

**Professional Options Trading Masterclass Video Series**

**POTM**

**Video 9**

**Covered Call Strategy**

# 1. Covered Call

## Quick Explanation

The Covered Call is an Options Trading Strategy can be used when you have an existing long position in a stock and you want to generate some returns if you believe the price of the Stock will be stable / neutral for a short period of time. It can also be used to provide a small measure of protection should the price fall.

The Covered Call strategy is a very straightforward strategy; you simply write call options on the stock that you own. As your expectation is that the price won't increase short term, your view is that these Options will expire worthless and you will have effectively made income from your stagnant stock. The Covered Call Strategy can also be used if you are losing money on a Long Stock position in an attempt to theoretically lower the average price of the Long Stock Position.

- **Non-Directional Bet**
- **Neutral Strategy**
- **Simple**
- **One Transaction**
- **Net Credit (Upfront Payment Received)**
- **Max Risk (Limited)**
- **Max Gain (Limited)**

## When to Use the Strategy

Although the Covered Call is technically considered an Options Trading Strategy, it isn't a strategy that is used to make profits solely from Options. It's designed primarily to return a profit when stock that you own goes through a period of remaining neutral i.e. it neither goes up nor down in price.

Typically, you would use it if your outlook on stock you own is neutral, but you don't particularly want to sell it and you would prefer to try and make some profits out of the price not moving. You can also use it to reduce any losses you may incur if the stock falls in price, although it's not particularly effective if it falls by a lot. The protective put (Long Put) is a better choice if you are looking for protection against any sizable fall.

Establishing a Covered Call is very simple. You just have to write enough Calls to cover the number of shares that you own. You can write these at whatever strike you choose, but traders will usually write them at a strike that is slightly higher than the current price of the shares.

By writing Options with a higher strike, you stand to make a higher return if the price of the underlying stock increases (because you are Long Stock on the other side), but you will make less if it stays the same. You will also have less protection should the underlying Stock fall.

In terms of choosing an expiration date for the Options you write, the general rule is to write them with an expiration that is close, typically at or within the nearest month. By doing this you stand to benefit from a quick rate of time decay and there's a shorter period of time for the underlying stock to move in price.

Establishing a Covered Call has 4X main uses; -

1. Hedge against Long Stock Position that is positive P/L and collect Premium.
2. Hedge against Long Stock Position that is Negative P/L and collect Premium.
3. Hedge against Long Stock Position in a Dividend paying Stock that is going ex-Dividend very soon and collect Premium.
4. Getting a "better" execution price on an intended Long Stock Position.

Although the Covered Call Strategy is a "Non-Directional" Neutral strategy overall, we include it in the "Useful" PDF because it has Medium usefulness in the real world for Retail Traders. Especially for Retail Traders that have a Long Only Portfolio i.e. a Pension. The Covered Call Strategy can be used in the U.S. IRA pensions scheme whereas selling naked Calls cannot. For International Investors, opening up an Options trading account in order to Hedge Long Only pensions infrastructure is the only real way to use strategies like the Covered Call strategy to ensure money is not lost when Stock Markets go down. The main uses for the strategy apply globally to anyone with a Long Only Pension or anyone with a trading account with Long Stock positions. It is useful and can add a lot of value over time to your Retirement Accounts and / or Trading Accounts if you know what you are doing and you stay active i.e. you add value to your account by using the Strategy. The only reason we mark its usefulness as

“medium” versus a Covered Call Collar strategy as “High” is because it has defined limited risk and limited upside that is small in comparison. This will become clearer in the next section on Covered Call Collar Strategy when we compare the two Strategies.

## How to Use the Strategy

As mentioned above there are 4X main uses for the Covered Call Strategy.

