Option Strategies – Selling Covered Calls

BULLISH/NEUTRAL

The Covered Call strategy involves the selling of call options against a long stock position. The short call position is considered “covered,” in the event of an assignment, by the long stock position. Investors may view covered call selling (writing) as leasing out the underlying stock with an option to buy.

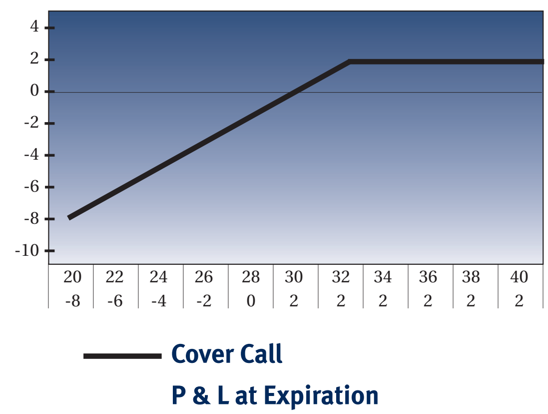
As a call writer, you obligate yourself to sell, at the strike price, the underlying shares of stock upon being assigned an exercise notice. For assuming this obligation, you are paid a premium at the time you sell the call.

Investors write covered calls primarily for the following two reasons:

- The potential to realize additional return on their underlying stock by earning premium income;
- to gain some protection (limited to the amount of the premium) from a decline in the underlying stock price.

If a writer is assigned, the profit or loss is determined by the amount of premium plus the difference, if any, between the strike price and the original stock price. If the stock price rises above the strike price of the option, the writer may have the stock called away (i.e., is assigned), and forgoes the opportunity to profit from further increases in the stock price.

If, however, the stock price decreases, the potential for loss on the stock position may be substantial; the hedging benefit is limited only to the amount of the premium income received.



Investors who use the covered call strategy should have a neutral to slightly bullish view of the underlying stock. Things to consider when choosing a covered write strategy:

- *Time Frame* — The options expiration date will have an influence on its premium. While call sellers will want to focus on shorter-term options, they will have to balance this with the amount of premium they are looking to receive.

- *Strike Price* — Typically, investors sell calls with strike prices that are greater than the stocks current price (out-of-the money). This allows for some appreciation of the underlying stock price before the stock may be called away. While an out-of-the money strike price allows for potential price appreciation on the stock, it will garner a smaller premium for the seller. The investor must balance their desire to receive a greater upfront premium from the sale of the call with the potential for additional price appreciation in the stock.
- *The Underlying Stock* — Understanding the fundamentals of the underlying stock and being comfortable owning the shares is the most important consideration in the covered write strategy! The rate of return generated from the strategy is secondary.

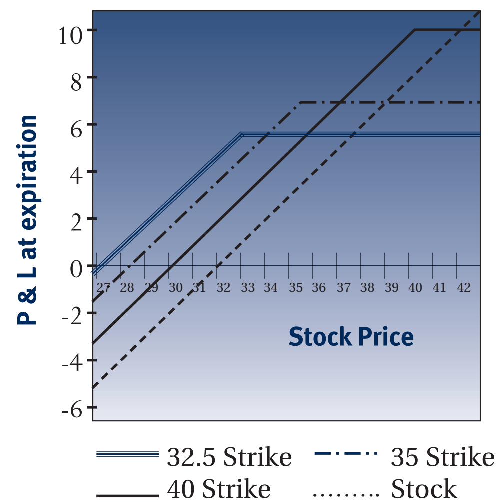
Example:

Stock XYZ is trading at $32/share.

Three month call options:

Strike Price	Premium
32.5	$4.50
35	$3.50
40	$2.00

Assuming the stock is purchased at $32 and the calls are sold at the above prices, the results (at expiration) for each strike price are shown below.



Option Strategies – Selling Covered Calls, continued

An important concept of covered writing is the capping effect of the short call. The maximum profit in a covered call position is capped at the difference between the purchase price of the stock and the strike price of the call plus the premium of the option. The table below shows the expiration results for various strike prices over different stock levels. You can see the tradeoff between the option premium and the strike price. If premium income is the main objective you may choose to sell the $32.5 strike call. This option brings in the most upfront premium. It also, by virtue of the lower strike price, caps the upside potential at the lowest level. If additional appreciation potential is desired you may choose the $40 strike call. This allows the investor to participate in a move from $32 to $40 before they are capped from further upside gains. In this case the maximum potential gain would be (call strike price {$40} minus stock purchase price {$32} plus option premium {$2.00} = $10.

STOCK PRICE

STRIKE PRICE	27	28	29	30	31	32	33	34	35	36	37	38	39	40	41	42
32.5	-.5	.5	1.5	2.5	3.5	4.5	5	5	5	5	5	5	5	5	5	5
35	-1.5	-.5	.5	1.5	2.5	3.5	4.5	4.5	6.5	6.5	6.5	6.5	6.5	6.5	6.5	6.5
40	-3	-2	-1	0	1	2	3	4	5	6	7	8	9	10	10	10

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