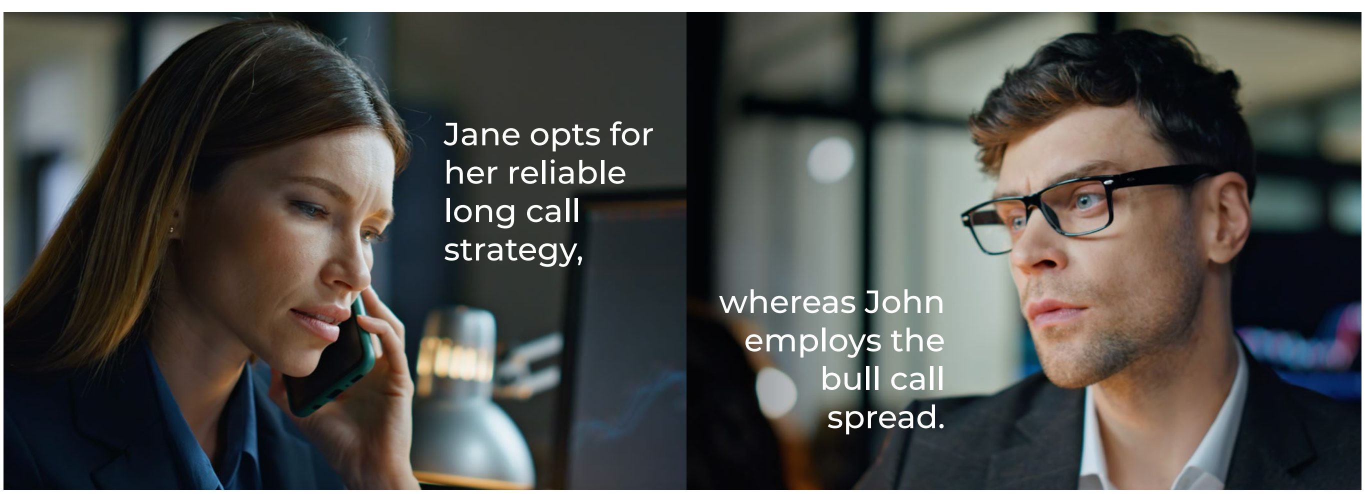
Improving Probabilities and Confidence with Bull Call Spreads

Options
Strategies

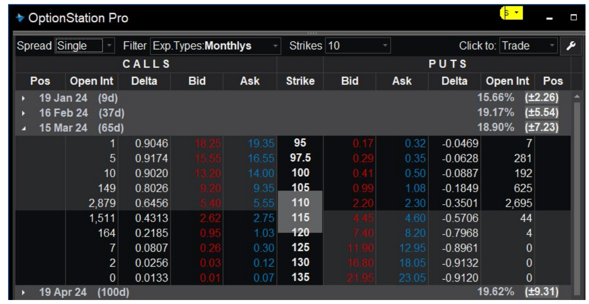
A bull call spread is a multi-leg options strategy designed to help investors capitalize on anticipated stock price increases, and benefit from heightened volatility. The video above, which contrasts the trading styles of Jane and John, reveals the many advantages of the multi-leg strategy over the single-leg long call. This article highlights these advantages, providing insights on how to place and manage the bull call spread.

A tale of two traders

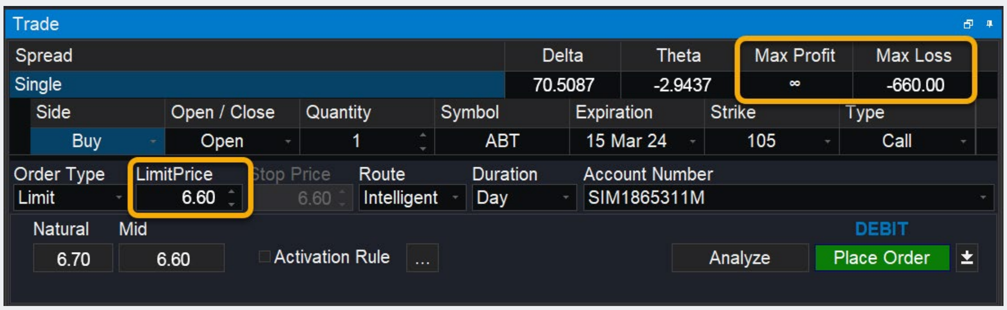
Consider a hypothetical trading scenario to evaluate the approaches of Jane and John. Both traders share the belief that ABT stock is poised for an upswing from its current $108 price, pinpointing a resistance target around $115.



