Option Trading Series – eBook 4 of 8

SELLING A NAKED CALL TO OPEN

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About the author

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We have seen in our previous chapter how a long call position will affect your account financially. But you may be wondering what your counterparty, i.e. the investor who sold you the call, is doing. What is his potential profit? What is his risk? What was his strategy?

Let's put ourselves in the shoes of our call seller. We will assume here that he sold us the call "to open", he created a short position.

With stocks, generally you can only buy stocks first, then sell later. Calls and put options are different: they can be bought to open, then sold to close, but they can also be sold to open, then bought to close.

There are two strategies when it comes to selling calls to open (also called "writing calls"):

- "naked calls" are sold without owning the underlying stock.
- "covered calls" are sold while owning the underlying stock.

These two strategies have very different risk profiles, and are for different kinds of investors.

Naked calls

First, what happens when an investor sells calls, without owning the underlying stock? To answer this question, we need to talk about margin.

Margin calculation is an important tool of a bank or broker, and will determine when positions need to be "closed off", that is to be closed unilaterally, to stop losses from exceeding an acceptable level.

With stocks, you generally don't need to worry about margin, because on most brokerage accounts (unless you use a Lombard credit or similar facility), if your portfolio loses value, there is no threat that the total account value may go below zero. Even if all the companies in which you invested went bankrupt, the stock positions would go to nil, but you would still not owe the bank anything.

However, for the seller of a call option, things are different. Think about it: the seller of our initial Microsoft call gave YOU the right to buy 100 shares from him at $260, whenever YOU decide to exercise the call (but no later than expiration day).

Let's take an extreme example. If our call seller does not own Microsoft shares and the stock price moves unexpectedly to $300, what will happen? Well, he will be liable to deliver the 100 shares and receive "only" $26,000 from you, should you decide to exercise the call. In order to deliver the 100 shares he does not own, he'll have to buy them on the open market at $300. If he holds at least $30,000, he is ok. If not, he has a problem, and so does his bank.

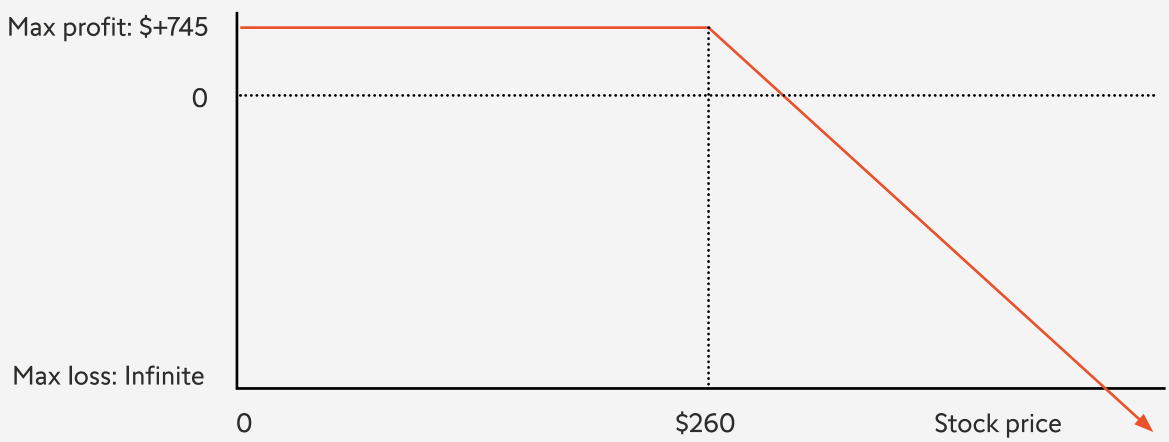
Therefore, at any time his bank needs to assess how much money he is liable to spend to fulfil his possible obligations. In this example, two things should happen on his account:

- $30,000 will be blocked on his account, and will not be made available to buy other assets. This is the required margin for keeping his short call;
- If his cash level gets dangerously close to his new margin requirement of $30,000, his broker will automatically buy his short call to close to cancel the financial risk.

Now let's see this exact same scenario (investor sold you a call $260 at $7.45, stock rises to $300) and focus on the call price only. If the stock price has gone from $260 to $300, the call price will move up significantly from the initial $7.45, to maybe $48. What he sold for $745 initially, is now going to cost him $4800 to buy back! Like all investors who made a trade that went wrong, he faces a dilemma. Should he cut his losses and buy back his short call now, or should he wait in the hope that the stock price will move back down? Well, thanks to margin calculations, his bank may take his decision for him, by cutting the risk and closing the position.

We purposefully looked at a short call trade gone wrong, to illustrate its risk. The trade-off for this risk, of course, is the premium, which the call seller cashes in immediately on writing (selling to open) the call. Just know that your broker will automatically start to calculate your margin requirements once you start writing naked options. Regular monitoring of your position is advised, and you should always consider cutting your losses early if the market starts going against you.

Selling naked calls to open: P&L Chart



Here is the profit and loss chart for the investor's short call trade

Two line summary

A call seller (call writer) wants to profit from time decay by cashing in the call premium, and hopes that the underlying price will not rapidly move up before expiration.

In our next chapter, we will discuss selling covered calls.

Thank you for your attention!

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