Writing Covered Calls – A Yield Enhancement Strategy

"Writing" covered calls involves selling call options on a long common stock position. A covered call strategy is used when the outlook for the stock is neutral or mildly positive. The strategy will outperform stock ownership alone if the share price falls, is stable, or rises modestly during the life of the option.

When an investor sells a call option they earn premium. In return, the investor agrees to deliver the underlying stock to the option buyer if the shares trade at a specified strike price by a specified expiry date. Having to deliver the underlying stock to the option buyer is called being assigned.

An option writer retains all of their rights as a common shareholder, including voting privileges and entitlement to dividends. They are also exposed to fluctuations in the value of the underlying stock and, as such, face the same risks as if the call options had not been written. However, the option premium earned lowers the cost of buying the common stock, which provides some downside protection if the share price falls. If not assigned, the strategy generates income for the portfolio as the call writer retains both the common stock and the premium.

There is a potential opportunity cost to writing call options. For example, if the option is assigned, upside potential on the underlying stock is limited to the strike price. For this reason, the option writer should be neutral between continuing to own the shares and "selling" them at the strike price.

If the Underlying Stock Price Falls

As mentioned above, an ideal time to write covered calls is when the outlook for the underlying stock is stable or moderately bullish. However, if the share price falls, the premium earned will offset some of that loss in value.

If the underlying shares fall more than expected, the call writer has several options available. They can either continue to hold the stock and let the options expire naturally or, if they turn more bearish on the stock, they can close out the entire position by buying back the options and selling the stock in the market.

An alternative strategy is to continue holding the stock, buy back the options, and sell a different option series with a lower strike price. This is called "rolling down". Rolling down brings in additional option premium, which increases downside protection. The risk to rolling down is that the stock rebounds, causing the option to be assigned at the lower strike price.

If the Underlying Stock Price Rises

If the share price rises more than expected, the call writer also has several choices. They can "do nothing" and potentially lose their stock at the strike price, or, if they turn more bullish on the stock, they can buy back the options, allowing the underlying shares to rise without the risk of being assigned.

An alternative strategy is to continue holding the stock, buy back the options, and sell a different option series with a higher strike price. This is called "rolling up". Rolling up allows the underlying stock to appreciate further without risk of being assigned, but generally reduces the amount of downside protection.

The Strategy at Work

An investor buys 100 XYZ common shares at \$52.40 per share. They then sell one XYZ January 55 call for \$2.50. The option expires in 30 days.

If, at expiry, the stock price trades at \$55 or higher and the option is assigned, the return is calculated as follows:

$$\text{Simple Return} = \frac{\$2.50 + (\$55 - \$52.40)}{\$52.40}$$

$$= 9.7\%$$

$$\text{Annualized Return} = \frac{9.7\%}{30} \times 365$$

$$= 118\%$$

If, at expiry, the stock price is below \$55, the option will expire worthless.
The option writer keeps the stock and the premium. In this case, the return is calculated as follows:

$$\text{Simple Return} = \frac{\$2.50}{\$52.40}$$

$$= 4.8\%$$

$$\text{Annualized Return} = \frac{4.8\%}{30} \times 365$$

$$= 58\%$$