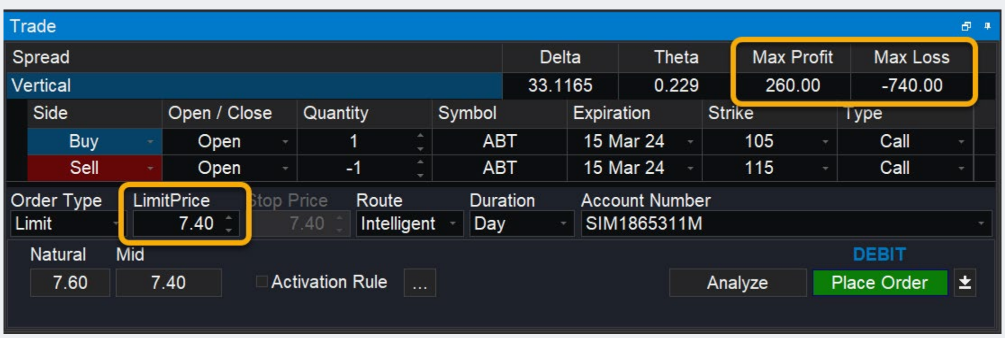
Let's assess the two strategies to determine their effectiveness.



Jane’s order



John’s order



Trade comparison

	Jane’s trade	John’s trade
Strategy used	Long call	Bull call spread
Debit (premium paid)	6.60	4.96
Maximum loss	$660	$496
Breakeven price	$111.60	$109.96
Maximum profit	Unlimited	$504
Realistic profit at target	$340	$504

Traders are drawn to the long call strategy due to its potential for unlimited profit. However, John's bull call spread presents several advantages:

- **Lower maximum loss**
- **Higher potential profit at the target**
- **Lower breakeven price**
- **Higher rate of return on the investment**

Quick reference guide: bull call spread

Market outlook	Bullish
Position net debit or credit	Debit (premium paid)
Number of legs	Two - one long call, and one short call
Maximum profit	High strike minus the low strike minus the net premium paid
Profits from	Underlying price moving up to or above the high strike price
Maximum loss	Premium paid if both options expire worthless
Breakeven	Lower strike plus the premium paid
Risk from	Underlying price dropping to or below the strike of the long call or assignment on the short call before expiration
Options level required	Level 3 – click here for additional information

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What is a bull call spread?

A bull call spread is a trading strategy that involves two actions:

1. **Buy a call option**

   This leg drives the position's profit. The long call's value can rise with an underlying price increase or with heightened volatility. The trade profits when the call is sold at a higher price than its initial purchase. While a closer strike to the underlying price entails a higher premium, it also increases the likelihood of the option finishing in the money.

2. **Sell a higher strike call option**

   This leg is sold simultaneously with the long call. The short call caps the position's reward, but the premium collected offsets some of the buying cost.

Bull call spread risk/reward profile

Reward
High strike minus lower strike minus premium paid times 100.

Breakeven
Lower strike plus the premium paid.

Risk
Debit paid to open the position.

Situations suited for a bull call spread

Consider a bull call spread when you are positive about a particular stock but want to mitigate potential losses, especially if you anticipate the stock not to rise above the upper strike price.

Here are some situations where a bull call spread may be used:

Moderate bullishness

When you believe the stock's price can increase up to or near a resistance level.

Lower cost

To profit from a bullish move at a lower cost than if you bought a call or the stock alone.

