Why Consider Covered Calls?
July 10, 2013 | Joe Burgoyne, OIC

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In order to simplify the computations, commissions, fees, margin interest and taxes have not been included in the examples used in these materials. These costs will impact the outcome of all stock and options transactions and must be considered prior to entering into any transactions. Investors should consult their tax advisor about any potential tax consequences.

Any strategies discussed, including examples using actual securities and price data, are strictly for illustrative and educational purposes only and are not to be construed as an endorsement, recommendation, or solicitation to buy or sell securities. Past performance is not a guarantee of future results.
3  Who We Are

OIC The Options Industry Council

4  Annual Options Volume, 1973-2012

[Bar chart showing annual options volume from 1973 to 2012, with categories for equity and index options]
Covered Call Overview

- Strategy is appropriate for a neutral to moderately bullish stock outlook
- You are looking to increase income in a stable market
- Profits are limited when the stock price rises above the strike price of the call
- Losses occur in the stock price if the stock falls below the break-even point
7 Covered Call Definition

- Covered call: investor simultaneously
  - Writes (sells) one or more equity call contracts
  - Buys equivalent number of underlying shares
  - One short call for each 100 long shares

- If stock bought and call written at same time
  - “Covered write” or “buy-write”

- If stock already owned when call is written
  - “Overwrite”

8 Questions To Consider

- Why write covered calls?
- What are the covered call writer’s obligations?
- Why is the short call considered “covered”?
- What are the covered call writer’s concerns?
9  Why Write Covered Calls?

• Primary goal – increase returns
  • Call premium received and kept (assigned or not)
  • Generate additional income (over any dividends)

• Investor’s forecast
  • Neutral to bullish on the underlying stock
  • Within a small price range over strategy’s lifetime

• Call premium’s limited downside benefits
  • Lowers stock’s break-even point (BEP)
  • Reduces cost basis for long stock by call premium amount

10  Covered Call Writer’s Obligations?

• Like any call writer (short call position)
  • Has the obligation to sell underlying shares
  • At strike price
  • If assigned

• Assignment (your potential obligation)
  • Possible at any time before expiration
  • Equity options are American-style

• In return for this obligation
  • Call writer receives and keeps option premium
### 11 Why Is the Short Call “Covered”?  

- **Long stock** "collateralizes" short call obligation  
  - If assigned → shares to be sold already purchased  
- **Upside loss potential of short call** is **limited**  
  - Any upside loss offset by stock gain  
- **Remember**  
  - Upside loss potential for uncovered call is unlimited

### 12 Covered Call Writer’s Concerns?  

<table>
<thead>
<tr>
<th>Long Stock</th>
<th>Covered Call</th>
</tr>
</thead>
</table>

- **Where’s the risk with a covered call?**  
  - **Risk is in the long stock**

- **Upside stock profit potential is limited**  
  - Assignment → stock sold at strike price  
  - Short call loss reduces long stock profit
Covered Call: Profit and Loss at Expiration

- **Upside profit potential is limited**
  - Strike price – stock price paid + call premium received
  - If assigned stock sold at strike price

- **Break-even point**
  - Stock price paid – call premium received

- **Downside loss potential is substantial**
  - Downside risk is with stock
  - Option in this case offers only limited protection
  - Entire stock cost less call premium received is the risk

Covered Call Example

You own 100 XYZ shares trading at $52.00

- Neutral to moderately bullish over next few months
- Want to generate income in a stable market
- You have target sale price for stock

Sell 1 90-day XYZ 55 call at $1.75

- Total premium received = $175.00
Covered Call Example

Own 100 shares XYZ at $52.00
Sell 1 XYZ 55 call at $1.75

<table>
<thead>
<tr>
<th>Stock Price at Expiration</th>
<th>Long Stock Profit/(Loss) at Expiration</th>
<th>Short Call Profit/(Loss) at Expiration</th>
<th>Net Profit/(Loss)</th>
</tr>
</thead>
<tbody>
<tr>
<td>$60.00</td>
<td>$8.00</td>
<td>($3.25)</td>
<td>$4.75</td>
</tr>
<tr>
<td>$55.00</td>
<td>$3.00</td>
<td>$1.75</td>
<td>$4.75</td>
</tr>
<tr>
<td>$52.00</td>
<td>0</td>
<td>$1.75</td>
<td>$1.75</td>
</tr>
<tr>
<td>$50.00</td>
<td>($2.00)</td>
<td>$1.75</td>
<td>($0.25)</td>
</tr>
<tr>
<td>$45.00</td>
<td>($7.00)</td>
<td>$1.75</td>
<td>($5.25)</td>
</tr>
<tr>
<td>$40.00</td>
<td>($12.00)</td>
<td>$1.75</td>
<td>($10.25)</td>
</tr>
</tbody>
</table>

