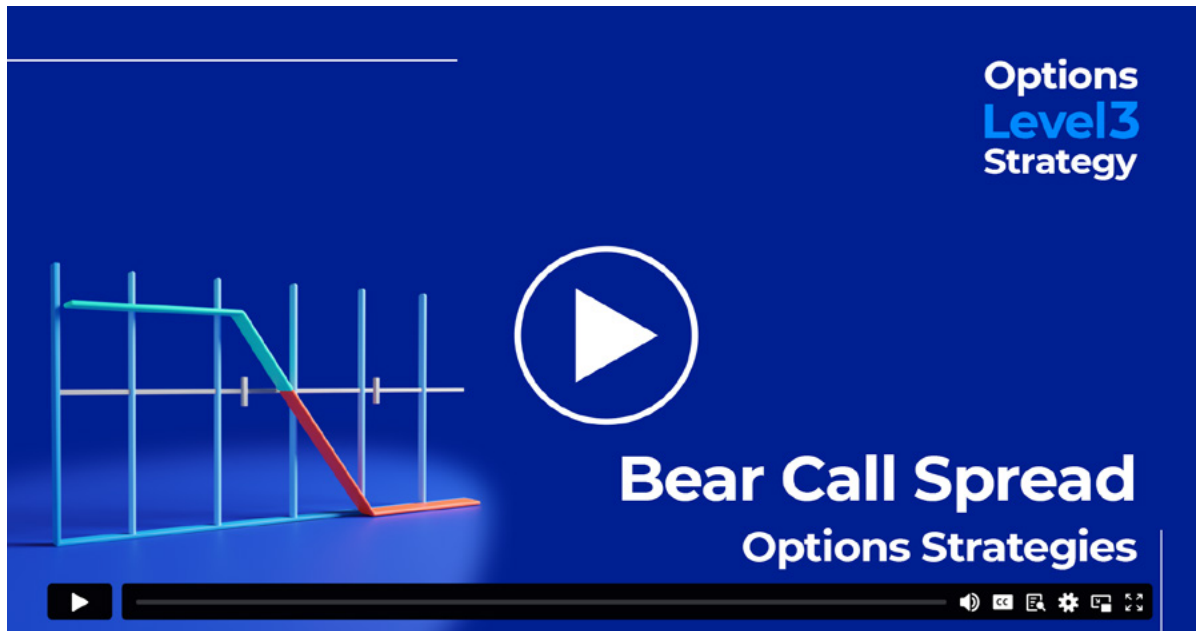




Bear Call Spreads: Trading Time and Volatility



Options
Strategies



Introduction

A bear call spread is an options trading strategy to apply when you anticipate the stock or index price will go down or trade sideways. It involves two call options to limit both risk and reward. One call is sold to collect a premium, and another is bought at a higher strike price to manage risk.

How bear call spreads work:

To open a bear call spread, you:

1 Sell a Call Option

The position's profit comes from the premium collected from the sale of this option. The short call's value can drop with a fall in the underlying price or a decline in volatility, allowing it to be repurchased at a lower cost.

- a.** Selling the Call exposes the trader to the risk of early assignment, which would require them to buy shares of the underlying and sell them at the strike price to meet the obligation.
- b.** Alternatively, the trader could exercise their long call to purchase the shares at its strike price to fulfill their assignment obligations on the short call. The loss would be limited to the difference between the strikes minus the premium collected when opening the spread.

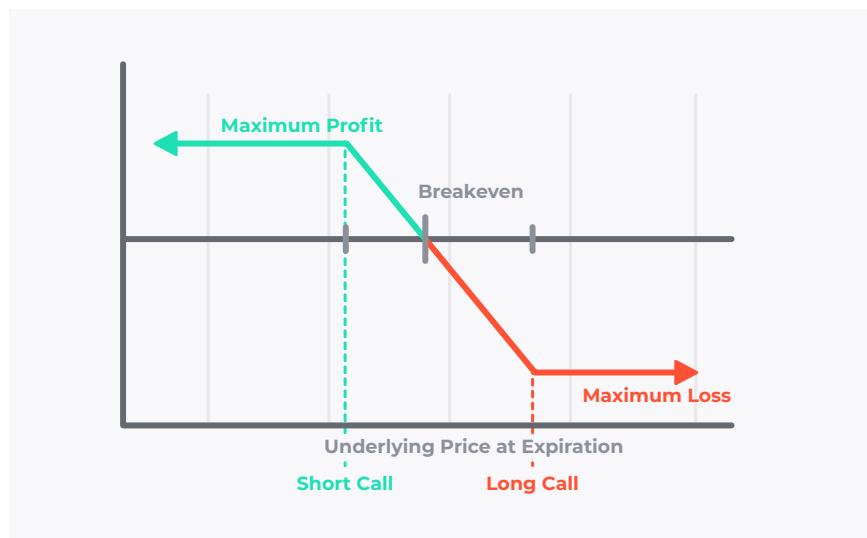
c. The trade profits when the call expires or is bought to close the position at a lower price than its initial sale. While selling a strike closer to the underlying price will offer a higher premium, it also increases the likelihood of the option finishing in the money.

