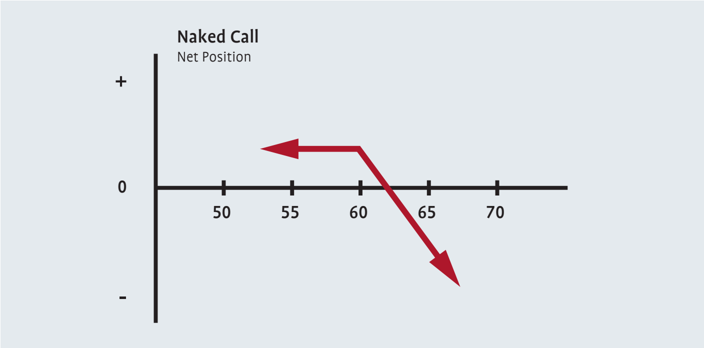
EQUITY OPTIONS STRATEGY

Naked Call (Uncovered Call, Short Call)

DESCRIPTION

An investor who writes a call option without owning the underlying stock is banking on a flat to bearish short-term forecast for the stock. The strategy consists of writing the call in hopes that it will lose value through time decay and eventually expire out-of-the-money. If the term ends without the option being assigned, the writer keeps the entire premium initially received, and all obligations under the short call position terminate.

The strategy's staggering risk stems from the investor's obligations should the stock unexpectedly rally and the call be assigned. The naked call writer has no way to offset assignment risk. To make matters worse, the obligation is open-ended. Since there is no limit to how high the stock's price could rise, there is no upper boundary to the losses to be incurred in acquiring the stock for delivery in the event of assignment. Choosing higher strike prices and shorter expiration terms could make the strategy somewhat less dangerous, but there is simply no way to predictably counter the huge risk.



EXEMPLE

Short 1 XYZ 60 call

MAXIMUN GAIN
Premium received

MAXIMUN LOSS
Unlimited

OUTLOOK

Looking for a steady or falling stock price during life of the option.

In principle, an investor who expects an imminent and severe downturn could write a naked call despite being bullish on the stock's long term prospects. However, success would require being right about the extent and exact timing of the short-term correction, and a great deal of confidence, given the risks.

SUMMARY

This strategy consists of writing an uncovered call option. It profits if the stock price holds steady or declines, and does best if the option expires worthless.

MOTIVATION

The only motive for writing an uncovered call option is to earn income from selling premium.

MAX LOSS

The maximum loss is unlimited. The worst that can happen is for the stock to rise to infinity, in which case the investor would have to buy stock in the market at that undefinably high price and sell it at the strike price.

MAX GAIN

The maximum gain is very limited. The best that can happen is for expiration to arrive with the stock price below the strike price. In that case, the option expires worthless and the investor pockets the premium received for selling the call option.

PROFIT/LOSS

This strategy represents the most extreme form of option investment risk. The potential profit is very limited. Potential losses are unlimited.

Since the strategy is done solely for the premium income, there may be a temptation to sell contracts that fetch greater prices. However, lower strike prices and longer terms only compound the risks of assignment. With a naked put, there is at least a limit to how high the losses can go. With naked calls, there is none.

BREAKEVEN

At expiration, the strategy breaks even if the stock price is above the strike price by the amount of the premium received; i.e., the option's intrinsic value equals the price at which the option was sold.

Breakeven = strike + premium

VOLATILITY

An increase in implied volatility would have a negative impact on this strategy, all other things equal. It means the market perceives there to be a greater chance than before of the option becoming in-the-money or more in-the-money. And even if the naked call writer weren't worried about that assessment, a higher call value would nonetheless matter because the cost of closing out the position would go up.

TIME DECAY

The passage of time will have an extremely positive impact on this strategy, all other things equal. As expiration approaches, option values tend to decline toward their intrinsic value. If, as hoped, the call is out-of-the-money, its intrinsic value is zero, and barring other developments it becomes increasingly likely to expire worthless.

ASSIGNMENT RISK

There is tremendous assignment risk. Early assignment, while possible at any time, generally occurs only when the stock goes ex-dividend.

Unless they are completely indifferent to being assigned, investors with short positions must continuously monitor the stock for possible early assignment.

A naked call writer is by definition not well prepared to honor an assignment notice, so the risk of early exercise is extreme.

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

The option writer cannot know until the Monday following expiration whether or not assignment occurred. And unless the investor is prepared (and approved) to hold a short stock position that is already 'under water' at the strike price, the goal is to buy back the assigned stock as soon as possible. The delay of a weekend exposes the investor to interim stock price risk, as well as the administrative challenge of delivering shares in time for settlement.

COMMENTS

This is the riskiest option strategy there is, and definitely not suitable for most investors. It requires posting a significant cash margin to initiate the transaction, but the risk is well in excess of that initial margin, and an unfavorable market move could force the investor to post additional margin on very short notice or to liquidate their position at a substantial loss.

RELATED POSITION

Comparable Position: **Covered Put**

Opposite Position: **Long Call**