The Basics: Writing Covered Calls

September 23, 2021

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Presentation Outline

- Covered Call Structure
- Motivation & Risk
- Risk Profile (Example)
- Choosing Strikes & Expiration

Covered Call Structure

Equity Call Options

- An equity call **buyer:**
  - Pays cash debit immediately
  - Owns the **right to buy** underlying stock/ETF
  - Bullish on underlying
  - Needs stock movement > time decay

- An equity call **seller**:
  - Receives cash credit immediately
  - Has the **obligation to sell** underlying stock/ETF
  - Likely already owns shares (Covered Call)

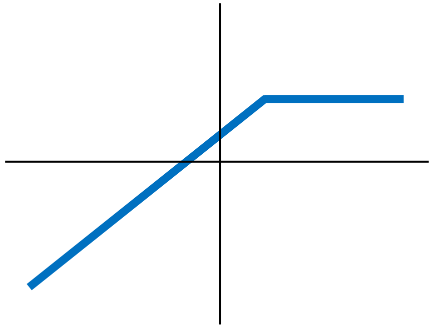
Covered Call Basics

- A covered call writer:
  - Writes (sells) one equity call contract for each 100 shares owned
  - Has the obligation to sell underlying shares at strike price, if assigned
- Assignment (your potential obligation)
  - Possible at any time on or before expiration
  - Equity options are American exercise style
  - Early assignment most likely before ex-dividend date

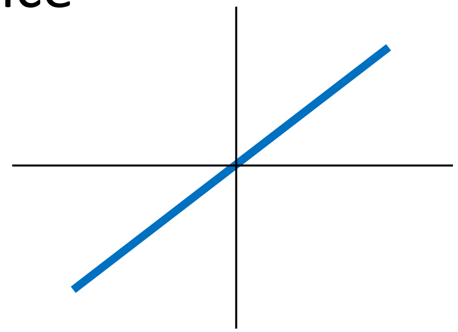
- In return for this obligation
  - Call writer receives and keeps option premium

Covered Call - Motivation

- Primary goal – increase returns
  - Call premium received and kept (assigned or not)
  - Generate <u>additional</u> income (over any dividends)
- Investor’s forecast
  - Capitalize on moderately bullish or neutral outlook on share price
  - Within a small price range over strategy’s lifetime
- Improve break even point
  - Overall cost is lower
  - Improved probability of profit



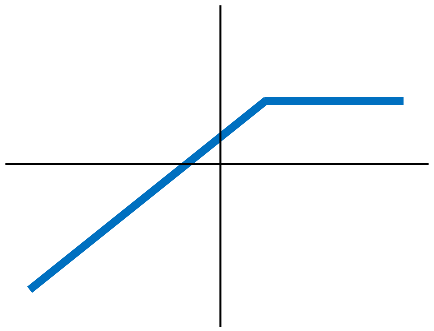
Covered Call



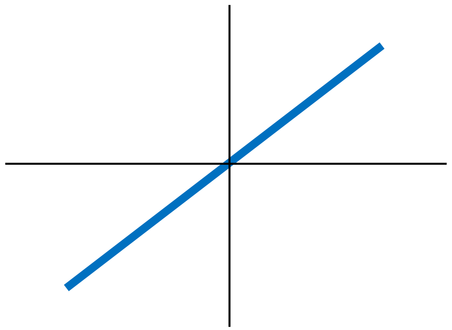
Long Stock

Covered Call - Risk

- Upside profit potential is limited
  - Strike price – stock price paid + call premium received
  - If assigned stock sold at strike price
- Downside loss potential is substantial
  - Downside risk is with stock
  - Option offers limited protection
  - Risk is equal to stock cost less call premium received



Covered Call



Long Stock

Risk Profile (Example)

Covered Call Example

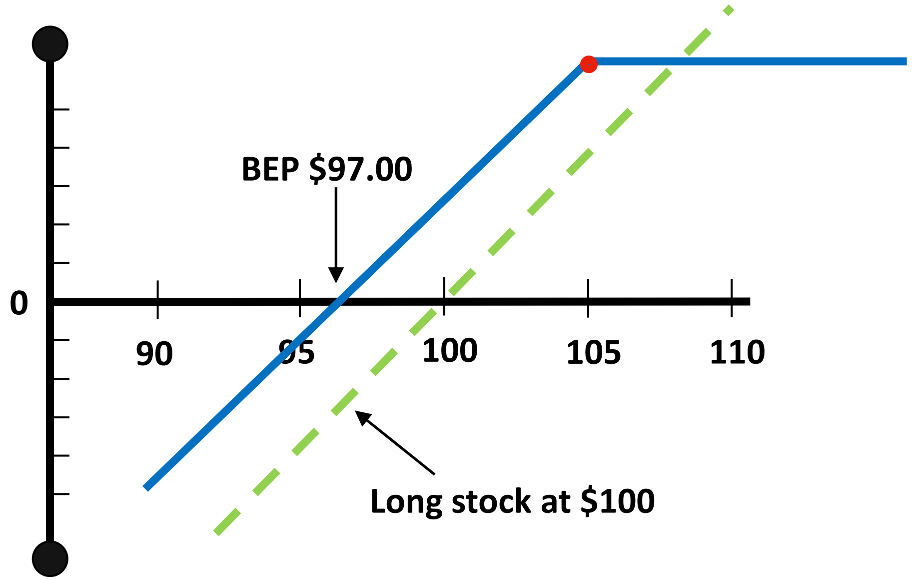
- Investor purchases 100 shares at $100/share
  - Bullish thesis based on market analysis

- Shares have consolidated and remain at $100/share
  - Investor is still bullish but now becoming somewhat cautious

- Choices to consider:
  - Do nothing (Hold shares)
  - Scale down share position to reduce risk (e.g. sell 50 shares)
  - Sell a call option with a strike price above $100

Covered Call Example

Own 100 shares XYZ at $100
Sell 1 XYZ 105 call at $3.00
(45 days, 35% volatility)



Maximum Profit if Assigned:
Effective Stock Sale Price –
Stock Price Paid
($105 + $3.00) – $100 = $8.00
$800.00 Total

Break-even at Expiration:
Stock Price Paid –
Call Premium Received
$100 – $3.00 = $97.00

Not including trading costs

Choosing Strike and Expiration

Covered Call – Choosing Strike

- In-the-money (ITM)
  - Highest premium
  - Most downside protection
  - Lowest profit potential
- At-the-money (ATM)
  - Highest amount of time value
  - Fastest rate of time decay
  - No potential for upside share price gains
- Out-of-the-money (OTM)
  - Lowest premium
  - Least downside protection
  - Highest profit potential

Covered Call – Choosing Expiration

- Could be decided by:
  - Technical or Fundamental Analysis
  - An event on the economic calendar
- Shorter term expiration (e.g. 1-2 weeks)
  - Faster time decay
  - Smaller premium amounts
- Longer term (e.g. 1-2 months)
  - Higher premium amounts
  - More downside protection
  - Slower time decay

Things to Know

- ❑Potential income generation is motivation for covered calls
- ❑Downside protection is defined by the premium received from the call sold
- ❑Risk is the long stock
- ❑Strike and timeframe selection can always be adjusted
- ❑Know if assignment is acceptable