2 Buy a Higher Strike Call Option

This leg is bought simultaneously with the short call. The long call reduces the premium collected and the position's reward but limits the short call's risk.

Bull put spread risk/reward profile:

- a. Reward:** The net premium collected.
- b. Breakeven:** Short (Lower) strike plus the premium received.
- c. Risk:** The difference between the two strikes minus the premium collected.



Quick reference guide: Bull Put Spread

Market outlook	Sideways to Moderately Bearish
Position net debit or credit	Credit (premium collected)
Margin required	The difference between the strikes, minus the premium collected
Number of legs	Two – one lower strike short call and one higher strike long call with same expiration date
Maximum profit	The premium collected
Profits from	The options expiring with the underlying below the short strike call, from the underlying price declining, or volatility dropping
Maximum loss	The difference between the strikes minus the premium collected. This occurs if the underlying price rises above the long call strike.
Breakeven	Short strike plus the premium received
Risk from	The underlying price rising to or above the strike of the long call or assignment on the short call before expiration. The use of margin is required. Review the Margin Disclosure Statement at www.TradeStation.com/DisclosureMargin
Options level required	Level 3 – Click here for additional information

Choosing strikes and expirations:

1 The short call

Choose a strike above the current stock price but not too far out of the money. A lower short strike means higher premiums are collected but also increases the risk of the option going into the money and being assigned. Traders often look for strikes above a level of resistance where they believe the price will stall before the expiration of the options.

2 The long call

For the long call, pick a strike price one or two levels above the short strike. A narrower spread width reduces risk but also limits potential reward, while wider spreads have greater profit potential but increased possible losses. Be sure that your account size and risk management plan allow for the maximum risk of the bear call spread selected. A stop loss may be attached to an open bear call spread to mitigate risk exposure.

3 Choosing expirations

Evaluating the expiration is also essential. Shorter-term options have less time value but decay faster. They are also more sensitive to price changes in the underlying, which increases risk. Many traders aim for expirations ranging from 30 to 45 days to allow sufficient time for the trade to unfold. Extending the expiration period results in more expensive long calls and increased volatility risk.

Strategy comparison:

Let's examine the trading strategies of three TradeStation clients. All three believe that DaVita Inc. (DVA) is near a resistance level of around \$140, and the price will likely stall and drop as it did before toward the support near \$125.




Our first trader, Julia, is using the bear call spread to attempt to profit from the downward price movement. Our next trader, Xavier, is buying a put option to trade the move. Finally, Steve is a trader who shorts stocks they think will decrease in price.

Julia is selling the 140/145 bear call spread, which has 24 days until expiration, for the natural price of 1.40.

Trade							Delta	Theta	Max Profit	Max Loss	
Spread							-12.31	1.76	140.00	-380.00	...
Vertical											
Side	Open / Close	Quantity	Symbol	Expiration	Strike	Type					
Sell	Open	-1	DVA	17 May 24	140	Call				x	
Buy	Open	1	DVA	17 May 24	145	Call				x	
Order Type	Limit Price	Stop Price	Route	Duration	Account Number						
Limit	1.40 (CR)	1.55 (CR)	Intelligent	Day	SIM1097305M						
Natural	Mid									CREDIT	
	1.40 (CR)	1.65 (CR)					Analyze			Place Order	

Xavier is buying a 140 put option for the natural price of 11.20. To time the exit, they chose an option with a farther expiration. Xavier wants the underlying target price to be reached while the option still has more than 30 days until expiration, reducing the effect of time decay on the position.

Trade							Delta	Theta	Max Profit	Max Loss	
Spread							-53.91	-3.72	12,880.00	-1,120.00	...
Single											
Side	Open / Close	Quantity	Symbol	Expiration	Strike	Type					
Buy	Open	1	DVA	19 Jul 24	140	Put				x	
Order Type	Limit Price	Stop Price	Route	Duration	Account Number						
Limit	11.20	11.00	Intelligent	Day	SIM1097305M						
Natural	Mid									DEBIT	
	11.20	11.00					Analyze			Place Order	



Watch the Webinar – “Understanding Bear Call Spreads: A Limited-Risk Options Strategy to Harness Time, Volatility, and Bearish Trends”. Learn how this credit spread strategy is utilized in bullish or sideways markets to potentially collect premium.

Steve is shorting 100 shares of DVA stock for \$135.40 per share.

Order Confirmation

Would you like to place the following order(s)?