### 1. Hedge against Long Stock Position that is positive P/L and collect premium.

The easiest to understand is in the first example in which you own a Stock (Long) and you are making a Profit from the trade. Stocks of course never go up in a straight 45-degree line. There will be periods where a Stock goes sideways or down during a fundamental and technical uptrend. If your fundamental view of a Stock is Long Term Bullish but in the Short term you believe that the Stock may struggle to rally through a certain Fundamental Valuation point or Technical Level you can become a more efficient trader and maximize returns by deploying a Covered Call Strategy. Your view here is not that the Stock has the potential to collapse, but it has the potential to either stay where it is for a while or go down short term. Instead of taking profits on the Stock and simply selling some Stock and trying to buy it back at a lower price you may simply decide to sell a Short-Term Call Option that is At the Money or Out of the Money to collect some Premium. The best way to do this is decide yourself on a discretionary basis (no rules) the level you believe the Stock to be capped at Short Term and sell that Strike. You will receive a credit for doing so and your Break Even is the Strike + Premium Collected per share. If the Stock stays below the Strike Price you have sold the contract will expire worthless and you will have added value to your Long position. You will receive the Max Gain if the Stock closes on the day of expiration at exactly the Strike Price you have sold. If the Stock goes above the Break-Even level you will be making money on the Stock Long but Losing Money on the Option and you would have added no value to your Long Position. Infact in this scenario you have lost because you would have been better off just staying long the Stock and not writing a Covered Call Option. If the Stock Rallies to between the Strike you sold and your Break-even level then the Call will be “In the Money” and you will be losing Money on the Call Option but making money on the Long Stock Position. You will most likely be making slightly more on your Stock Long than losing on your Call Option Short but only very marginally. What you really want is that the Stock doesn’t move much and closes at or as near to the Strike as possible to get the Max Gain, whilst you have the Covered Call Options short on and then the Call Option contract to expire worthless, then for the Stock to go up through the Strike Price when you don’t have a Covered Call Option Strategy on. So, your timing has to be good. Notice that this differs from being bearish or seriously concerned about the stock falling in value by a large amount. If this was the case then you would likely sell stock. Here you are simply hedging a long-term position you believe will go up over the Long term but for a short period of time will trade sideways or perhaps down small.

Something you must be careful of when considering this simple strategy is publicly known upcoming events that could see Volatility increase..., for example earnings announcements. [See Volatility Video ..](#),

### 2. Hedge against Long Stock Position that is Negative P/L and collect Premium and collect premium.

The Covered Call Strategy is very useful in this scenario. Let’s say for example you are Long a Stock and it is down say 7% since you bought it. But you have a Fundamental Pre-Disposition that the Stock will rally 40% over the next year. Your timing may have been off by 1-2 Months. In Trading we must assume that we are never going to Buy at exactly the bottom and Sell at exactly the top. For this example, we will use some theoretical numbers. Let’s say you are Long a Stock at \$100 and since you bought the Stock 3 weeks ago it has fallen to \$93. If your Fundamental Predisposition has not changed and you still believe the Stock will go to \$140 in the next 12 Months, you can consider a Short Term Covered Call Strategy. Let’s say for example you pull up the Options Chain and you see that the 2-week Call Option with a Strike Price of \$97 is trading at \$1.15 ..., if you Sold the Call and it expired worthless you would make \$1.15 and your theoretical average price per share would drop from \$100 to \$98.85 per share (as long as you are perfectly hedged). Then if the Stock rallies above once your Covered Call Position is closed you have managed to lower your average price by \$1.15. Don’t forget you can also trade the Option itself. Let’s say in this example you Short the Call at \$1.15 and it drops \$1 in value and you decide to buy it back at \$0.15 to lock in Profits on the value of the Call and / or you believe the Stock may now rally. Then your average price would drop to \$99.

The beauty of the Covered Call Strategy overall is that if you know you have the option to Sell Covered Calls prior to owning a Stock, you know before you go into a position that you can choose to be active in always attempting to add value to your execution or in times when you believe the Stock will go sideways or fall. In the circumstance when you are losing money this may keep you from “cutting” a Long Stock Position and missing out on all the upside once the Stock rallies. The above example of when you are making money on a Long Stock position is really no different except the P/L is positive. You are simply attempting to add value to your Long Stock Position and managing risk in your portfolio more optimally than just simply sitting with a Long Stock Position and riding the up and down moves in the Stock.

In practice this doesn't simply mean the average price on your Long Stock position will change when you decide to buy back the Short Call or it expires worthless. What will happen is that the average price on your Long Stock position will remain in the above example at \$100. But, let's say you were Long \$100,000 of Stock, you will have received a credit of \$1,150 by shorting a Covered Call on a \$100,000 position to your account. You must work out with an average price calculator prior to entering the Position what your \$ upside would be on using the Covered Call Strategy (above in point 1) if the call expires worthless and assess whether it is worth it or not. Then in your own spreadsheets you can amend the average price of the Long Stock Position or add into your spreadsheets your Options Trading Book as a separate Asset and the P/L of your Options Account. You will be able to keep a track record of how much value over time you add to your Long Stock Positions [See Covered Call Video Download Resources](#).

### 3. Hedge against Long Stock Position in a Dividend paying Stock that is going ex-Dividend very soon and collect Premium.

