

Covered Calls and Cash-Secured Puts

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Presentation Outline

- Assignment / Pin Risk
- Covered Calls
 - Risk Profile
 - Selecting Strike and Expiration
 - Managing Position
- Cash-Secured Puts
 - Risk Profile
 - Selecting Strike and Expiration



Assignment / Pin Risk

What is Assignment?

- The option seller has the obligation:
 - to sell (for a call) or buy (for a put)
 - 100 shares of underlying stock/ETF
 - at the strike price per share
 - **if he/she is assigned an exercise notice**
- Assignment notice is received from seller's brokerage firm
- Only option sellers may be assigned on an option contract



Pin Risk

What is it?

Pinning occurs when the stock settles close to the strike price at expiration. The risk is the uncertainty of the seller as to whether or not the option will finish ITM (In The Money) and thus be assigned

Why is it important?

Sellers need to be aware of the potential uncertainty/likelihood and risk of being assigned—including overnight gap risk and commitment of capital



Covered Calls



Why Write Covered Calls?

- Primary goal – increase returns
 - Call premium received and kept (assigned or not)
 - Potential to generate additional income (over any dividends)
- Investor's forecast
 - Neutral to moderately 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) by call premium amount

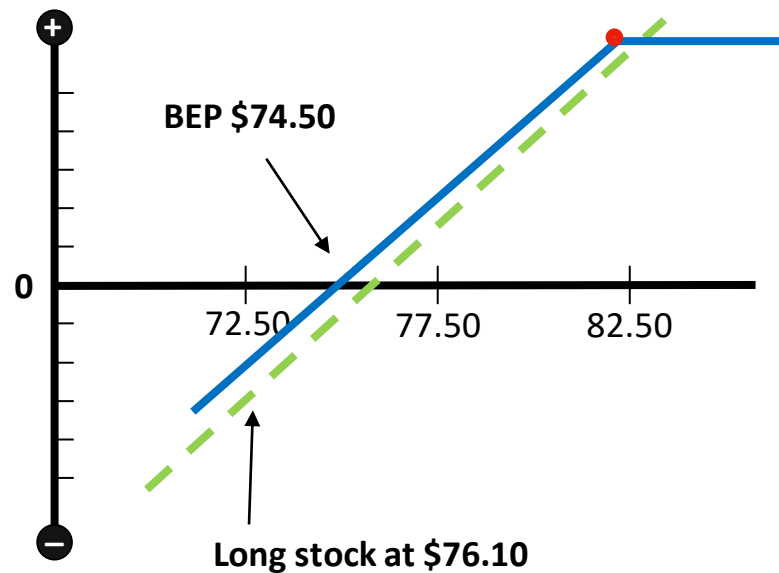
Selecting Strike Price(s)

- I own various stock positions in my portfolio. How can I add alpha by writing Covered Calls?
- Techniques you might consider:
 - 1. Sell slightly out-of-the money (OTM) calls**
 - Sell call options with a strike price that is consistent with a level that you have determined to be resistance for the shares (select strike as low as possible)
 - 2. Stagger strike selection and/or sell fewer calls than shares owned**
 - Allows the investor to scale out of the position as the stock rallies and realize healthy gains on a small portion of their position should the stock price rise dramatically

Covered Call Example (OTM)

Own 100 shares XYZ at \$76.10

Sell 1 XYZ 82 call at \$1.60



Maximum Profit if Assigned:

Effective Stock Sale Price –
Stock Price Paid

$$(\$82 + \$1.60) - \$76.10 = \$7.50$$

\$750.00 Total

Break-even at Expiration:

$$\begin{aligned} &\text{Stock Price Paid} - \\ &\text{Call Premium Received} \\ &\$76.10 - \$1.60 = \$74.50 \end{aligned}$$

