Writing Covered Calls

Learn the advanced concepts of building, evaluating and managing a covered call strategy
AGENDA

1. What is a covered call strategy?
2. What should you consider when choosing a strike price?
3. What should you consider when choosing an expiration?
4. How can you manage the strategy?
Before we get started...

• Options trading entails significant risk and is not appropriate for all investors. Certain complex options strategies carry additional risk. Before trading options, please read Characteristics and Risks of Standardized Options. Supporting documentation for any claims, if applicable, will be furnished upon request.

• Examples in this presentation do not include transaction costs (commissions, margin interest, fees) or tax implications, but they should be considered prior to entering into any transactions.

• The information in this presentation, including examples using actual securities and price data, is strictly for illustrative and educational purposes only and is not to be construed as an endorsement or recommendation.
What is a covered call strategy?

- The basics
- Goals of the strategy
- Risks of the strategy
The basics: Covered call strategy

**Outlook:**
Bullish neutral

**Construction:**
Buying (or owning) stock and selling call options on a share-for-share basis

**Max Gain:**
(Strike Price + Call premium received) – Cost of the long shares

**Max Loss:**
Cost of the long shares - call premium received

**Breakeven @ expiration:**
Stock price - call premium received

Where can I learn more?
Research > Learning Center > Options Strategy Guide
Goals: Why do traders sell covered calls?

• **Generate income**
  – Take in premium on bullish neutral outlook
  – Enhance returns on a security that is not expected to move in the short-term

• **As a method of selling stock**
  – Can be used as an exit strategy for a long position

• **To help manage a long stock position**
  – Reduce cost basis / breakeven
  – Reduce delta exposure (share exposure)
  – Generate positive returns in a sideways market

Where can I learn more?

*Research > Learning Center > Generating income with options*
Risks: Get to know the Greeks

### The Greeks (at time of trade)
- Delta - rate of change (+)
- Gamma - rate of change of delta (-)
- Theta - time decay (+)
- Vega - volatility (-)

### What are the risks?
- The underlying price moves down
- Increase in realized volatility
- Not applicable
- Increase in implied volatility

### Trader’s View:
Understand the risks of early assignment to your personal situation – upcoming dividends and tax considerations are often mistakenly overlooked when writing covered calls.

### Where can I learn more?
*News & Insights > Viewpoints > Get to know the Greeks*
What should you consider when choosing a strike price?

- Underlying security exposure
- Rate of return potential
- Key resistance levels
- Probability of assignment
Underlying security exposure

Evaluate how the short call will affect your exposure to the underlying security:

<table>
<thead>
<tr>
<th>Strike</th>
<th>Calls</th>
<th>Delta</th>
<th>Net Delta (1 lot)</th>
</tr>
</thead>
<tbody>
<tr>
<td>60</td>
<td>36.85</td>
<td>0.9959</td>
<td></td>
</tr>
<tr>
<td>65</td>
<td>31.05</td>
<td>0.9953</td>
<td></td>
</tr>
<tr>
<td>70</td>
<td>26.24</td>
<td>0.9865</td>
<td></td>
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<tr>
<td>75</td>
<td>22.80</td>
<td>0.9759</td>
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<td>95</td>
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<td>97.5</td>
<td>3.20</td>
<td>0.5203</td>
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<td>100</td>
<td>2.08</td>
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<td>105</td>
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<td>0.1775</td>
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<td>110</td>
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<td>120</td>
<td>0.06</td>
<td>0.014</td>
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</tr>
<tr>
<td>125</td>
<td>0.03</td>
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<td>130</td>
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<td></td>
</tr>
<tr>
<td>140</td>
<td>0.01</td>
<td>0.0015</td>
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</tr>
</tbody>
</table>

**ITM 92.5 Call**
- Delta = 75
- Net Delta (1 lot) = 25 share exposure (100-75)

**ATM 97.5 Call**
- Delta = 52
- Net Delta (1 lot) = 48 share exposure (100-52)

**OTM 105 Call**
- Delta = 18
- Net Delta (1 lot) = 82 share exposure (100-18)

Image is for illustrative purposes.
Evaluate rate of return (ROR) potential

<table>
<thead>
<tr>
<th>Covered call contract</th>
<th>Bid</th>
<th>Break-Even</th>
<th>Static ROR</th>
<th>Profit if Assigned</th>
<th>Assigned ROR</th>
</tr>
</thead>
<tbody>
<tr>
<td>ITM 92.5 Call</td>
<td>6.4</td>
<td>91.32</td>
<td>-</td>
<td>1.18</td>
<td>1.29%</td>
</tr>
<tr>
<td>ATM 97.5 Call</td>
<td>3.15</td>
<td>94.57</td>
<td>-</td>
<td>2.93</td>
<td>3.10%</td>
</tr>
<tr>
<td>OTM 105 Call</td>
<td>0.7</td>
<td>97.02</td>
<td>0.72%</td>
<td>7.98</td>
<td>8.23%</td>
</tr>
</tbody>
</table>

