

# COVERED CALL STRATEGIES, EXPLAINED

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## 1 WHAT ARE CALL OPTIONS?

Call options contracts are financial derivatives that give a buyer the right, but not the obligation, to purchase a security at a pre-determined price, called the **strike price**.

Conversely, the seller of an option must sell the security at that strike price if the buyer chooses to exercise the option.

Options do not create value, but merely transfer value from one party to another. They can be used for a variety of different strategies such as making leveraged bets on securities, managing risk, and generating income.

The price of the option paid by the buyer, otherwise known as the **premium**, is influenced by the strike price, level of volatility, the option's time to expiration and the price of the underlying asset.

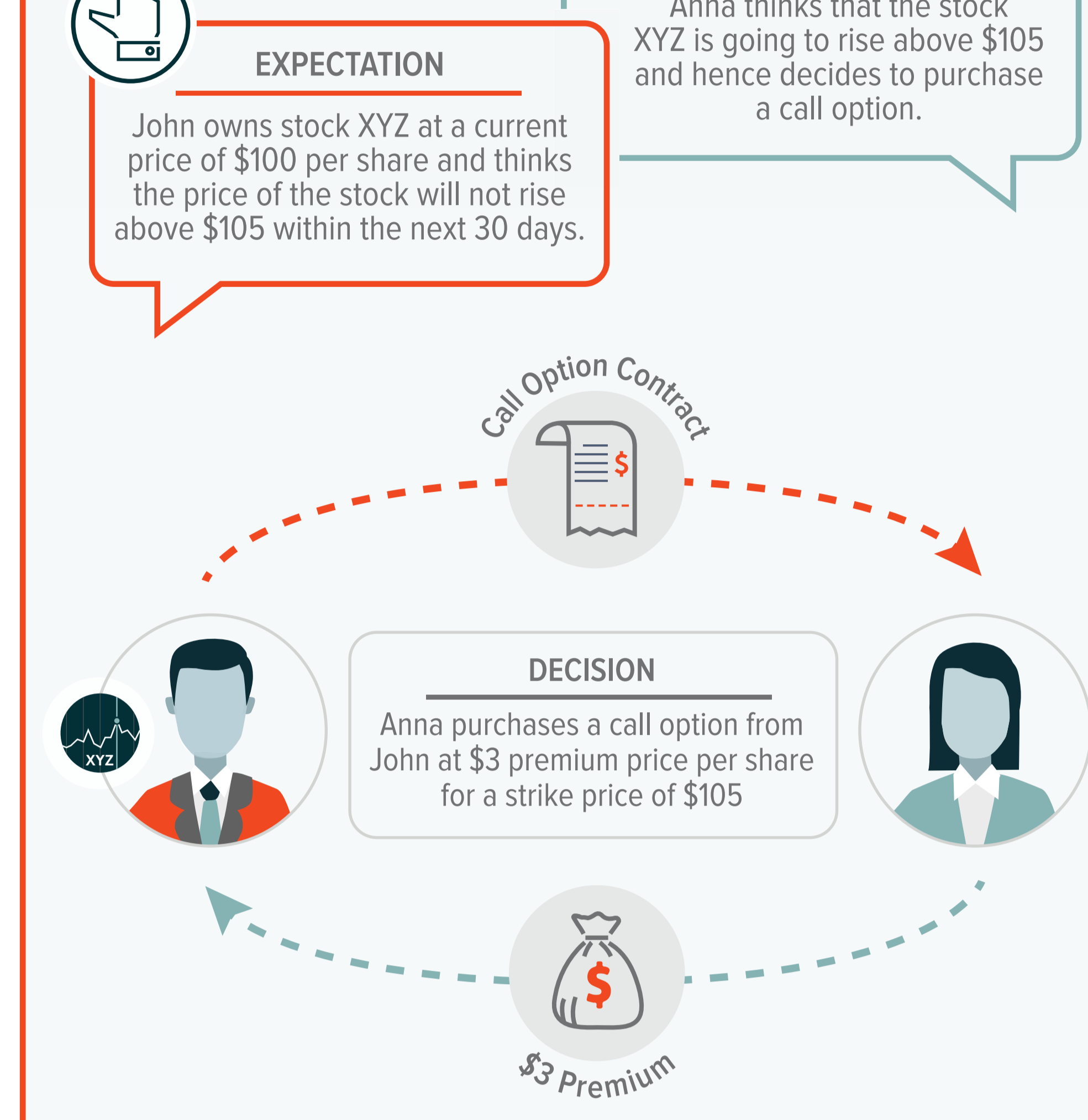
## 2 WHAT IS A COVERED CALL STRATEGY?



A covered call strategy is an **option-based income strategy** that seeks to collect the income from selling options, while also mitigating the risk of writing a call option.