Covered Call Example

Own 100 shares XYZ at $52.00
Sell 1 XYZ 55 call at $1.75

Break-even at Expiration:
Stock Price Paid – Call Premium Received
$52.00 – $1.75 = $50.25

Maximum Profit if Assigned:
Effective Stock Sale Price – Stock Price Paid
($55.00 + $1.75) – $52.00 = $4.75
$475.00 Total
17  
**Covered Call**  
*In-the-Money vs. Out-of-the-Money*

- Writing in-the-money covered call  
  - Defensive and more conservative  
  - More premium received → more downside protection  
  - Less upside profit potential

- Writing out-of-the-money covered call  
  - Aggressive and less conservative  
  - Less premium received → less downside protection  
  - More upside profit potential

18  
**Another Covered Call Example**

**Date:** July 31

**XYZ Options**

<table>
<thead>
<tr>
<th>Calls</th>
<th>Puts</th>
</tr>
</thead>
<tbody>
<tr>
<td>Oct</td>
<td></td>
</tr>
<tr>
<td>35</td>
<td>$8.75</td>
</tr>
<tr>
<td>40</td>
<td>$4.90</td>
</tr>
<tr>
<td>45</td>
<td>$2.30</td>
</tr>
<tr>
<td>50</td>
<td>$0.90</td>
</tr>
</tbody>
</table>

October expiration in 80 days  
Not including commissions

**Data on XYZ:**
- Currently trading at $43.50  
  - 52-week high = $49.87  
  - 52-week low = $36.75

**Your forecast:**
- Expect XYZ to trade between $40 and $45 for next 80 days

**Action:**
- Buy 100 XYZ at $43.50  
- Sell 1 XYZ Oct 45 call at $2.30
19  Another Covered Call Example

- XYZ currently trading at $43.50
- Your position
  - Long 100 XYZ at $43.50
  - Short 1 XYZ Oct 45 call at $2.30
- Important information
  - October expiration is in 80 days
  - XYZ pays $0.18 dividend in 27 days

20  Covered Call Example
Profit and Loss at Expiration

Long 100 shares XYZ at $43.50
Short 1 XYZ Oct 45 call at $2.30

Break-even at Expiration:
$43.50 – $2.30 = $41.20

Maximum Profit:
($45.00 – $43.50) + $2.30 = $3.80
$380.00 Total

Not including commissions
### Covered Call Example
#### Profit and Loss at Expiration

Long 100 shares XYZ at $43.50
Short 1 XYZ Oct 45 call at $2.30

<table>
<thead>
<tr>
<th>Stock Price at Expiration</th>
<th>Long Stock Profit/(Loss) at Expiration</th>
<th>Short 45 Call Profit/(Loss) at Expiration</th>
<th>Net Profit/(Loss)</th>
</tr>
</thead>
<tbody>
<tr>
<td>$50.00</td>
<td>$6.50</td>
<td>($2.70)</td>
<td>$3.80</td>
</tr>
<tr>
<td>$45.00</td>
<td>$1.50</td>
<td>$2.30</td>
<td>$3.80</td>
</tr>
<tr>
<td>$43.50</td>
<td>0</td>
<td>$2.30</td>
<td>$2.30</td>
</tr>
<tr>
<td>$40.00</td>
<td>($3.50)</td>
<td>$2.30</td>
<td>($1.20)</td>
</tr>
<tr>
<td>$35.00</td>
<td>($8.50)</td>
<td>$2.30</td>
<td>($6.20)</td>
</tr>
<tr>
<td>$30.00</td>
<td>($13.50)</td>
<td>$2.30</td>
<td>($11.20)</td>
</tr>
</tbody>
</table>

Not including commissions

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### Return Calculations

Return calculations assume the same per period profit can be reached repeatedly throughout the year. This may not be possible.
Static Return Formula

- "Static return" on investment
  - Stock unchanged at expiration (same as price paid)
  - If out-of-the-money call written → expires worthless
  - Also known as "stand still return"

\[
\frac{\text{Income}}{\text{Investment}} \times \text{Time Factor}
\]
\[
\frac{\text{Call Premium + Dividend}}{\text{Stock Price}} \times \frac{\text{Days/Year}}{\text{Days to Expiration}}
\]