Limited risk

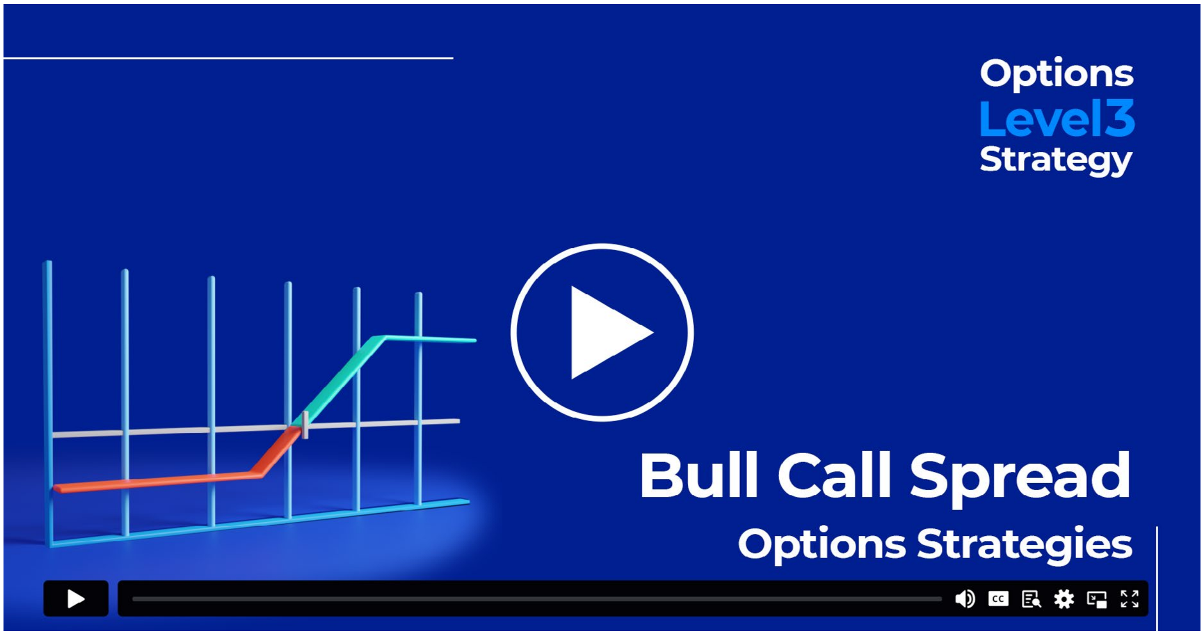
To limit your potential losses by selling a call and lowering the cost of buying another.

Strike selection

The long call strike should be at or near a support level. The premium paid to buy the option is usually lowest when the price is in or near the support. The short strike should be at or above a resistance level where you do not think the price may reach or exceed before the position is exited.

***Join Webinar** – Optimize Profit Potential with Bull Call Spreads, January 31 2:00 pm ET.. Learn about bull call spreads and how you can use this strategy effectively.*

How to place a bull call spread trade



1 Select a Stock

Identify a stock expected to increase in price or remain steady.

2 Choose strike prices and expiration

Pick two call options with different strike prices, ensuring the short call has a higher strike. Both options should share the same expiration date.

3 Considerations

a. The strike of the call that is bought determines the position's risk because the premium paid is the potential loss. The premium collected from the short call will be subtracted from the premium of the long call. The maximum loss is the difference between the strikes minus the premium collected.

b. The strike of the sold call should be as low as possible to collect a premium, but far enough from the long strike to allow for profit. The maximum profit is the difference between the strikes minus the premium paid.

c. Because this is a debit spread, time decay works against the position. To avoid exponential time decay, expirations that are greater than sixty days out should be chosen, and the position should be closed approximately thirty days before expiration. Time decay increases exponentially within the last thirty days before options expiration.

d. Choosing shorter expirations or using deeper out-of-the-money call options may cause losses or smaller profits due to greater time decay or a lower delta. The lower delta means the premium will not respond as much to changes in the underlying price. A bull call spread lowers the cost of an at-the-money call and provides a better delta.

Exiting the bull call spread

1 Close the spread by selling the bought call and buying back the sold call option. Profit is realized if this is done at a higher value than the premium paid when the spread was opened.

2 Since time decay works against the position's profitability, consider closing the spread approximately 30 days before expiration. A smaller profit would be made if the underlying price did not reach the upper strike.

3 If the underlying stock price is below the strike of the long call option, and there are only 30 days until expiration, the spread can be closed. This would result in a loss that is less than the maximum, attributable to the time value of the options.

Test before you trade

Access the TradeStation platform in Simulated Trading mode to acquaint yourself with strategy analysis and order entry. Utilize this environment to practice placing bull call spreads without exposing real money, allowing you to gain confidence in executing the strategy.

Download Workspace *– Scan for stocks on the move and identify opportunities to implement a bull call spread strategy.*

Conclusion

The bull call spread is a valuable strategy for investors seeking to profit from expected stock increases while managing risk. This involves buying a call option and selling a higher strike call. The strategy aims to benefit from increased volatility and underlying price movements. It offers limited rewards and potential losses, necessitating careful strike selection and vigilant trade monitoring. Traders typically close the spread before option expiration to mitigate maximum time decay.

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