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.

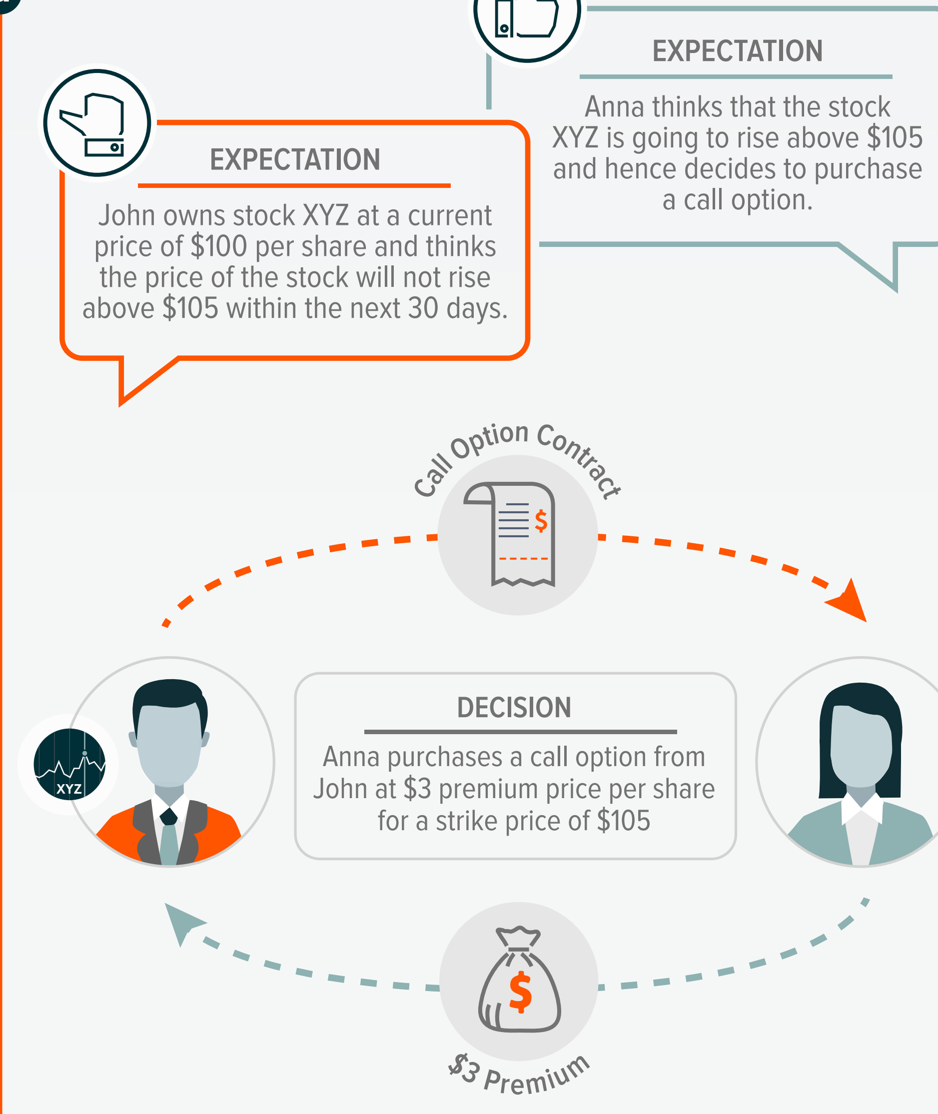
The price of the option paid by the buyer, otherwise known as the premium, is influenced by the strike price, level of volatility, the option's time to expiration and the price of the underlying asset.

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**

a

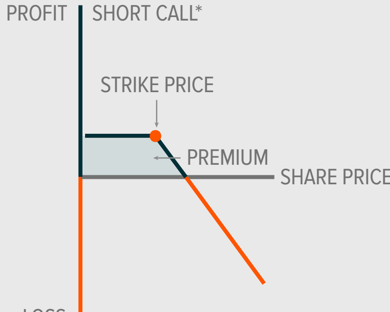


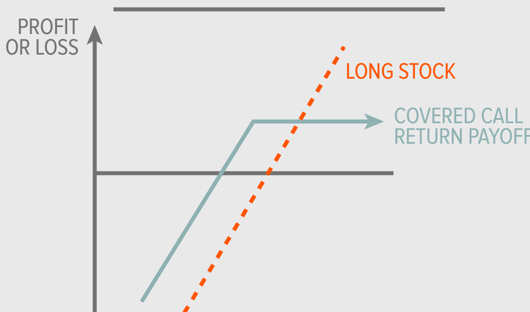
b UPON CONTRACT EXPIRATION

Potential Outcomes	John takes on **price risk** should the option's value move against him, but earns a **steady income stream** in any outcome.	Anna has **unlimited upside** should stock XYZ rise beyond the option's strike price.
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

For income-oriented portfolios, covered call strategies can play a particularly important role in the **current market environment** where income is hard to find. With yields around the world at historic lows, traditional **income-generating investments like bonds are failing short of investor needs**. Covered call strategies **can produce high income, while diversifying the sources of risk in a portfolio.**

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.

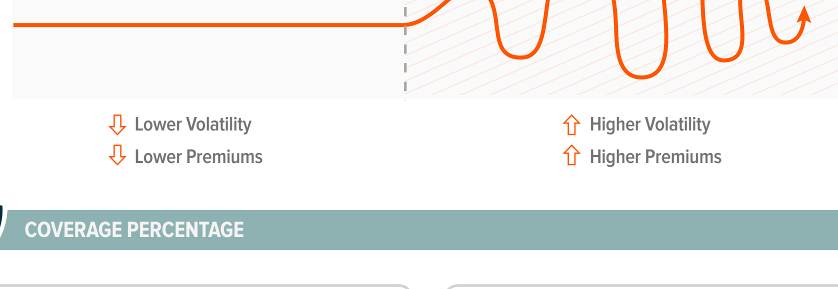
BEAR MARKET: The investor will likely outperform as they keep the premium received from selling the call option, which offsets some of the stock's decline.

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.



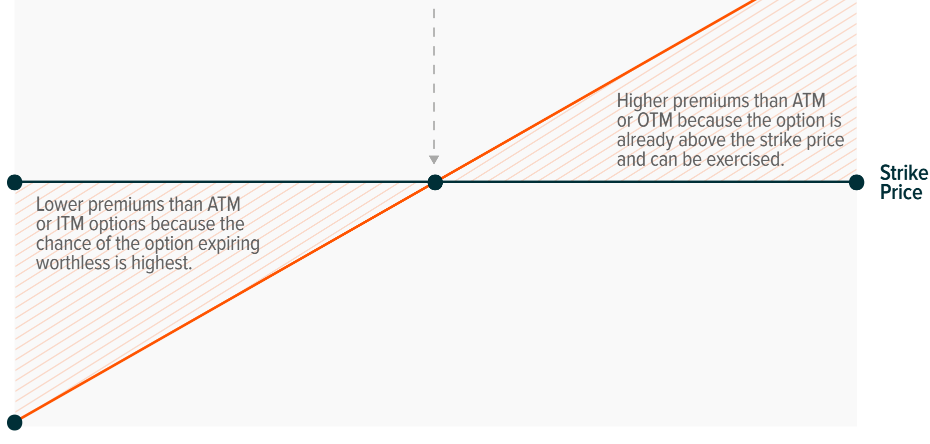
COVERAGE PERCENTAGE

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.

MONEYNESS OF THE OPTIONS

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



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