Covered Call Strategy

There are essentially three main reasons why people use options as part of their overall Investment strategy:

1. Portfolio Protection
2. Generate additional income (writing covered calls)
3. Speculation / Leverage

Let's begin with a clear understanding of what is a Call and a Put option.

What is a Call Option?

A call option is a standardized contract that gives the buyer the RIGHT (but not the obligation) to BUY a parcel of shares (100-1000 shares) at a predetermined price (strike price) on, or before a predetermined date.

For a fraction of the price "buying" a call option gives you the RIGHT to control shares of the stock (the cost is the premium paid for this option).

What is a Put Option?

A Put option is a standardized contract that gives the buyer the RIGHT (but not the obligation) to SELL a parcel of shares (100-1000 shares) at a predetermined price (strike price) on, or before a predetermined date. The seller of the option has an obligation to buy the shares at the strike price in the event that the option is assigned.

For a fraction of the price "buying" a Put option gives you the RIGHT to control shares of the stock (the cost is the premium paid for this option).

	Buyer (Holder)	**Seller (Writer)**
Call Option	Right to buy	Obligation to sell
Put Option	Right to sell	Obligation to buy

Why do people buy call options? What are the risks?

Stock options are considerably cheaper than buying the equivalent stock position, so leverage is the greatest attraction. Large and small speculators buy call options because they think the stock will go up in price.

If BHP was trading at $33.00 and you believed the stock would rally to $40 in the next month, as an example - you can buy a one month call option (at $33.00) for $1.00 premium. A $1000 outlay gives you the RIGHT to buy 1000 BHP at $33.00 prior to the expiry date (in the next month). If BHP surged to $40 by month end, you could sell your option for $7.00.

If price failed to move above $33.00 by month end, your option would expire worthless (losing your total outlay of $1000) $34.00 would be your breakeven level ($33.00 + Premium paid $1.00 = $34.00).

Therefore BHP would have to rally greater than 4% in this example to just make it above your breakeven level. The rewards can be extraordinary for the buyer of an option as you can often multiply your capital if you are right, however the odds are firmly with the seller as typically 70-90% of options expire worthless.

Because you are buying TIME value with options you own a wasting asset (all options experience time decay as they get closer to expiry).

If you're a buyer of options you not only have to be RIGHT with the direction of the share price, you have to be VERY RIGHT with your timing, in order to make money.

A seller of an option on the other hand, can still win even if they are not right with the direction of the share price or their timing (because time decay works in their favour).

Speculate in options if you need some excitement in your life but if you are looking for a consistent source of income then WRITE covered calls (especially for self Managed Super Funds with potentially great tax advantages).

Writing a Covered Call

Covered Call = Buy Shares of Stock + Sell Call Options on those Shares for Income

Covered calls are a very conservative and simple strategy to establish. It is just a combination of buying shares and selling call options on those shares. The basis of doing a covered call strategy is to generate a consistent income, approximately 2% to 5% each and every month.

The strategy that works = Covered Calls

By purchasing stock and writing options over the stock the Sellers obligations are completely covered as you can deliver the stock if required.

Using BHP as an example, say we bought 1000 BHP shares at $33.00 and at the same time we sold 1 BHP 33.00 Call option at $1.00 with one month to expiry.

B 1000 BHP @ 33.00 = $33,000
S 1 BHP 33.00 Call (1 month expiry) = $1,000

At end of month, if share closes above 33.00 we get assigned and sell stock at 33.00 and receive a 3% return for 30 days. (1000/33000 = 3%)

If share closes below $33.00 the option expires worthless and we keep our 3% premium ($1000) and we can then write another call option for the following month.

The covered call writer receives the juicy call premium, no matter what happens with the underlying stock. Covered call writing can provide a consistent monthly income.

Instead of only receiving 2 dividends a year with some stocks you can potentially receive one every month of the year (great for Self Managed Superannuation Funds).

Let us first explain some of the concepts behind writing call options.

SHOULD WE SELL NAKED CALLS INSTEAD? DO YOU WANT TO LOSE THE SHIRT OFF YOUR BACK?

Selling calls without owning the underlying stock can be potentially very hazardous. Although the odds are in your favour as most options expire worthless, in the few cases you get it wrong you can potentially suffer large or even massive losses.

For example you had a different opinion than the last investor and believed BHP was going lower so you SOLD the BHP $33.00 Call for $1.00.

You received the $1000 premium however if BHP traded as high as $40 similar to our previous example, you would have to buy back the option for $7.00 suffering a loss of $6.00 ($6000) = 500% loss.

If there was some sort of corporate action and the stock jumped 10 or 20% higher, then this type of overnight move could be crushing to your trading a/c.

Bottom Line: Selling Naked Calls and Puts are not highly recommended and not a very wise investment, having said that, selling naked Puts in a Bull market can be rewarding provided you were prepared to buy and take ownership of the underlying shares. It’s the ability to leverage this situation which is what can be treacherous for the average trader.

Is there a conservative way of writing call options?

Yes there is!

It’s called the Covered Call strategy.