

## Covered Writing - A Way to Reduce Risk?

*Generating extra income from a stock portfolio*

Len Yates

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Covered writing, also known as a "buy write", is often touted as a safe way to generate extra income from a stock portfolio, and the Short Covered Call is often an investor's first introduction to trading options. It follows naturally from the simple purchase of stock. It is relatively easy to explain and results in immediate income. And finally, it seems to be just as safe as simply investing in stock.

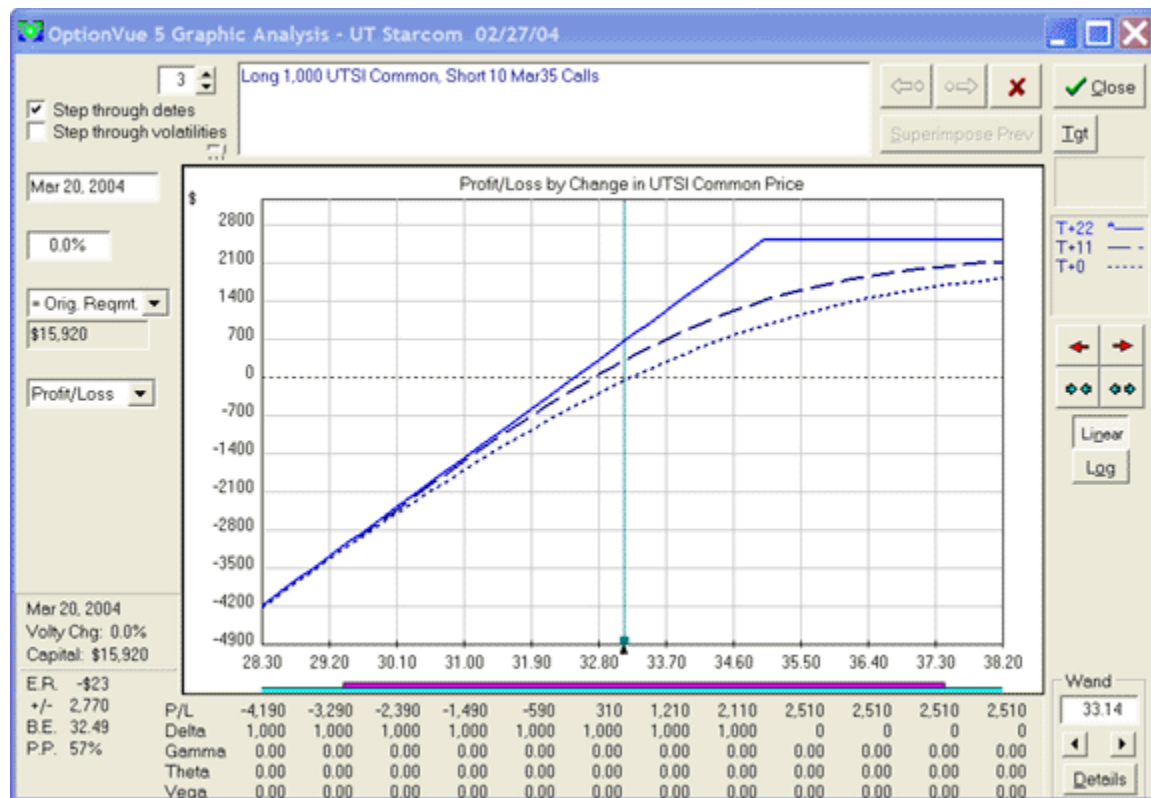
While speculative call buyers usually hold their position for only a short time, the covered call writer often expects to hold his position to expiration. If the option is out-of-the-money at that time, it expires worthless. If the option is in-the-money at expiration, the investor may decide to buy the option back to close the position and keep his stock, or he can do nothing and see his stock "called away".

Some investors keep their stock and sell covered calls repeatedly after each expiration, thus continually adding to their income. A real plus is that covered writers make money during periods when their stock holdings go nowhere. And the income that can be generated can be impressive. Upwards of 40% annual returns are typical. Remember, however, such returns are possible only if the stock goes up or remains at around the same price.

When someone says they don't trade options because they're too risky, the covered call is usually cited as an example of using options to reduce risk. And it's true. The sale of call options against stock holdings reduces the overall variance of returns, thus reducing risk in the traditional sense.

However, if you take the time to study this strategy and its risk curve, it can in fact be a risky way to invest. The risk curve for this trade looks like, and in fact is exactly, the shape of the risk curve that results from simply selling a naked put. While covered writing is attractive because of the extra income it generates, it also has a major shortcoming. The covered writer has the same downside risk as he did just owning the stock. At the same time, his upside potential is limited.

The basic strategy is that a trader sells (shorts) a near-term at-the-money (ATM) or slightly out-of-the-money (OTM) call, and then "covers" the short position by going long (purchasing or already owning) 100 shares of the stock for each call sold. In other words, for every 100 shares of stock you own, you can sell one call against it. The performance graph below illustrates the covered call strategy's downside risk and limited potential:



Option sellers are said to be "writing" options, because they originate the contract (although nobody ever sees actual paper contracts). When you write a call, the credit received for the option you have sold goes immediately into your trading account. The hope is that the stock will move in a sideways or slightly downward pattern during the life of the option, and the call will eventually expire worthless. When this happens, you still have the stock (which otherwise would have made little profit during this time) and you get to keep the premium for the call sold. You can then sell another call for the next month out, collecting more premium.

The key thing to remember is that when you sell calls against your stock holdings, you are giving someone the option to buy your stock from you any time during the life of the option for a stated price -- the strike price -- of the option. In return for giving up gains above the strike price, you receive cash for the options sold.

