COVERED CALLS
INCOME GENERATING OPTIONS STRATEGY

STRATEGY OVERVIEW

Strategy Name	Covered Calls
Risk Level	Medium Risk
Objectives	Income Generating
Market Outlook	Neutral to Mildly Bullish

What is a Covered Call?

A Covered Call is an options strategy where an investor holds a long position in the underlying (typically shares) and writes (sells) call options against the underlying to generate income. This strategy is typically entered into when the investor is mildly bullish or neutral on the underlying. The Covered Call strategy is also commonly referred to as a Buy-Write as it is effectively the buying of shares and the simultaneous writing of a call contract.

Parts that make up a Covered Call

There are two parts that make up a Covered Call:

1. Purchase Shares.
2. Write (Sell) Call option.

Example

An investor purchases 1,000 shares in XYZ, currently trading at $10.00 per share. The investor would sell 1 XYZ March $10.50 call option and receive $0.25 or $250.00 in premium. By selling the call option the investor is receiving $250.00 but for receiving this premium the investor could be asked at any time between the time the trade was entered and options expiry in March, to sell 1,000 XYZ shares at $10.50. Effectively the premium is the amount you receive for agreeing to give up the potential upside above $10.50.

What are the uses of Covered Calls?

The main use of Covered Calls is to improve the percentage return on an investment and enhance the profitability of owning a particular share. If you purchased shares in a blue chip company, over the course of a year you would typically expect to earn two dividend payments, an interim dividend and then a final dividend. The dividend you receive relative to the share price is commonly referred to as the dividend yield. The sale of call options over your shares helps generate additional income and increase the yield on owning the underlying share. This strategy is particularly attractive for clients with existing portfolios who may be looking to enhance the return on their shares.

Risk / Reward

Covered Calls have limited upside potential while the loss is unlimited on the down side.

Risk

The risk in this strategy is if the stock falls by an amount greater than the combination of the premium and/or dividend income generated. If the share price falls by more than this amount a loss is incurred on the stock position that is only stopped if the share price falls to zero. In the 'Strategy' section we discuss how to avoid this risk.

Reward

The reward from selling call options against your shares is twofold; the income that is generated and the way in which this income reduces your average entry price of buying the shares while improving the yield on owning the shares.

The Specifics

Market Outlook	Neutral/Mildly Bullish
Breakeven	Share price at time of purchasing shares (less premium and/or dividends received)
Maximum Profit	Maximum Profit = Strike price of sold call – purchase price of shares + call premium + dividends received
Maximum Loss	Occurs if the share price falls to zero (less premium received)
Time Decay	Helps
Margins to be paid	No - underlying stock is lodged as collateral

Considerations

When you are thinking about opening a Covered Call position, there are two main variables to consider:

1. Underlying – You should look to select a stock that has traditionally paid dividends, represents good value at current prices and that is slowly trending on the upside.
2. Strike Price – Do you select an 'at-the-money' or 'out-of-the-money' option? An at-the-money option will always provide you with a higher premium and as such will provide greater protection against a fall in the value of the share price. The trade-off is that should the share price rise, the potential profit on buying and selling the shares will be less.

Follow Up Action

When a position has been opened it must be monitored to see if there is any advantage to be gained by any of the following:

1. Closing the trade early.
2. Purchasing put options to protect the capital invested in the position.
3. Buying back sold call options as the cost is low and the time period to expiry is long.

Strategy

1. Purchase shares in lots of 100 that have the ability to increase in value taking into account the possibility of dividends.
2. Sell out-of-the-money call options to generate income.
3. Set a point at which to buy put options if the share price falls. We do this to eliminate the risk identified earlier i.e. the risk of the share price falling to zero.
4. Identify important company dates (such as reporting of earnings) and consider purchasing put options to guard against a fall in the value of shares.

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