Example:
• Assumes cost basis of the long stock shares is the current price of $97.72
• Assumes November contracts are being sold

Don’t forget that long stock position has an unlimited potential ROR!

Trader’s View:
Consider the purpose of the underlying position in your account before selling a covered call against it. Does it make sense to cap your potential gains on a security you own strictly for its growth potential?
Key resistance levels

Other factors to consider when choosing a strike price are key resistance levels...

- Identifying price points where the security has had trouble breaking through
- Using slow moving averages (more periods included) as a resistance level

Image is for illustrative purposes.
Probability of assignment

...or targeting an option with a specific statistical probability of assignment.

Tells you that there is a 16.29% statistical probability that AAPL will be above $109.25 on 11/22/14 – the probability of assignment.

Trader’s View:

Because the risk of assignment is to the upside, by selling a 16% probability option, a trader is expecting less than a 1 standard deviation move in the underlying.

• 1 standard deviation captures ~68% of occurrences
• 2 standard deviation captures ~95% of occurrences
• 3 standard deviation captures ~99% of occurrences
Use Delta to evaluate your probability of being assigned:

**ITM 92.5 Call**
- Probability of being ITM at expiration is approximately **75%**
- Bid: 6.40

**ATM 97.5 Call**
- Probability of being ITM at expiration is approximately **52%**
- Bid: 3.15

**OTM 105 Call**
- Probability of being ITM at expiration is approximately **18%**
- Bid: 0.70

Image is for illustrative purposes.
Consider your goals and objective for the trade

<table>
<thead>
<tr>
<th>Method of selling the stock</th>
<th>Higher premium received</th>
<th>More conservative (less bullish)</th>
<th>Offers the most downside protection</th>
<th>Higher probability of being assigned</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>In-the-Money (ITM)</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Offers the most exposure to time decay</td>
<td>ATM options have the most time value</td>
<td>Highest gamma risk</td>
<td>Probability of being assigned, approximately 50%</td>
<td></td>
</tr>
<tr>
<td><strong>At-the-Money (ATM)</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Income generation with upside potential</td>
<td>Lower premium received</td>
<td>Lower up front downside protection</td>
<td>Lower probability of being assigned</td>
<td>More aggressive (more bullish)</td>
</tr>
<tr>
<td><strong>Out-of-the-Money (OTM)</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

What should you consider when choosing an expiration?

- Time decay
- Rolling vs. selling
- Shorter vs. longer-term expirations
Consider time decay in option prices

Time decay typically accelerates as expiration comes closer, meaning shorter-term options have the highest time decay.

<table>
<thead>
<tr>
<th>Strike</th>
<th>Last</th>
<th>Bid</th>
<th>Ask</th>
<th>Theta</th>
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<tbody>
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<td>13.40</td>
<td>13.45</td>
<td>13.65</td>
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<td>87.5</td>
<td>11.25</td>
<td>11.10</td>
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<td>90</td>
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<td>0.13</td>
<td>-0.0099</td>
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</tbody>
</table>

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<th>Ask</th>
<th>Theta</th>
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<td>96.43</td>
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<td>8.05</td>
<td>8.20</td>
<td>-0.0204</td>
</tr>
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<td>97.14</td>
<td>7.95</td>
<td>7.70</td>
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<td>-0.0205</td>
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<td>97.86</td>
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<td>98.57</td>
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<td>7.00</td>
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<td>-0.0205</td>
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<tr>
<td>99.29</td>
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<td>6.65</td>
<td>6.80</td>
<td>-0.0204</td>
</tr>
<tr>
<td>100</td>
<td>6.45</td>
<td>6.35</td>
<td>6.45</td>
<td>-0.0204</td>
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<tr>
<td>100.71</td>
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</tr>
<tr>
<td>101.43</td>
<td>5.70</td>
<td>5.75</td>
<td>5.90</td>
<td>-0.0203</td>
</tr>
</tbody>
</table>
Rolling versus Selling

Rolling shorter-term contracts vs. selling one long-term contract

Over a 6 month period…

Write a 30 day option 6 times?
$1.00 \times 6 = $6.00

OR…

Write a 180 day option 1 time?
$2.75 \times 1 = $2.75
Shorter-term versus longer-term expiration

So why would anyone sell a longer-term covered call?

