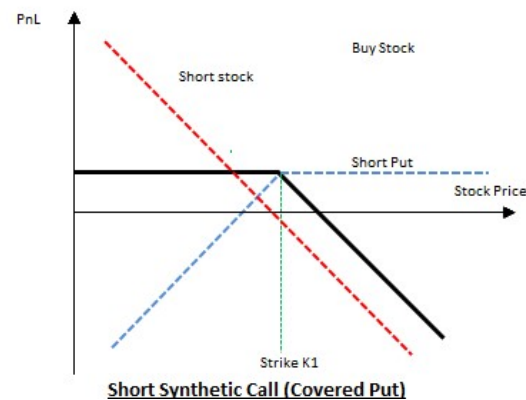
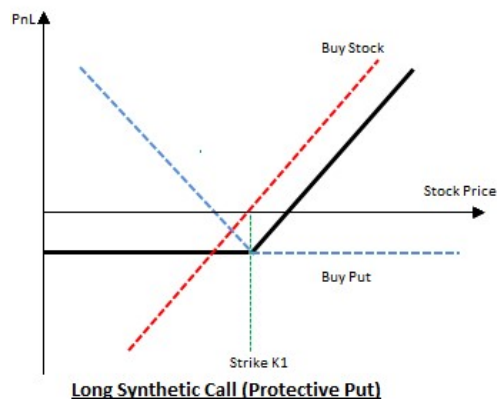
4. Synthetic strategies involve a single option and a stock.

Synthetic options are fairly easy to understand; they can be classified as combinations as well.

- Writing Synthetic Put (Covered Call) is long stock and short call.
- Long Synthetic Put (Protective Call) is short stock and long call.



- Long Synthetic Call (Protective Put) is long stock and long put.
- Writing Synthetic Call (Covered Put) is short stock and short put.



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Another trader may sell the calendar spread if they feel the underlying will have dramatic moves in the near term and stabilize on a longer time horizon.

Traders may have a complex view of future market activity and implied volatility.

Calendar spreads are one tool for traders to express their views within a certain timeframe.