

Writing (selling) Covered Calls

Unlike the writing of naked (uncovered) calls, which has limited profit potential and virtually unlimited risk, the writing of covered calls is one of the most conservative ways to participate in the options game.

In order to write covered calls, one must not only own the stock that they will be using to collateralize ("cover") the option, and they must own it in round lots of 100 shares for each contract they intend to write. For example, an investor who owns 350 shares of a stock would only be allowed to write three (3) covered calls (against the first 300 shares of the position) since the last 50 shares would not represent enough collateral to cover another contract (each contract represents 100 shares).

Though the strategy of writing covered calls against an existing position can be used effectively in any market environment, it is most often employed by investors who are bullish on a stock's long-term potential but neutral or bearish about the near-term outlook. In addition, while the financial impact on one's portfolio is the same regardless of the reason why they decided to write covered calls against their stock, investors often approach this strategy from one of two angles (or perhaps a combination of the two under certain circumstances).

Reducing Downside Risk

The first way to look at covered call writing is as a way to reduce downside risk. For example, let's say Nervous Nelly owns 100 shares of XYZ Corp., and true to her reputation, she starts to get nervous about next month's earnings report a full two months before it is going to be released. Though Nelly loves the long-term prospects of XYZ and would ideally like to hold the stock for several years, she may decide to sell a covered call against the stock position in order to reduce her downside risk ahead of the earnings report. Let's say that XYZ is trading at \$31.50 and that, if she chooses to, Nelly can write a covered call with a strike price of \$35 that expires in two months for \$1.50 (i.e. \$150, since each contract represents not 1 but 100 shares).

If Nelly somehow finds the courage to just ride out whatever fate befalls the stock after the earnings report (i.e. she decides not write the call), the possible outcomes for her portfolio over the next two months can be summarized as follows:

- if the stock is below \$31.50, she will have lost money (but still owns the stock)
- if the stock is above \$31.50, she will have made money (but still owns the stock)

- if the stock is still trading at \$31.50, she will have broken even (but still owns the stock)

On the other hand, if Nelly decides to "play it safe" and writes the call after all, her pool of possible outcomes looks like this:

- if the stock is below \$30 (not \$31.50 - Nelly has bought herself an extra buck-fifty of downside protection!), she will have lost money (but still owns the stock)
- if the stock is above \$30 (not \$31.50!) she will have made money, and
- if the stock is still below \$35, she will continue to own the stock (a wonderful source of worry for Nelly!)
- if the stock is above \$35, she will no longer own the stock because it got called away from her at that price - but Nelly won't mind because she made \$350 on the stock over those two months and pocketed \$150 from writing the call, giving her a gain of almost 16% in a two month period (which makes Nelly smile).

Generating Income

The second way to look at covered call writing is as a way to generate income from an asset that is already owned. For example, let's say that Income Irving also owns 100 shares of XYZ Corp. (again selling at \$31.50) and realizes that he can write a covered call with a strike price of \$35 that expires in two months for \$1.50.

If Irving does not write the call, his possible outcomes are:

- stock below \$31.50 = lost money (but still owns the stock)
- stock above \$31.50 = made money (but still owns the stock)
- stock at \$31.50 = broke even (but still owns the stock)

On the other hand, if Irving goes after the income and writes the call, his possible outcomes are:

- if the stock is between \$30 and \$35 at expiration, he will still own his stock and will have pocketed the \$150 he collected for writing the option on stock he was going to own anyway for those two months
- if the stock is above \$35, he will have pocketed the \$150 as income and realized another 11% appreciation on his stock investment over those two months. Of course, he no longer owns the stock, but Irving is content because he realizes that, even after taxes, 16% combined return in two months is not a bad return.

- if the stock is below \$30, he will have lost money (but still owns the stock)

Conclusion

As you can see, even though their reasons for writing covered calls are different, the possible outcomes for Nervous Nelly and Income Irving are the same... and hopefully this helps reinforce the idea that regardless of which angle an investor chooses to approach the strategy from, it really just boils down to "a numbers game" in which an investor figures out which set of numbers most closely addresses their needs and desires when it comes to balancing risk and reward.

In addition, if you are writing calls against stock that you really are hoping to hold for years, it is very, very, very important to keep in mind that one of the biggest risks when writing covered calls is that your stock might get called away from you in the early stages of a bull move for the stock, thus resulting in a huge "missed opportunity cost" as the stock continues to rise. If this is of concern to you, you may want to consider keeping a small pool of money handy that can be used to repurchase (probably at a loss) any contracts you have written that appear to be headed for exercise by their holders.