So what happens if the stock does go up? In that case, the short call will be exercised by the owner, and your broker will "assign" your stock (sell it to the holder of the option) for the strike price of the call you sold. This is not necessarily a bad thing, since it means that you sell the stock for a little bit more than you paid for it, plus get to keep the premium from the option you sold.

So what could possibly go wrong? Well, what we haven't looked at what happens if the stock goes up or down a lot in a short time.

If the stock price quickly increases, even doubles in price, your profit is limited (to the strike price of the option you sold, minus what you paid for the stock, plus the premium received for the short call). The main reason to buy a stock is that you expect it to increase in value. But with the covered call, your gains are limited by the option you have sold. In this case your decision to buy the stock was correct, yet you will profit very little from it.

And what if the stock price falls dramatically? Your calls really do nothing to protect you against losses as the market falls. Sure, you get to keep the premium from selling the call (when it expires worthless), but you still own the stock, which is now worth considerably less than what you paid for it.

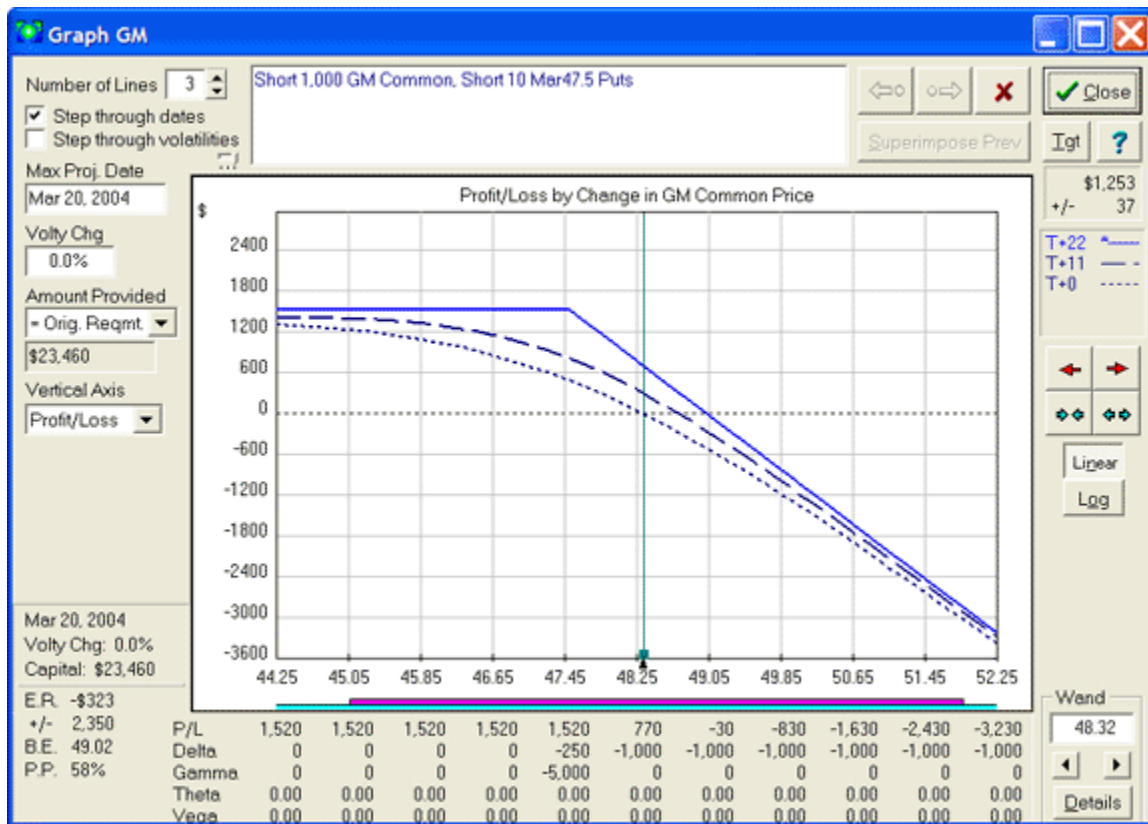
The problem then is that you will not be able to sell another call at the original strike price. Instead, you will have to sell the next call at a lower strike price. If the stock then moves back to its original price, you will be assigned on the short call at the lower strike, locking in a significant loss. And if the stock continues to drop, you will end in a worse position than if you simply accepted your loss after the first month and moved on.

This is the main "knock" on covered writing -- that it takes away your upside profit potential but leaves you with the same downside risk as a regular stockholder.

While that's true in theory, experienced traders will keep some of their upside potential through careful position management. How? By rolling. After a stock moves up, they re-purchase the short calls (at a loss) and sell new calls at a higher strike. This strategy allows you to stay in an up-trending stock. Note that this also means that capital gains (from sale of the stock) are deferred, while the loss from the short calls can be claimed immediately.

An upside down version of covered writing is the Short Covered Put. This strategy is so seldom used or discussed that the term "covered write" is universally understood to mean buying stock and selling calls. But shorting the stock and selling put(s) is technically also a covered write. The covered put writer gives up control over his short stock position for a limited time in return for income from the sale of the put.

The performance graph of this strategy is a mirror image (in terms of stock price direction) of the traditional covered write:



The main thing that experienced option traders do when writing covered options is to sell only when options are expensive (as measured by their implied volatility). Option prices fluctuate between periods when they are cheap or expensive. If you focus on selling when options are expensive, it makes a big difference! Historical volatility charts, such as those available to OptionVue Research subscribers on this website, can help you know when a stock's options are cheap or dear on a historical basis.