OIC The Options Industry Council

An Income Strategy: Let’s Sell Some Options

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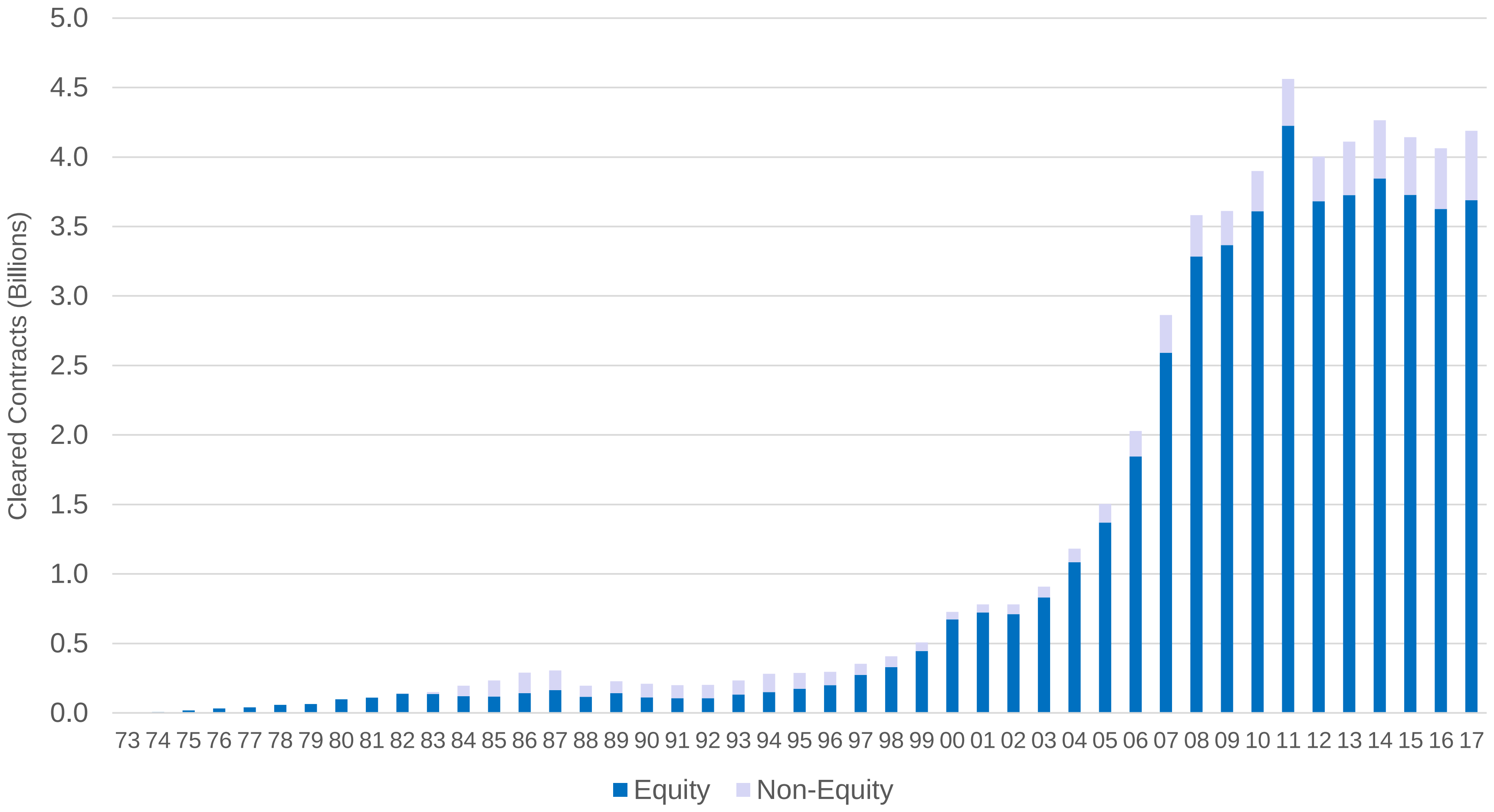
- **OptionsEducation.org**
- Unbiased and professional options education
- Online courses, podcasts, videos, & webinars
- Investor Services desk at *options@theocc.com*

OCC THE FOUNDATION FOR SECURE MARKETS

OIC The Options Industry Council

4 Annual Options Volume 1973-2017

OCC Annual Contract Volume by Contract Type



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U.S. Listed Options Exchanges

Cboe Global Markets

BOX Options Exchange

MIAX Options

Nasdaq

NYSE

Presentation Outline

- Covered Calls
  - definition and questions to consider
  - specific covered call example
  - the importance of planning

Covered Call Definition

- Covered call: investor simultaneously
  - <u>writes</u> (sells) one or more equity <u>call contracts</u>
  - <u>buys</u> equivalent number of <u>underlying shares</u>
  - one short call for each 100 long shares
- If stock <u>bought</u> and call <u>written</u> at <u>same time</u>
  - “covered write” or “buy-write”
- If stock <u>already owned</u> when call is <u>written</u>
  - “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?

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Why Write Covered Calls?

Primary goal – increase returns

- call premium received and kept (assigned or not)
- generate <u>additional</u> 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

Why Is the Short Call “Covered”?

