

MONTREAL EXCHANGE

Cash-Backed Call

(Cash-Secured Call)

Description

The investor buys a call option, and sets aside in a risk-free interest-bearing instrument enough cash to exercise it.

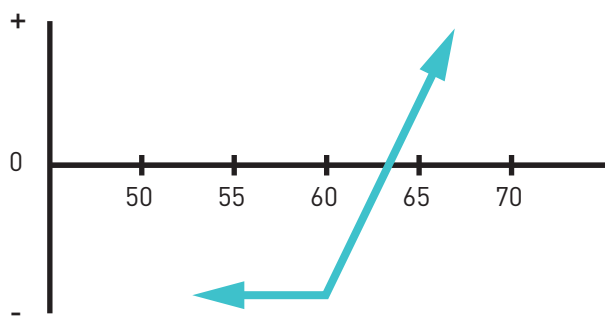
This strategy is the equivalent of a rain check for the underlying stock, because it allows an investor to postpone the purchase decision. The call guarantees a maximum purchase price during the life of the option, while leaving the investor free to take advantage of any downturn that might occur in the stock price.

If the stock rallies above the strike price, a call owner can consider exercising or selling to close, hopefully at a higher price. If, on the other hand, the stock is below the strike at expiration, the call expires worthless.

However, by purchasing the call option, the investor locked in an opportunity to re-consider the stock purchase. Assuming that the long-term outlook for the stock still looks good, it might be a great time to buy the stock at the new, lower market price.

Cash-Backed Call

Net Position



Example

Long 1 XYZ 60 call
Long \$6,000 T-Bill

MAXIMUM GAIN

Unlimited

MAXIMUM LOSS

Premium paid

If the stock's prospects now seem fundamentally worse, the investor 'dodged a bullet' by only risking the call premium. The remaining capital is still available for other investments.

Outlook

Looking for a sharp move in underlying stock, either up or down, during life of option. The longer-term outlook for stock is bullish.

Summary

This strategy allows an investor to purchase stock at the lower of strike price or market price during the life of the option.

Motivation

Acquire stock. This is a classic option strategy whereby an investor locks in a future purchase price without giving up the ability to purchase the stock at a lower price should the market decline during the life of the option.

Variations

This strategy differs from a long call only in the motivation of the investor and their ability to actually exercise the option and pay for the underlying stock. A long call strategy is usually liquidated for a profit or loss before its expiration, whereas an investor using the cash-backed call strategy actually intends to purchase the stock and hold it for the longer term.

A common variation of this strategy is to liquidate a long position in the stock and replace it with the cash-backed call, thus preserving the investor's exposure to the stock while limiting the risk. There could, however, be tax consequences for using this replacement strategy. And for any variation of this strategy, ownership of a call option does not give the investor any voting rights in the company, nor will they receive any dividends.

Max Loss

The maximum loss from the option itself would be the premium paid. Since this strategy is designed to acquire stock, the ultimate gain or loss depends on the longer-term performance of the stock. From this perspective, the option expiring worthless would be a positive event since it would allow the investor to purchase stock at an even lower price.

Max Gain

The maximum gain from the option is unlimited since there is no upper bound on the price of the underlying stock.

Profit/Loss

The potential profit is unlimited, whether measured by the option's near-term or stock's long-term performance. Losses during the life of the option are limited.

The worst situation would be if at expiration the stock were exactly at the strike price of the call option; in this case the premium paid would have been lost without the benefit of being able to purchase the stock at a reduced price.

Assuming the investor's outlook for the stock remains bullish, they would benefit from a move in either direction. If the stock goes down it can be purchased at the lower price; however high it might rise, the stock can be purchased at the strike price of the option.

Breakeven

Breakeven at expiration can be defined here in two ways. The standard definition for an option breakeven is the point where the benefits of exercising the option are equal to the premium paid:

Breakeven = strike price + premium.

But to really understand this strategy, it should be compared to the alternative of simply buying the stock today. If the stock moves higher, the investor using the cash-backed call strategy is worse off by a fixed amount: the premium paid, plus (minus) the original out-of-the-money (in-the-money) amount. But if the stock drops by more than the premium amount, the investor will be better off for having delayed the purchase, i.e., the downside 'breakeven' point could be seen as:

Breakeven = starting stock price – premium

Volatility

An increase in implied volatility, all other things equal, would have a positive impact on this strategy. However, since the investor's motivation is to purchase the stock, this is not the driving factor.

Time Decay

The passage of time, all other things equal, will have a negative impact on this strategy. As expiration approaches the insurance value of the strategy is eroded because there is less likelihood of a significant move in the underlying stock.

Assignment Risk

None.

Expiration Risk

None. It is presumed that the investor will want to exercise the option if it's in-the-money. If in-the-money at expiration, the option will most likely be exercised on the holder's behalf unless contrary instructions are submitted to their brokerage firm, so it's always a good idea to be familiar with all your broker's procedures and deadlines for option expirations.

Comments

This strategy is especially suitable for investors who have a large amount of cash to invest in the market. It allows them to immediately lock in some upside potential without giving up the ability to dollar-cost average their stock purchases.

Should the stock rise and the option go in-the-money, the investor should pay particular attention to any dividend payments as it may be optimal to exercise the call early to reap the dividend.

Unlike a shareholder, the owner of a call has no voting rights, receives no dividends and, in the event of a merger or spinoff, is not entitled to take advantage of any election that might be offered.

Related Position

Comparable Position: [Protective Put](#)

Opposite Position: N/A