Not including commissions

Static Return Worksheet

Call price less commissions $2.30

Plus dividends $0.18

Equals income $2.48

Divided by (stock price plus commissions) 43.50

Equals % income 5.7%

Times 365/80 (days to expiration) 4.5

Equals annualized static return 26%

Not including commissions
If-Called Return Formula

- If-called return on investment
  - Stock price **above strike price** at expiration
  - Call is assigned
  - Stock sold at strike price

\[
\frac{\text{Income} + \text{Stock Gain}}{\text{Investment}} \times \frac{\text{Time Factor}}{\text{Days/Year}} \times \frac{(\text{Call} + \text{Dividend}) + (\text{Strike} - \text{Stock})}{\text{Stock price}} \times \frac{\text{Days to Expiration}}{\text{Days to Expiration}}
\]

Not including commissions

If-Called Return Worksheet

<p>| | | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Call price less commissions</td>
<td></td>
<td>$2.30</td>
</tr>
<tr>
<td>Plus dividends</td>
<td>+</td>
<td>$0.18</td>
</tr>
<tr>
<td>Plus profit from stock sale</td>
<td>$45.00 - $43.50</td>
<td>+ $1.50</td>
</tr>
<tr>
<td>Equals income</td>
<td>=</td>
<td>$3.98</td>
</tr>
<tr>
<td>Divided by (stock price plus commissions)</td>
<td>÷ $43.50</td>
<td></td>
</tr>
<tr>
<td>Equals % income</td>
<td>=</td>
<td>9.1%</td>
</tr>
<tr>
<td>Times 365 / 80 (days to expiration)</td>
<td>× 4.5</td>
<td></td>
</tr>
<tr>
<td>Equals annualized if-called return</td>
<td>=</td>
<td>41%</td>
</tr>
</tbody>
</table>

Not including commissions
At-the-Money or Out-of-the-Money Calls?

- Typically, writing closer-to-the-money calls yields a higher static return and a lower if-called return.

- Writing further out-of-the-money calls typically yields a lower static return and higher if-called return.

Planning and Considering What-Ifs
Scenario 1

What should you do if XYZ rises above $45.00 prior to expiration?

A. Do nothing and wait for assignment.

B. Buy back the call and keep the stock.

C. Close the entire position by buying the call and selling the stock.

When should you choose between A, B, or C? 

Market conditions can change, but...you should have a plan when you initiate the position.

Scenario 2

What should you do if XYZ is unchanged at $43.50 at expiration?

A. Write another call.

B. Sell the stock.

There is no “objective answer” to this question. Every investor must make an individual decision.
**Scenario 3**

What should you do if the price of XYZ begins to decline sharply?

A. Write another call (at a lower strike?).

B. Hold the stock.

C. Buy back the short call and sell the stock.

Having a pre-determined stop-loss point is advisable in this situation.

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**Start With A Plan**

- Start with cash
  - You’re buying underlying shares
  - Full cash amount or on margin?

- Find a stock
  - Your forecast is neutral to bullish

- Buy stock / sell call
  - Call in-the-money or out-of-the-money?
The Plan

• Be willing to sell stock at strike price
  • Hope to end up with cash at expiration

• Have a stop loss point
  • Close the position there – requires discipline

• Diversify
  • Multiple stocks and/or industry sectors
  • Write in-the-money and out-of-the-money calls

• Do it again – always be looking for more stocks

Misconceptions about Covered Calls
35  Misconception #1

Being assigned is bad!

THE REALITY:

• Being assigned can be “good” or “bad”
  • What was your initial goal?

36  Misconception #2

Covered writing is good because most options expire out-of-the-money or worthless.

THE REALITY:

Only 25 percent expire out-of-the-money or worthless. You should have a positive motivation for covered writing:

• To outperform a sideways market
• To sell a stock at a target price & generate additional income
• To obtain limited downside protection
37  Misconception #3

Covered writing forces you to “sell winners and keep losers.”

THE REALITY:

• Investing requires active management
• Declining stocks should be sold
• If a short call is assigned, you can repurchase the stock if you are bullish

38  Misconception #4

The larger the premium, the better.

THE REALITY:

• The market is fairly “efficient.” High option premiums mean the market perceives higher risk
• Your market forecast is most important
Covered Call Summary

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For More Information

- 1-888-OPTIONS
- www.OptionsEducation.org
Thank you for attending.