<table>
<thead>
<tr>
<th>Shorter-Term Expiration</th>
<th>Longer-Term Expiration</th>
</tr>
</thead>
<tbody>
<tr>
<td>• Offer the most exposure to time decay</td>
<td>• Offer more upfront premium</td>
</tr>
<tr>
<td>• Have the highest gamma risk</td>
<td>• Provide more downside protection</td>
</tr>
<tr>
<td>• Allow for the higher return by continually rolling (all else equal)</td>
<td>• Low exposure to time decay</td>
</tr>
<tr>
<td>• Higher probability of early assignment</td>
<td>• Lower gamma risk</td>
</tr>
<tr>
<td>• More commissions incurred</td>
<td>• Higher probability of being ITM at expiry</td>
</tr>
<tr>
<td>• More aggressive (more bullish)</td>
<td>• Less aggressive (less bullish)</td>
</tr>
</tbody>
</table>

...consider the trade in light of the outlook/objective.
How can you manage the strategy?

- 3 ways to manage any strategy
- Use Fidelity’s tools
3 ways to manage any strategy

1. Leave the strategy alone
   - Let the covered call(s) expire
   - Allow assignment

2. Close the strategy
   - Unwind – sell the shares, buy to close the covered call(s)

3. Adjust the strategy
   - Close the calls, keep the long shares
   - Rollout – same strike, up or down

Where can I learn more?

Research > Learning Center > Position Management
Find trading ideas with Fidelity’s tools
There are a number of resources available to help find covered call ideas:

• S&P Best 10 – Covered Calls
• Strategy Ideas – Covered Call
• S&P Intra-Day Trade Ideas
• Market Scanner

To begin, select filters to narrow down matching strategies, or click on any strategy name to learn more.

Where can I learn more?
Research > Learning Center > Find, analyze & execute options strategies on Fidelity.com
Key Takeways

- Covered call strategies can be put on for different reasons:
  - Generate income
  - Method of selling a long stock position
  - Manage a long stock position

- Properly identify what you’re looking to accomplish with the trade before implementing it will, this helps to easily choose the appropriate strike and expiration.

- Tradeoffs should be considered during the strike and expiration selection process. Consider the premium being received vs. the risks being taken (impact on exposure to price movements, probability of being assigned, gamma exposure, rate of return potential, opportunity costs, etc).

- Properly manage risk management and look at the strategy to determine if it makes sense today and going forward – don’t get distracted by the past.

- Do not blindly roll strategies without considering why you are doing it, especially for covered call strategies. Rolling is simply closing one trade, and opening a brand new one. Go through the same thought process you would for a brand new trade.
Use the Fidelity Learning Center at home to...

**Get more information**
Visit Fidelity.com - select Research > Learning Center and obtain even more information and insight about options

*Example:* 5 steps to develop an options trading plan

**Take a course**
Complete a course online to learn more about the basic concepts of covered calls

*Example:* Generating income with covered calls

**Watch videos**
Learn how to navigate and leverage Fidelity’s option research and trading tools.

*Example:* Creating market scans; Monitor and manage your option portfolio with Option Summary

**Attend seminars/webinars**
View one of our monthly options webinars and the library of archived webinars

*Example:* Get a Plan! How an options trading plan can help avoid large losses
Important Information

Before investing, consider the funds' investment objectives, risks, charges, and expenses. Contact Fidelity for a prospectus or, if available, a summary prospectus containing this information. Read it carefully.

Charts, screenshots, company stock symbols and examples contained in this module are for illustrative purposes only.

Options trading entails significant risk and is not appropriate for all investors. Certain complex options strategies carry additional risk. Before trading options, contact Fidelity Investments by calling 800-544-5115 to receive a copy of Characteristics and Risks of Standardized Options. Supporting documentation for any claims, if applicable, will be furnished upon request.

Greeks are mathematical calculations used to determine the effect of various factors on options.

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