Cut Down Option Risk With Covered Calls

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The covered call strategy is an excellent strategy that is often employed by both experienced traders and traders new to options. Because it is a limited risk strategy, it is often used in lieu of writing calls "naked" and, therefore, brokerage firms do not place as many restrictions on the use of this strategy. You will need to be approved for options by your broker prior to using this strategy, and it is likely that you will need to be specifically approved for covered calls. Read on as we cover this option strategy and show you how you can use it to your advantage.

SEE: Options Basics

Options Basics

For those who are new to options, let's review some basic options terminology. A call option gives the buyer the right, but not the obligation, to buy the underlying instrument (in this case, a stock) at a predetermined price (the strike price) on or before a predetermined date (option expiration). For example, if you buy July 40 XYZ calls, you have the right, but not the obligation, to buy XYZ at $40 per share any time between now and the July expiration. This type of option can be very valuable in the event of a significant move above $40. Each option contract you buy is for 100 shares. The amount the trader pays for the option is called the premium.

There are two values to the option, the intrinsic and extrinsic value, or time premium. The intrinsic value is also referred to as the option's moneyness. Using our XYZ example, if the stock is trading at $45, our July 40 calls have $5 of intrinsic value. If the calls are trading at $6, that extra dollar is the time premium. If the stock is trading at $38 and our option is trading at $2, the option only has a time premium and is said to be out of the money.

It is often said that professionals sell options and amateurs buy them. This is not true 100% of the time, but it is certainly true that professional option traders know when it is appropriate to employ a given strategy. Option sellers write the option in exchange for receiving the premium from the option buyer. They are expecting the option to expire worthless and, therefore, keep the premium. For some traders, the disadvantage of writing options naked is the unlimited risk. When you are an option buyer, your risk is limited to the premium you paid for the option. But when you are a seller, you assume unlimited risk.

Refer back to our XYZ example. The seller of that option has given the buyer the right to buy XYZ at 40. If the stock goes to 50 and the buyer exercises the option, the option seller will be selling XYZ at $40. If the seller does not own the underlying stock, he or she will have to buy it on the open market for $50 to sell it at $40. Clearly, the more the stock's price increases, the greater the risk for the seller.

How Can a Covered Call Help?

In the covered call strategy, we are going to assume the role of the option seller. However, we are not going to assume unlimited risk because we will already own the underlying stock. This gives rise to the term "covered" call--you are covered against unlimited losses in the event that the option goes in the money and is exercised.

The covered call strategy is twofold. First, you already own the stock. It needn't be in 100 share blocks, but it will need to be at least 100 shares. You will then sell, or write, one call option for each multiple of 100 shares (i.e., 100 shares = 1 call, 200 shares = 2 calls, 276 shares = 2 calls).

When using the covered call strategy, you have slightly different risk considerations than you do if you own the stock outright. You do get to keep the premium you receive when you sell the option, but if the stock goes above the strike price, you have capped the amount you can make. If the stock goes lower, you are not able to simply sell the stock; you will need to buy back the option as well.

When to Use a Covered Call

There are a number of reasons traders employ covered calls. The most obvious is to produce income on stock that is already in your portfolio. Others like the idea of profiting from option premium time decay, but do not like the unlimited risk of writing options uncovered.

A good use of this strategy is for a stock that you might be holding and that you want to keep as a long-term hold, possibly for tax or dividend purposes. You feel that in the current market environment, the stock value is not likely to appreciate, or it might drop some. As a result, you may decide to write covered calls against your existing position.

Alternatively, many traders look for opportunities on options they feel are overvalued and will offer a good return. To enter a covered call position on a stock you do not own, you should simultaneously buy the stock and sell the call. Remember when doing this that the stock may go down in value. In order to exit the position entirely, you would need to buy back the option and sell the stock.

What to Do at Expiration

Eventually, we will reach expiration day. What do you do then?

If the option is still out of the money, it is likely that it will just expire worthless and not be exercised. In this case, you don't need to do anything. If you still want to hold the position, you could "roll out" and write another option against your stock further out in time. Although there is the possibility that an out of the money option will be exercised, this is extremely rare.

If the option is in the money, you can expect the option to be exercised. Depending on your brokerage firm, it is very possible that you don't need to worry about this; everything will be automatic when the stock is called away. What you do need to be aware of, however, is what, if any, fees will be charged in this situation. You will need to be aware of this so that you can plan appropriately when determining whether writing a given covered call will be profitable.

Let's look at a brief example. Suppose that you buy 100 shares of XYZ at $38 and sell the July 40 calls for $1. In this case, you would bring in $100 in premiums for the option you sold. This would make your cost basis on the stock $37 ($38 paid per share - $1 for the option). If the July expiration arrives and the stock is trading at or below $40 per share, it is very likely that the option will simply expire worthless and you will keep the premium (in cash). You can then continue to hold the stock and write another option for the next month if you choose.

If, however, the stock is trading at $41, you can expect the stock to be called away. You will be selling it at $40 - the option's strike price. But remember, you brought in $1 in premium for the option, so your profit on the trade will be $3 (bought the stock for $38, received $1 for the option, stock called away at $40). Likewise, if you had bought the stock and not sold the option, your profit in this example would be the same $3 (bought at $38, sold at $41). If the stock was higher than $41, the trader that held the stock and did not write the 40 call would be gaining more, whereas for the trader who wrote the 40 covered call the profits would be capped.

The Bottom Line

The covered call strategy works best for the stocks for which you do not expect a lot of upside or downside. Essentially, you want your stock to stay consistent as you collect the premiums and lower your average cost every month. Also, always remember to account for trading costs in your calculations and possible scenarios.

Like any strategy, covered call writing has advantages and disadvantages. If used with the right stock, covered calls can be a great way to reduce your average cost.