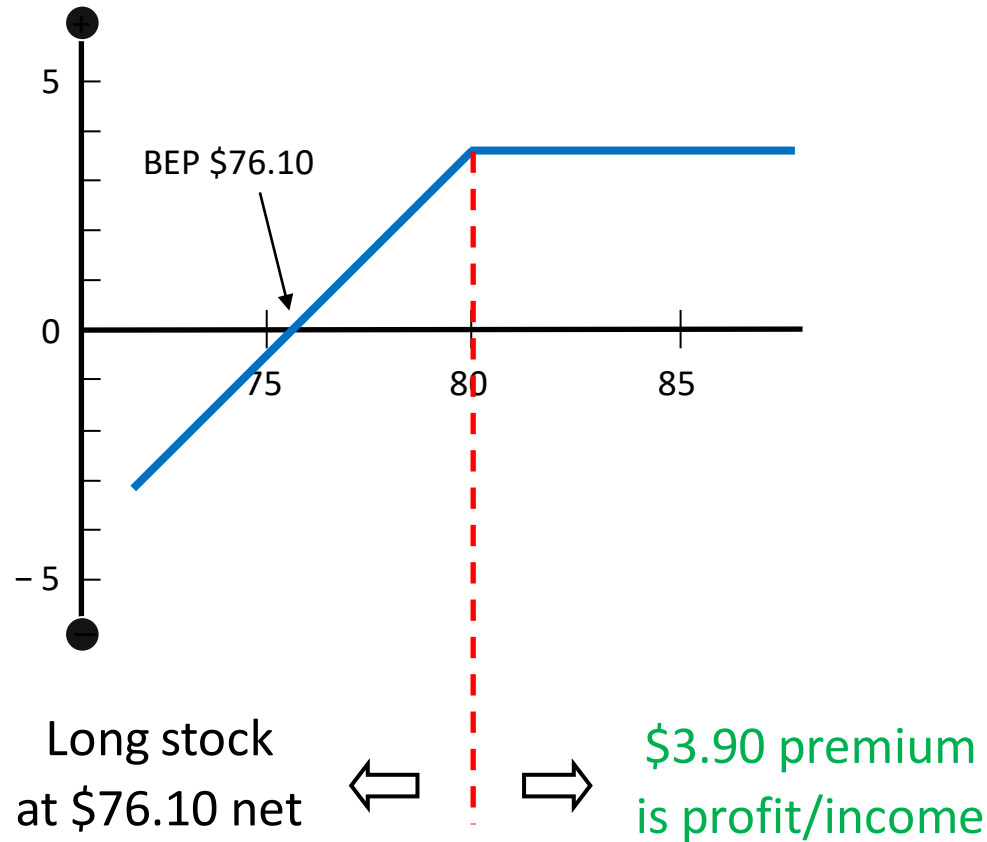
Cash-Secured Puts

Why Cash-Secured Puts?

- Do you **forecast** a temporary downturn in the market?
- Are you **bullish** on the stock or ETF?
- Do you want to own the stock below its current market level?
- ***Do you want to buy the potential dip?***



OTM Cash-Secured Put at Expiration



Break-even at Expiration:
 $\$80 - \$3.90 = \$76.10$

Maximum Profit:
\$3.90 premium received
\$390 total

Not including commissions

Annualized Return Calculation

Calculation provides a method for evaluating trade opportunities

XYZ at or above \$80 → put worthless

Keep \$3.90 premium as income

Return if put expires and no assignment:

$$\begin{array}{rcccl} \frac{\text{Income}}{\text{Investment}} & \times & \text{Time Factor} & & \\ \hline \frac{\text{Put Premium} + \text{Interest}}{\text{Cash Deposit}} & \times & \frac{\text{Days/Year}}{\text{Days to Expiration}} & & \\ \hline \frac{\$390 + \$0}{\$7,610} & \times & \frac{365}{45} & = & 41.6\% \text{ annualized} \end{array}$$

Not including commissions

Things to Consider Before Getting Started

- Be familiar with the underlying
- Know when to expect assignment
- Evaluate premium received vs. risk of assignment
- Be prepared to manage position



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