

Misconceptions About Covered Call Writing

Essay **34**

Covered call writing appears to be one of the most popular strategies for serious option traders. Over the years I have noticed, however, that covered call writing is often presented to novices in a very misleading manner. Thus, I am going to use this essay to air my own personal grievance about the way in which so-called experts, meaning oftentimes consultants and more often than not, brokers, describe this strategy.

Let's begin by giving a quick description of exactly what covered call writing is. For simplicity let us assume that the stock pays no dividends and that the options are European style, meaning that they cannot be exercised until the expiration day.

If you buy a stock and it goes up, you make money. If it goes down, you lose money. If you sell a call, without owning the stock, and the stock goes up and ends up above the exercise price, the call is exercised. You have to buy the stock at whatever price it is selling for and deliver to the call buyer who pays you the exercise price. If the call expires out-of-the-money, you do nothing. In either case, you keep the premium.

If you combine owning the stock with selling the call, you end up either keeping the stock or selling your stock for, at most, the

exercise price. On the downside, the loss on the stock is cushioned by the retention of the option premium. On the upside, your stock profit is the exercise price minus what you originally paid for the stock plus the call premium that you get to keep.

My complaint about this strategy, or rather with the way in which it is presented by many brokers and consultants, is that it is described as an *income-enhancement strategy*. The argument goes like this. You own a stock. You do not plan to sell it. The stock is not expected to go up by much if at all. Why not sell a call against it and pick up some income? This makes it sound like either there is money on the floor waiting to be picked up or that your stock is generating some income and you are not getting your share.

Okay, go ahead and pick those dollar bills up. But you need to realize what you could be missing. You are giving up all of the capital gains beyond the exercise price. Those gains go to the buyer of the call. This may seem simple but you would not believe how many people are duped by this.

I once had an investment manager tell me that her organization had taken the advice of a consultant about a year earlier and instituted a covered call writing program. The consultant had presented it as an income-enhancement strategy. The fund then missed out on a strong bull market. Of course, it is easy for us to criticize after the fact. Who are we to brag about our market timing ability? But the simple fact was that the consultant had not made it clear what they would be missing if the market went up. Or at least no one asked the question "What's the catch?"

Covered call writing is a risk-reducing strategy. It is designed to do precisely what investors do when they select stocks that pay high dividends over stocks that have greater growth prospects. Covered call writing converts the prospects for uncertain future capital gains into immediate cash flows that resemble dividends. There may be good reasons to do an occasional covered call, but a formal program of regular covered call writing might well be no better than simply buying high dividend stocks instead. Of course, there *is* a big difference where the broker is concerned. A systematic program of covered call writing generates commissions, not only from the initial sale of the call but also from the occasional

exercise of the call, resulting in the delivery of the stock, and from the rolling over into new calls as the old ones expire. The broker will be quite happy if the client does covered calls and that should immediately make one suspicious.

The sad thing is that many retired people owning stocks are being misled. The notion that they should be willing to give up capital gains for current income may make sense, but they should not see covered call writing as the only way to achieve that goal.

Another misunderstanding about covered calls arises from the way in which the profit is calculated. First ignore the transaction costs. Let S be the stock price when the call is written, X be the exercise price, c be the call premium, and S^* be the stock price when the call expires. If the call expires out-of-the-money, the profit is $S^* - S + c$. If the call expires in-the-money, the profit is $X - S + c$. Many people have a hard time seeing why we subtract the stock price at the time the call is written. They reason that you might well have bought the stock prior to when you wrote the call. If that is the way you think, then you do not see the opportunity cost in holding a stock. When you attached the call to the stock, you made a conscious decision to hold on to the stock. You could have sold it, liberating the S dollars for use elsewhere. Thus, you have to account for the S dollars even though you may have bought the stock much earlier.

In summarizing, covered call writing is a risk reducing strategy. *When risk is reduced, expected return is reduced as well.* That is the first and foremost principle of finance. The investor who does not believe this point has the luckiest broker in the world.

For More Reading

Yates, James W., Jr. and Robert W. Kopprasch, Jr. "Writing Covered Call Options: Profits and Risks." *The Journal of Portfolio Management* 7 (1980), 74-79.