A COVERED CALL CONSISTS OF AN INVESTOR BOTH:

**OWNING A STOCK & SELLING A CALL OPTION ON THAT STOCK**

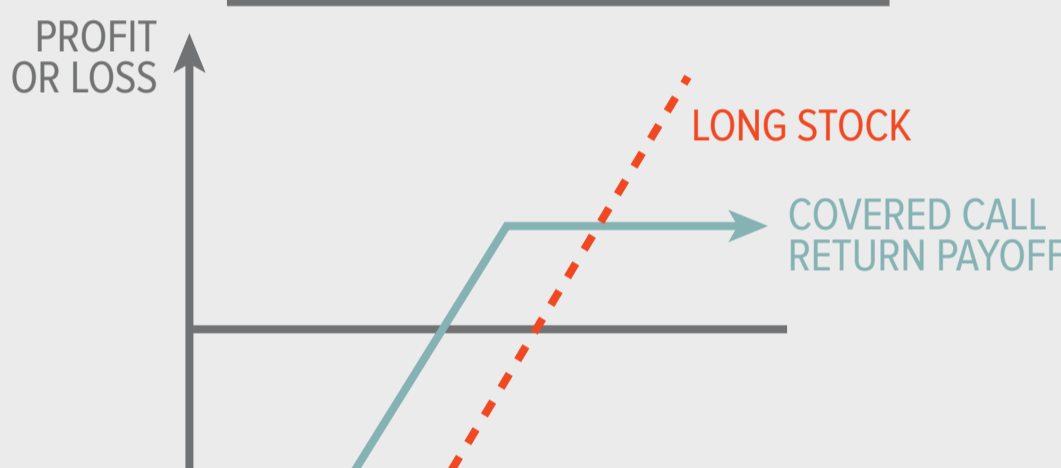
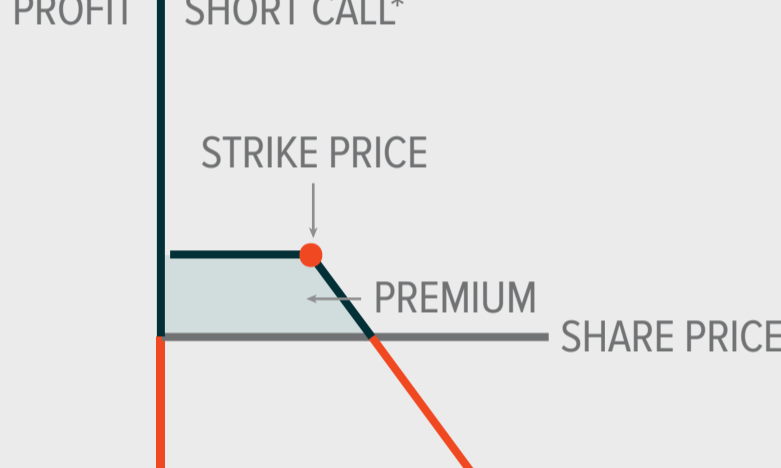


### b UPON CONTRACT EXPIRATION

| Potential Outcomes                | John   | Anna  |
|-----------------------------------|--|---|
| Stock XYZ price rises above \$105 | John has an obligation to sell the stock for \$105, which is less than the market price, but will earn a \$3 premium from the contract | Anna has the option to purchase the stock XYZ at \$105 even though the stock is above \$105, earning all the differences above \$105. |
| Stock XYZ price is exactly \$105  | John earns a \$3 premium regardless of Anna's decision to purchase stock XYZ from him.   | Anna is ambivalent between purchasing stock XYZ from John, and simply foregoing the option.   |
| Stock XYZ price falls below \$105 | John keeps both stock XYZ and the \$3 premium from the contract.   | Anna has no reason to buy the stock for \$105 which is more than the market price.  |

The term 'covered' comes from the fact that if the stock price **increases**, the option can be **'in the money'** which is a negative for the option seller, but because the seller also owns the underlying stock, **the gains on the equity position offset the losses on the option.**

Another way to look at it is that **the investor forfeits the upside potential** of their stock position in exchange for receiving the premiums for selling call options on that position.



\*SHORT CALL: A bearish options strategy, which obligates the call seller to sell a security to the call buyer at the strike price if the call is exercised.

## 3 WHY INCLUDE A COVERED CALL STRATEGY IN YOUR PORTFOLIO?

Covered call strategies inherently forfeit upside in exchange for current income. Therefore, covered call strategies can be used strategically in income-focused portfolios, or tactically for investors who believe the markets are unlikely to continue to rise.

**INCOME** Covered call strategies provide **income-driven investors** with a means by which to **increase the yield on their existing portfolios while diversifying away some of the market risk** that is typically inherent in traditional income-generating securities. They offer an **opportunity to benefit from rising levels of volatility** that might otherwise have a negative impact on bonds or dividend paying stocks.

**TACTICAL** More tactical portfolios may find use cases for covered call strategies as well. Below, we show at a broad level how investors in covered call strategies could expect to fare in **different market environments**.