Long stock “<u>collateralizes</u>” short call obligation

- if assigned → shares to be sold already purchased

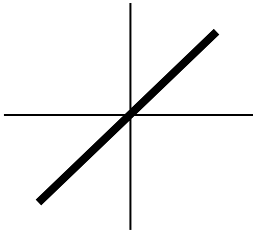
Upside loss potential of short call is <u>limited</u>

- any upside loss offset by stock gain

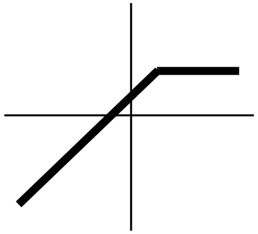
Remember

- upside loss potential for uncovered call is unlimited

12 Covered Call Writer's Concerns?



Long Stock



Covered Call

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

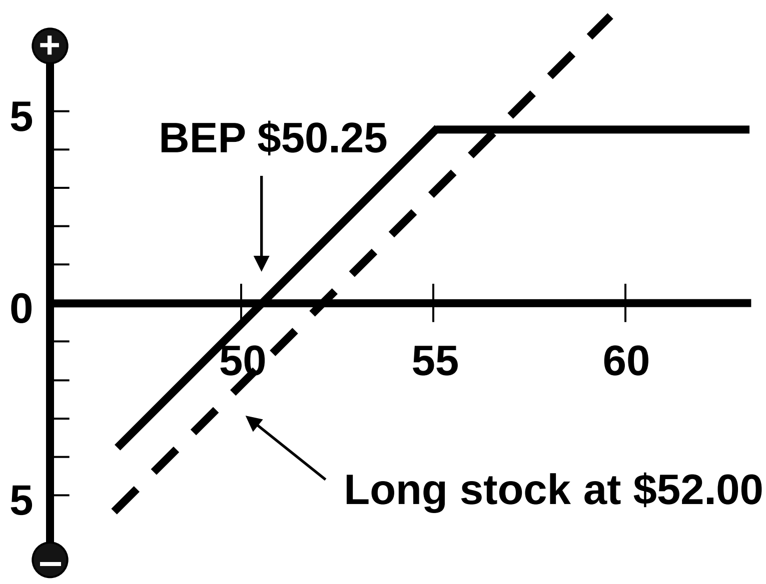
Covered Call Example

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

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

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

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

Another Covered Call Example

Date: July 31

XYZ Options

		Calls	Puts
Oct	**35**	**$8.75**	**$0.30**
	40	**$4.90**	**$1.40**
	45	**$2.30**	**$3.80**
	50	**$0.90**	**$7.50**

October expiration in 80 days

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

Not including commissions

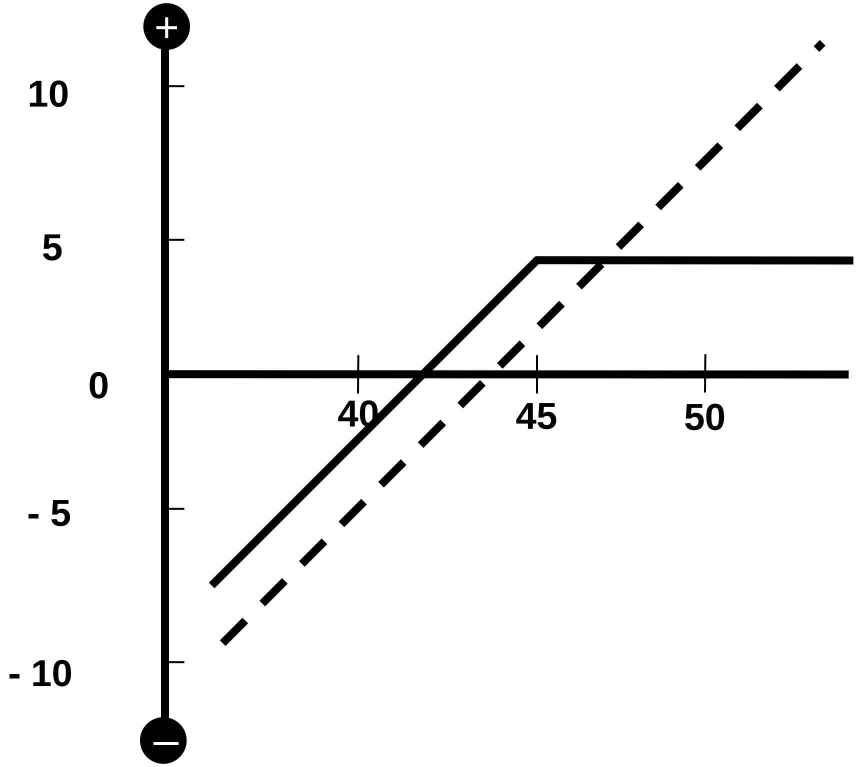
Another Covered Call Example

- 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

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

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

Not including commissions

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.

23 | 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.

24 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.

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

Covered Call Obligation

- Assignment
  - possible at any time before expiration
  - expect at expiration if call expires in-the-money
- Early assignment for dividend?
  - expect if dividend amount is greater than option’s premium
  - expect if little or no time value in option’s premium
  - expiration relatively near

Not including commissions

Covered Call Summary

- 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

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