Equity Options
Strategy

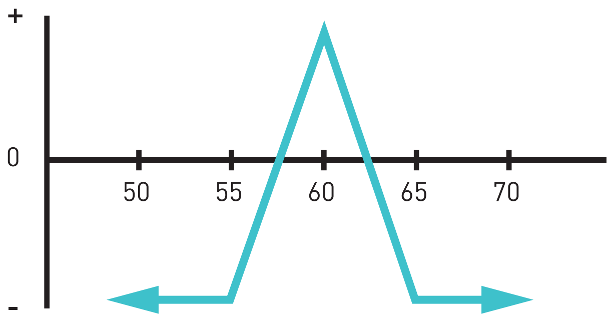
MONTRÉAL EXCHANGE

Long Call Butterfly

Description

Combining two short calls at a middle strike, and one long call each at a lower and upper strike creates a long call butterfly. The upper and lower strikes (wings) must both be equidistant from the middle strike (body), and all the options must have the same expiration date.

Long Call Butterfly
Net Position



Example

Long 1 XYZ 65 call
Short 2 XYZ 60 calls
Long 1 XYZ 55 call

MAXIMUM GAIN
Short call strike- Lower long call strike - Net premium paid

MAXIMUM LOSS
Net premium paid

Outlook

Looking for the underlying stock to achieve a specific price target at the expiration of the options.

Profit by correctly predicting the stock price at expiration.

Breakeven

The strategy breaks even if at expiration the underlying stock is above the lower strike or below the upper strike by the amount of premium paid to initiate the position.

Volatility

An increase in implied volatility, all other things equal, will usually have a slightly negative impact on this strategy.

Time Decay

The passage of time, all other things equal, will usually have a positive impact on this strategy if the body of the butterfly is at-the-money, and a negative impact if the body is away from the money.

Assignment Risk

Yes. The short calls that form the body of the butterfly are subject to exercise at any time, while the investor decides if and when to exercise the wings. The components of this position form an integral unit, and any early exercise could be disruptive to the strategy. In general, since the cost of carry makes it optimal to exercise a call option on the last day before expiration, this usually does not pose a problem. But the investor should be wary of using this strategy where dividend situations or tax complications have the potential to intrude.

And be aware, a situation where a stock is involved in a restructuring or capitalization event, such as a merger, takeover, spin-off or special dividend, could completely upset typical expectations regarding early exercise of options on the stock.

Expiration Risk

Yes. This strategy has an extremely high expiration risk. Consider that the maximum profit occurs when at expiration if the stock is trading right at the body of the butterfly. Presumably the investor will choose to exercise their in-the-money wing, but there is no way of knowing for sure whether none, one or both of the calls in the body will be exercised. If the investor guesses wrong, they face the risk of the stock opening sharply higher or lower when trading resumes after the expiration weekend.