# WRITING COVERED CALLS

Believe it! If you own shares of a high quality stock, there are people lined up to give you money now, which can be thousands of dollars, to buy your shares from you, at a higher price! Let me explain.

Writing (selling) covered calls has become a popular means for investors and traders to manage long-term stock portfolios, generate profits without having to sell stock and reduce the impact of losses. It is a useful strategy for increasing investment income, while providing a relatively conservative means to offset downside risk and improve upside returns. The strategy yields cash, even on stocks that don't produce a dividend, and can also be used to decrease cost-basis and thereby improve tax implications. However, as with any investment strategy, an individual's particular situation, goals and risk tolerance must be considered carefully in order to assess whether this strategy is appropriate.

**WHAT IS A COVERED CALL?**

Stock-holders have the right to sell their stocks at market price, at any time. But they also may sell this right to someone else. In a covered call, the stock-holder sells the buyer the option to acquire the stock, at an agreed-upon price, called the strike price, within a set time-period.

Contracts are then written, each of which typically covers 100 shares of stock. These are known as covered call contracts. The seller of the contracts is paid a premium at the time of sale, producing immediate income additional to any he might earn on the stock itself long-term. This cash may also offset any losses should the stock lose value.

Because the seller owns the underlying stock, the call is said to be "covered." Otherwise, the seller would be forced to buy the stock, at whatever the market price might be, should the option buyer decide to exercise his option. This situation is called a "naked call," but involves an inherently high degree of risk.

If, within the agreed upon time-period, the buyer does not exercise his right to acquire the stock at the agreed strike-price (usually because the strike price is at or above market price), then the contract becomes void, the seller retains the stock and the right to sell it. He keeps the cash, regardless of whether the options are called or not. He can write more covered calls, even on the same stock.

**WHY SELL COVERED CALLS?**

In short, covered calls generate cash on stocks that are already owned. Investors sometimes hold certain stocks as part of a long-term strategy. When, over a short-term period, these stocks decrease slightly, remain flat or rise slowly in value, they can be used to generate cash via the sale of covered calls, above and beyond any dividends that may be distributed. Often, the goal is not to sell these stocks, but to hold them and generate cash from covered call premiums.

Some investors write covered calls with the intention of selling the underlying stock. If they have decided to close out a stock, a covered call makes it possible for them to do so while also generating a premium in addition to the stock's market value. Of course, if the strike price isn't reached, they retain their stock and risk further losses if it falls in value.

**WHAT ARE THE RISKS?**

If the stock loses value, the covered call will almost certainly expire, leaving you with less valuable stock than you began with. On the other hand, if the stock gains value, you risk losing potential profit over the strike price. Once that agreed-upon price becomes lower than the market price, it is likely your stock will be called away – and that the new owner will benefit from the difference between the strike price and market price.

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## HOW DOES IT WORK?

### *Strike Price*

Let's say you own 100 shares of x corp. You bought them at $40/share and they now are trading at $50/share. You don't expect the stock to rise much, if at all, in the short term, but want to hold the shares as part of your long-term strategy, and generate some additional income.

You decide to write 1 covered call contract for 100 shares of x corp. To write the contract you must select a strike price. A range of strike prices can be found listed in the options quotes. As the strike price rises, the premiums fall. This is because the lower the strike price, the more the buyer stands to profit from your covered call contract. It is simply more likely that your stock value will reach $41/share than $45/share. This reality is reflected in the premiums. In this case, let's say you select the bid price, or premium, of $2 for a strike price of $42.

### *Expiration Date*

Expiration dates are set to the third Friday of each month. By the end of that day of trading, either your option is assigned and your stock is sold, or the contract expires and you keep the stock. As with the strike price, variations in the duration of the contract will affect the premium buyers are willing to pay for it. The longer the contract, the higher the likelihood that the strike price will be reached. For our example, we'll assume that, like many investors, you decide to keep the contract open for only a couple of months. You write the covered call contract in June, to expire in August.

