

Covered Call Writing

Extra Income Generation through Stock Ownership

By Nick Katiforis

Volatility in the financial markets is a fact of life. Many people holding long term share portfolios have seen significant falls in their share values, or if you don't hold direct share investments then have seen an erosion in their superannuation balances with funds reporting negative earnings results in the last financial year.

The decision then is what to do during this very confusing period in the market? Should you stay out of the markets altogether and put your money into a fixed interest account? You will certainly sleep better and preserve your capital if stock markets continue to fall, but with interest rates almost certain to keep declining, income generation will be minimal at best. Also you miss out on any appreciation in stock values should we see a turnaround in share prices.

You could go the other way and look at this unique period in the market as a once in a lifetime opportunity to grab a swag load of blue chip shares at never to be seen again low prices, and comparatively high dividend yields.

Alternatively you could get the best of both worlds, allowing you to reap the benefits of share ownership (including capital appreciation and dividend income and franking credits where applicable) as well as a steady monthly cash flow.

What's the catch? Well you might have to sell your shares at a higher price than what you bought them at. Hang on I hear you asking, if I sell my shares at a higher price than I bought them for doesn't that mean I have made a profit? The answer is yes.

But wait there is more....someone is also going to pay you up front cash for the privilege of potentially buying your shares at a higher price!! Its called *Covered Call Writing*. In a nutshell it involves buying a certain number of shares and writing a call option against the stock to receive income premium. Let's have a look at a real life example:

It's Monday the weekend after the US Senate and House of Representatives finally passed the much talked about \$700 billion assistance package. Let's look at a potential Covered Call Trade using real market prices. The stock I will choose is BHP which is the biggest share by market capitalization on the ASX and one that has had a reasonably hefty price fall recently.

Trade Details:

| | |
|--------------------|--|
| Date: | 6/10/08 |
| Current price BHP: | \$29.94 |
| Option to Write: | BHP OCT 33 call (1 contract = 1000 BHP shares) |
| Option Expiry: | 30 Oct 2008 (24 days) |
| Option Value: | 0.97 cents (\$970 per contract) |

Strategy:

Buy 1000 BHP @ 29.94 = \$29,940
Write 1 BHP Oct 33 Call @ 97 cents (Receive \$970)
Net cost \$28,970

There are 3 scenarios that can play out here by the end of the month :

Scenario 1: No change in price of BHP

Scenario 2: BHP is Higher

Scenario 3: BHP is lower

Scenario 1

If stock prices are unchanged you will get to keep the option premium that you wrote the option for (\$970), and in the process make a return for the month of over 3%. You would then be free to write another option for the next month by doing the exact same thing again, this time for the November option series.

Scenario 2

Let us say that BHP is up sharply and has finished at \$33.50 by the end of the month. You would be assigned on your 33 call option position (in other words you would need to fulfill your obligation by selling your shares @ \$33.00). This would leave you with a profit of \$3.06 per share AND you would get to keep the premium of 97 cents per share effectively taking your profit to \$4.03 per share or over 13% for the month.

If the share price is higher but finishes by the end of the month below \$33.00 then you would as in the first case keep the premium of 97 cents per share, and be in a position to again repeat the process for the November options.

Scenario 3

If the third scenario plays out and the share price is below your original entry price to say \$27.00, then you would be losing money on your share purchase (\$1.94 per share) but would get to keep all the premium (97 cents per share or \$970) which then would lower overall current loss to \$970. Again you would then be free to write another option for November at perhaps a lower strike than 33 to again take in more premium income.

Conclusion:

Having looked at these real life examples of covered call writing several conclusions can be drawn from this exercise:

1. *Risk is lowered*

Someone pays you a premium which effectively reduces the entry cost for your shares therefore lowering your risk by the amount received.

2. *Your maximum profit is capped*

If the stock rises above your strike price (in the example \$33) by expiry of the option then you will be obliged to sell your shares at that price. This can still be a very lucrative outcome as can be seen in this example.

3. *You keep the option premium*

Regardless of the outcome you will keep 100% of the premium that you received for writing the option.

4. *Options can be written regularly against your share holding*

Many actively traded share options can be written every single month.

5. *Time is your ally*

Time decay of written options work in your favour when writing options particularly in the last month of expiry which can help give you an edge.

6. *This strategy offers flexibility*

At any time you can close your options and stock positions if you wish to. You don't have to wait till expiry before doing so.

Final Thoughts

In a volatile market environment where we may bump along the bottom for a while yet, covered call writing can provide an effective means of providing income through premium option writing and the collection of dividends and franking credits where applicable, whilst still giving you potential for capital gains. It is a very effective strategy to suit the current climate.

NB: (In this example I have not taken into account brokerage nor have I touched on other variations of this strategy such as utilising capital protection strategies by buying put options as insurance, or rolling strategies for those wishing to keep their shares.)

About the Author

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