Sell Short 100 DVA @ 135.4000 Limit

Order Details

Account: SIM1097305M
 Duration: Day
 Route: Intelligent

Symbol Snapshot

DaVita Inc (DVA) - NYSE
 Last: \$135.21 x 100 (NASDAQ)
 Bid: \$135.04 x 400
 Ask: \$135.36 x 400
 As of: 4/23/2024 10:37:22 AM

Estimated Credit: \$13,540.00
Estimated Commission: \$1.00

Don't show me this again for Trade Bar and Macros Equity orders

Yes
No

	Julia Bear Call Spread	Xavier Long Put	Steve Short Stock
Trade cost /margin	\$360 (Difference between strikes minus premium X 100)	\$1120 Premium X 100 shares	\$6,770 \$135.40 X 100 shares at 50% Margin
Maximum loss	\$360	\$1120	Unlimited
Breakeven price	\$141.40	\$128.80	N/A
Maximum profit	\$140	\$12,880 (Strike to 0)	\$13,540
Realistic profit at the target of \$125	\$140 – options expired out-of-the-money	\$416.28 – sold with 30 days to expiration, with underlying at \$125	\$1040 – with the underlying at \$125
Rate of return at the target	38.9%	37.1%	13.4%
Drawbacks/Risks	1. Options expiring with the underlying above the short strike 2. Assignment risk on the short call 3. More commissions	1. Higher cost 2. Option expires with the underlying above breakeven 3. Underlying price doesn't move fast/far enough	1. Highest cost 2. Lowest rate of return 3. The stock price rises above the purchase price
Features	1. Lower cost 2. Lower max risk 3. Higher rate of return 4. Can profit with little or no price movement	1. Larger potential maximum profit 2. Simple strategy, one leg 3. One commission 4. No assignment risk	1. No time limit/decay 2. Can receive dividends 3. Simple strategy 4. One commission

Julia's bear call spread could achieve the maximum profit if the price of DVA moved down to the target, stayed sideways, or even rose slightly as long as it remained under \$140 until the options expired without the short call being assigned.

Favorable conditions for a bear call spread:

The bear call spread offers the possibility of profiting from a sideways to moderately bearish stock or index movement. The trader expects the calls to expire worthless, so they can potentially capture the entire net credit received when initiating the spread as profit. The bear call spread may have a lower cost and might offer lower risk than buying call options outright.

Traders may consider implementing a bear call spread when implied volatility is relatively high. In such conditions, options tend to be more expensive, which can result in a larger credit received when initiating the spread. This credit represents the maximum potential profit for the trade. The bear call spread benefits from decreasing volatility and time decay. Suppose the trader closes the position before expiration by buying back the spread. In that case, a decrease in implied volatility and the passage of time may work in their favor, potentially lowering the cost to close the position and allowing them to retain a portion of the initial credit as profit.

How to place a bear call spread trade:

1 Select a Stock or Index

Identify a stock or index expected to decline in price or drop in volatility.

2 Choose Strike Prices and Expiration

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

3 Considerations

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

b) The strike of the sold call should be as low as possible to collect a premium but above the price the stock or index is expected to be when the options expire. The maximum profit is the net premium collected at entry.

c) Because this is a credit spread, time decay helps the position. The options in the spread can be allowed to expire if they are out of the money. To experience more significant time decay, expirations that are less than thirty days out could be chosen. Time decay increases exponentially within the last thirty days before options expiration.

d) Choosing longer expirations may offer greater premiums, but they experience slower time decay and may increase the possibility of assignment on the short call. Selecting deeper out-of-the-money options will lower the chance of assignment and the premium received.

Exiting the bear call spread:

- 1 Some traders opt to hold the bear call spread position until the options expire. If both options expire out of the money, the total premium collected at entry will become profit minus commissions and fees.
- 2 Close the spread by selling the bought call and buying back the sold call option. Profit is realized if this is done at a lower value than the premium collected when the spread was opened.
- 3 Since time decay helps the position's profitability, consider using options with approximately 30 days or less before expiration. Closing the spread before options expiry may result in a smaller profit.
- 4 The spread can be closed if the underlying stock or index price is above the short call's strike and the short option has not been assigned. This may result in a loss that is potentially less than the maximum.
- 5 A stop loss can be placed on an open bear call spread. Refer to the Options Education Center's "Placing activation rules on options orders" for more information.



Explore Strategies – Discover options strategies and empower your trading with the knowledge and skills to navigate dynamic market conditions.

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 bear call spreads without exposing real money, allowing you to gain confidence in executing the strategy.

Conclusion

In summary, the bear call spread is a strategy that involves simultaneously selling a call option and purchasing another one with a higher strike price on the same underlying asset and expiration date. The net premium received from this transaction represents the maximum potential profit for the spread. While buying the higher strike call option reduces the potential profit, it also effectively limits the maximum risk associated with the position.

The bear call spread strategy can be a valuable tool for traders anticipating that a stock or index's price will remain relatively stable or experience a slight decline. Compared to other bearish strategies, the bear call spread offers the advantage of profiting from a broader range of potential price outcomes while maintaining limited risk exposure.

To effectively incorporate the bear call spread into your trading arsenal, it is essential to thoroughly understand its mechanics, risk-reward profile, and suitable market conditions. As with any options strategy, practicing with small positions and gaining experience through various market scenarios is crucial for success.

By mastering the bear call spread, traders can enhance their ability to navigate bearish markets, manage risk, and achieve their financial goals. When used appropriately, this strategy can be a powerful addition to a trader's toolkit, providing an alternative approach to capitalizing on market opportunities and optimizing risk-adjusted returns.



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