For this example, let's assume the covered call is sold the day it is written. There are several scenarios that can play out.

### *Called Away*

If the stock value exceeds the strike price, at any time after the contract is written, it can be "called away" from you. You can be assigned an exercise notice and must sell the stock. Because you are obligated to sell at the strike price, which in our example is $42/share, you cannot benefit from any value above that price. If, for example, the stock rises to $48/share, you still only receive the $42/share written into the call contract. However, you have made a profit, both from a rise in your stock's value since purchase, and from the premium you received from the sale of the contract.

### *Expiration*

If the stock value never reaches the strike price, your contract will likely expire – and you keep the stock. Unless the stock is dropping rapidly, many investors write more covered call contracts at this point, accruing more cash from premiums. If the stock has dropped significantly, however, these premiums may not offset losses. Once the option expires, you can now sell your stock if you wish to.

## STRATEGIC INSIGHTS

### *Volatility*

A covered call strategy is effective when you own stocks whose implied volatility is in the middle range. Higher volatility stocks tend to command higher covered call premiums – because they are deemed more likely to hit a higher price if they go up. A low volatility commands a lower premium because the stock is less likely to hit strike prices. The more volatile the stock, the more likely it will move significantly. This also means there's a likelihood you'll take a loss, should the stock swing too far in the wrong direction.

Somewhere in the middle range is a stock that will command enough of a premium to make the covered call worthwhile, while presenting only a minimal risk of holding a losing stock. Experienced traders look at these, and many other factors, very carefully, before writing covered call contracts.

### *Capital Gains*

In some cases, usually in which an investor owns shares of stock purchased at different times, and at different prices, it is beneficial to select specific shares to deliver when assigned. If, for example, you have been buying 100 shares of a stock each year, for several years, and the price has gone up each year, and a contract for 100 shares is assigned, it is possible to deliver a particular set of shares, purchased at a particular price. It may be advisable to deliver the most recently purchased shares to avoid a large tax bill due to capital gains. Of course, any decision of this type should be taken only with the advice of an experienced tax professional.

The cash proceeds, or premiums, that the seller (also called the writer) of the options gets are not taxable until the option position is closed out. So if the option expiration date is in

the next calendar year, and the option expires, or is assigned , or is closed out in the next calendar year, the taxable gain is not recognized until that calendar year.

### *Buy Back the Call*

Selling a call does not necessarily lock you in to the stock should it drop in value. It is possible to buy back your call contract. If the stock price is dropping, you may be able to buy it back for less than you sold it, possibly making a profit. Of course, once you have bought back the call, you are free to sell, should you see the need to dump your long stock position.

### *Buy-writes*

Some investors choose to buy the stock and sell the covered call option in a single transaction. This is often part of an ongoing income-generation strategy. In addition to convenience, the strategy can minimize some trading risks associated with options trades of this type, but also may have tax implications. Talk to a tax professional to establish whether this approach is right for your particular situation.

## CALCULATING COVERED CALL RETURNS

Call sold: March 55 call

Call premium: $2.50

Stock price at time of covered call trade: $50

Number of shares traded: 100

Number of contracts traded: 1

Commission for this trade: $10.55 ($4.95 + $4.95 + $0.65)

Assignment commission – if assigned: $4.95

### STATIC RETURN

$$\frac{\text{Call premium for 100 shares less commissions}}{\text{(Stock Price – Call Premium) for 100 shares}}$$

$$\frac{\$2.50 \times 100 - \$10.55}{(\$50 - \$2.50) \times 100} = 5\%$$

### IF CALLED RETURN

$$\frac{\text{Call strike – Stock Prices + Call Premium for 100 shares less commissions}}{\text{(Stock Cost – Call Premium) for 100 shares}}$$

$$\frac{(\$55 - \$50 + \$2.50) \times 100 - \$15.50}{(\$50 - \$2.50) \times 100} = 15\%$$

NOTE: If an In-the-money call is used, assignment is nearly guaranteed, unless the stock tanks. Therefore you need to pay attention to the “if called return” calculation.