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INVESTMENT INCOME STRATEGIES

COVERED CALLS

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WHAT IS A **COVERED CALL?**

A covered call is an option strategy designed to manage risk and help investors earn additional income on securities that they already own. The strategy involves an investor holding or buying a stock and simultaneously selling (writing) a call option on that same stock at a strike price above the stock's current price. Typically, this strategy is employed by investors who believe that the underlying stock will experience only minor price fluctuations (and feel that there is a substantial probability that the call will not be exercised by the buyer).

The buyer of the option contract ("Call Buyer") is buying the legal right (but not the obligation) to buy a specified amount of shares of the underlying stock at a predetermined future price (strike price) on or before the contract's expiration date. The seller of the option contract ("Call Seller") is selling this right to the buyer in exchange for cash (premium). The premium is a cash fee paid on the day the option is sold and is the Call Seller's money to keep, regardless of whether the option is exercised or not.

Let's look at an example:

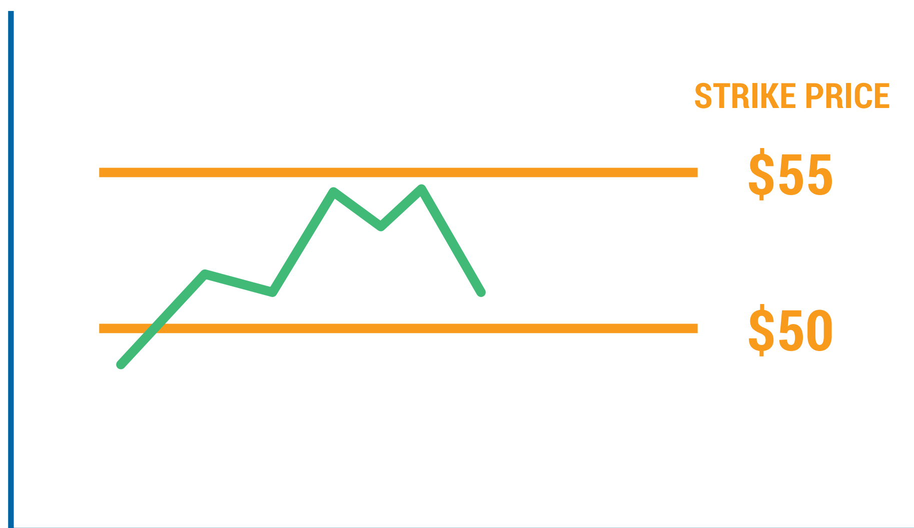
- An investor owns 100 shares of XYZ stock that is currently trading for $50 a share.
- The investor believes that the price of XYZ stock will not appreciate above $55 in the next three months.
- The investor sells 1 option contract with a strike price exercisable at $55 that will expire in 3 months (note that 1 call option contract consists of 100 shares)
- The premium on this contract is $1.50 a share. Therefore, the Call Seller immediately receives $150.

Apart from the premium that the Call Seller already collected, the total future payoff depends on the price of the stock in three months when the contract expires. The Call Seller faces three scenarios:

Scenario 1

The stock price does not appreciate above the strike price ($55) over the course of the contract. This is the ideal scenario for the Call Seller.

In this scenario, the Call Buyer would not likely exercise the call option because the trade is out-of-the-money, meaning that the strike price exceeds the stock price. Let's say that at the end of the contract, the stock price is at $54. The Call Seller will earn $4 per share in stock appreciation in addition to the $1.50 per share they made in premium. Because the contract was never exercised, the Call Seller keeps the 100 shares of XYZ stock. In total, the covered call writer receives $150 in income from this covered call.



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Scenario 2

The stock price appreciates above the strike price ($55) and is exercised by the Call Buyer of the contract.

If the stock price rises above $55 per share on or before the contract's expiration date, the contract would most likely be exercised by the Call Buyer. For this example, let's say that the Call Buyer exercises the contract when the stock price reaches $59. In this scenario, the trade is considered in-the-money because the strike price ($55) is less than the stock price ($59). When the contract is exercised, the Call Seller receives $55 per share for each 100 shares that the Call Seller must sell to the Call Buyer. That sale, combined with the premium received when the contract was originally sold, nets the Call Seller $650.

The Call Seller could have made more than $650 at the time the contract was exercised depending on their overall cost basis in XYZ stock. The $650 just represents the sale proceeds between the time that the contract was entered into and the time that it was exercised. It does not take into account the original price that the investor bought XYZ stock at.

While the Call Seller did technically receive a total of $650 from this covered call, it's important to note that they no longer own any shares of XYZ stock, and will therefore miss out on any future gains in XYZ's share price. The premium that the Call Seller immediately received from the call buyer when they entered into the contract serves as consideration for the risk that comes with them potentially being forced to sell their shares.

Selling price of the stock.
$5,500
-
Original price of the stock at the time that the contract was entered into
$5,000
+
Cash Premium Received
$150
=
$650

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Scenario 3

The stock price decreases below its original value ($50)

Let's say that, at the contract's expiration date, the price of the stock is $45 per share. The contract would expire worthless, meaning that the Call Seller would not be forced to sell the 100 shares of XYZ stock to the Call Buyer. However, the Call Seller would incur a $5 per share loss in value, totaling $500 (this, of course, would not be a realized loss, as the Call Seller still owns all 100 shares). But, the option premium of $1.50 per share received by the Call Seller would partially offset the loss in value. Therefore, the Call Seller's loss in value of $5 per share would instead be $3.50 per share at the time of the contract's expiration date. This short-term unrealized loss in value could, of course, be offset by any future gains in XYZ stock.

If you would like to speak with an advisor regarding the contents of this piece or other financial planning and investment matters, please reach out to StrategIQ today.

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