Money Matters

The Independent Press
January 5, 2011

Question of the Month: What Is a Covered Call?

By Aaron Skloff

Q: Can I turn the tables on Wall Street and profit from its greed? What are my options with options?

A: Many Wall Street firms are driven by greed — to the detriment of clients, shareholders and other stakeholders.

The solution is covered call writing which turns the tables on Wall Street's greed, generates a stream of income and protects your portfolio — all at the same time.

With this strategy, named covered call writing, you sell (or write) the option for someone to buy a stock you already own for a set price (called a strike price) in the future. Covered call writing is considered to be even more conservative than simply owning a stock outright, as your risk is actually reduced by the amount you receive (called a premium) when you sell a call.

Let's Look at an Example. On January 3, 2011, you write one ABC December 60 call (each call represents 100 shares of stock) at a premium of $4, covered by 100 shares of ABC stock you bought for $50 per share (for a total investment of $5,000). For ease of discussion, transaction costs will be excluded in the examples below.

Stream of Income. When you write the one ABC December 60 call you receive $400; equal to $4 times the 100 shares of underlying stock the one option represents. That $400 provides you an 8% return on your $5,000 investment.

If ABC Advances to $60 on July 1 and your stock is called away from you, you would be forced to sell your initial $5,000 investment for $6,000, generating a $1,000 profit or a 20% return.

Your return would have been 20% (before dividends) if you simply invested $5,000 at the beginning of the year, held it throughout the year and sold it for $6,000 at the end of the year. Since it only took half of a year to generate a 20% return, your annualized return is 40%.

If your ABC stock paid you $100 in dividends on your $5,000 investment, you would earn another 2%. Remember, if you collect 2% over the course of six months, your annualized return is 4%. This brings the annualized return on your investment to 44%.

Don't forget about the premium you receive when you wrote the call. In the example above, the $400 you receive provided you an 8% return over six months on your $5,000 investment, for an annualized return of 16%. This brings the total annualized return on your investment to 60%.

Often Overlooked. Let's assume ABC stock declines to $40 in a year's time and you sell the stock for a 20% loss. Offsetting your loss would be the 8% return you generated from the covered call you wrote and the full year's 4% dividend – providing you an 8% net loss. Thus, covered call writing is considered to be even more conservative than simply owning a stock outright, as your risk is actually reduced by the amount you receive (called a premium) when you sell a call.

Note. Aaron Skloff, Accredited Investment Fiduciary (AIF), Chartered Financial Analyst (CFA), Master of Business Administration (MBA) is CEO of Skloff Financial Group, a Registered Investment Advisory firm based in Berkeley Heights. He can be contacted at www.skloff.com or 908-464-3060.