**BULL MARKET:** An investor will likely underperform the market as they keep the option premium but forfeit some or all of the upside.

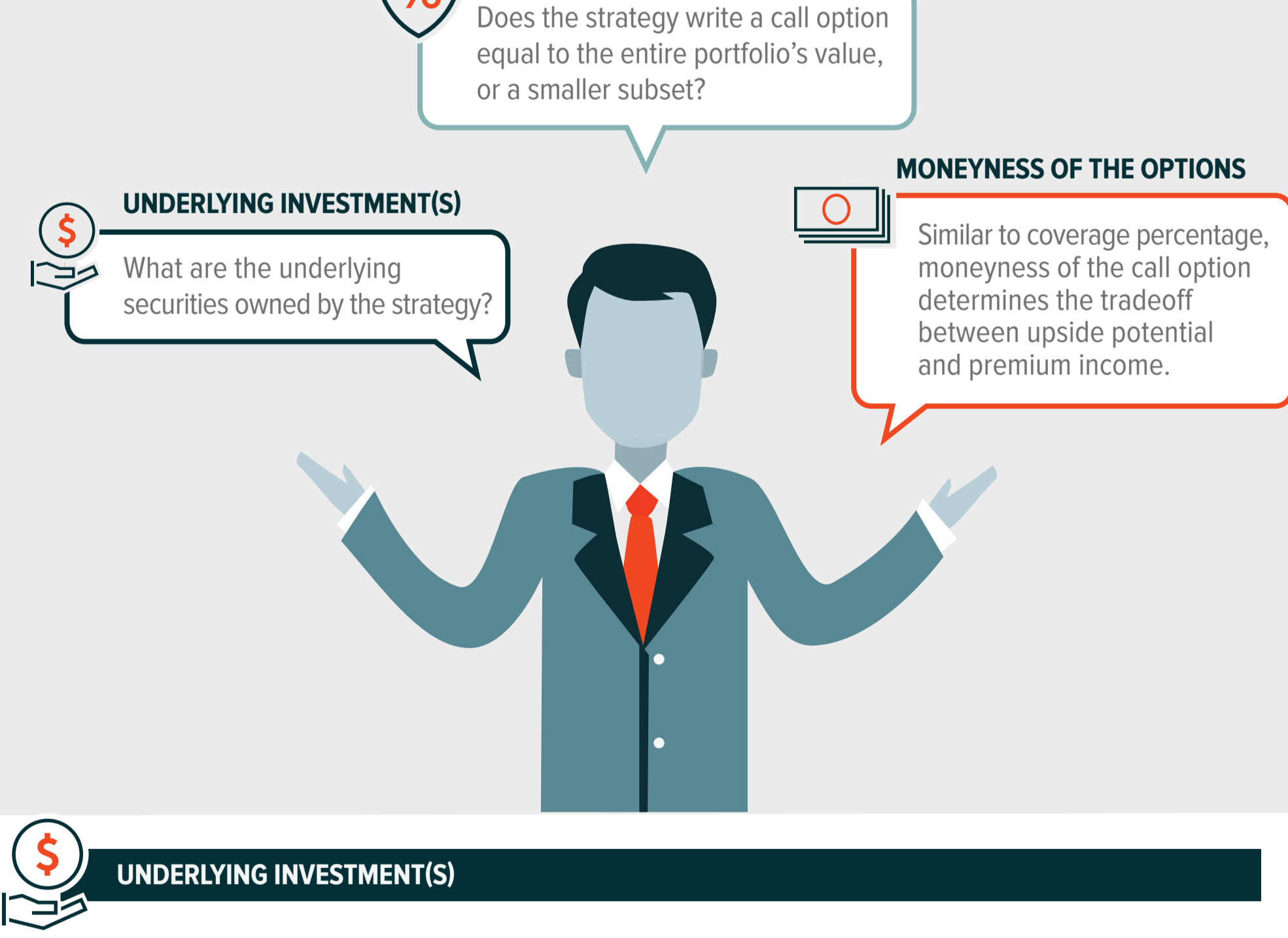
**FLAT MARKET:** The investor will likely outperform as the markets go nowhere, but the investor keeps the premium from selling the call option.



**BEAR MARKET:** The investor will likely outperform as they keep the premium received from selling the call option, which offsets some of the stock's decline.

## 4 WHAT DISTINGUISHES DIFFERENT COVERED CALL APPROACHES?

There are numerous ways to implement a covered call strategy, but three of the most important factors to consider include:



### UNDERLYING INVESTMENT(S)

More volatile securities can generate greater premiums, but have greater downside risk.



### COVERAGE PERCENTAGE

**100% COVERED PORTFOLIO**

Maximizes the premium income but forfeits all upside.

**50% COVERED PORTFOLIO**

Half the premium income but participates in half the upside of the underlying securities.

### MONEYNES OF THE OPTIONS

The further out of the money the call options are written, the greater upside potential, but the lower the premiums.