This is a very simple and useful scenario / strategy especially for Retail Traders / Pensions investors who hold Long Stock positions in their Long Only Pensions especially in Mega Cap and / or Large Cap Stocks in the U.S. that have active liquid Options Markets. When a Stock goes ex dividend, theoretically (all things being equal), the day that it goes ex-dividend the Stock will fall by the amount of the Dividend. However, the Options price of both Calls and Puts does not re-adjust. The expectation of the Dividend is already in the Options prices. Options are valued taking into account the projected dividends receivable in the coming weeks and months up to the Option expiration date. Consequently, Options of high cash dividend stocks have lower premium calls and higher premium puts.

So, let's say you are Long a Stock that is at \$100 and the Stock pays a \$4 Dividend per year or \$1 per quarter. We all know when the ex-dividend date is going to be. This is usually public information. Therefore, you know that in say 1 weeks' time the stock will automatically fall by \$1. You will not lose money on your Long Stock Position in this scenario because you will actually be receiving the Dividend and the average price of your Long Stock position in your Retirement / Trading Account should adjust automatically. In this time, it might be worth considering a Covered Call Strategy if you believe the price will not rise prior to the ex-dividend date or straight after i.e. you believe that due to the ex-dividend date and price re-adjustment there will be a period of "indigestion" in the Stock so it will trade sideways overall during the period or fall slightly. In this scenario you can add value to your Stock Position by writing a Covered Call, because Options prices do not re-adjust for Dividends. So, for example. Let's say you are reasonably confident that the Stock will be sticky to \$100 before the ex-Dividend date..., this means then that you believe that it will be sticky to \$99.00 on the ex-dividend date and immediately after. Let's say you sell a Covered Call with a Strike of \$103 for \$1.25 per share with an expiration that is a week after the ex-Dividend date. Your breakeven will be \$97.75 (dividend adjusted) and \$98.75 (non-Dividend Adjusted). Leading into the ex-dividend date your Call Option will likely fall in value and reprice to be worth around \$0.25 as the Stock drops to \$99.00 BUT your average price on the Short Option trade WILL NOT change down to \$0.25. However, the Stock WILL reprice by \$1 lower. However, the Stock WILL reprice by \$1 lower. So, in this instance you will make a \$1 Dividend and \$1 on the Covered Call trade. What you are doing here is called "Dividend Protection." In reality you are not making \$1 on the Dividend because the Stock reprices down \$1 and your average price on the long reprices down by \$1. But you are making \$1 on the Options contract because your average price remains at \$1.25 on the Option. So, you are adding \$1 value to your Long Stock Position. Of course, you can get caught out on this transaction and nothing is ever this simple. This is a theoretical example of what you could do if you believe the stock will not go up before during or after an ex-Dividend date. You could easily get caught out by the Stock "going ex-dividend well" i.e. on the day the Stock goes ex dividend i.e. the day you think the Stock is "supposed to automatically drop \$1 on the open" could be the day after Global markets had a massive 3% rally overnight or a competitor company somewhere in the world reports amazingly positive numbers..., the Stock might go ex-dividend but open at \$102.00 and rally all day to \$104.50. When we use the phrase "a Stock goes ex-dividend well" we mean that the Stock goes up on the day of the dividend price re-adjustment. Conversely, when we say "a Stock goes ex dividend badly" we mean that the Stock falls on the day of the re-adjustment by a larger amount than the dividend price re-adjustment. In reality, the closer we get to ex-dividend days the premium in Calls erodes quickly and the premium in Puts rises quickly because the whole world knows and so do Market Makers that the Dividend date is coming up., so Options get priced accordingly. Calls WILL BE low priced. You can however still add value to your Long Stock Position if your Stock view of being Neutral into, on and after the ex-dividend date is correct and you can still bank some meaningful premium.

The best way to familiarise yourself with this Covered Call Strategy is to monitor your Mega Cap and Large Cap Long Only Stock holdings in your Pension and watch the price action of the Stocks 1-2 weeks before the Stocks go ex-dividend, on the day the Stock goes ex-dividend and 1 week after the Stock goes ex-dividend and also watch the Call and Put Options Markets into, on and after the day of the Stock going ex-dividend. Familiarize yourself with the process and do some theoretical paper trades selling Out of the Money Call Options and see if you would have added value to your Stock position. This will help get you used to the risk of the trade and understanding of the dynamics of how it works. Plus, you will feel more confident in putting "dividend protection" trades on.

### 4. Getting a better execution price on an intended Long Stock Position.

This Covered Call scenario is very useful especially for Retail Traders who do not trade fulltime and who can recognise good medium to long term fundamental Long ideas but don't have the execution capability or expertise to time their trades very accurately or who don't want to necessarily spend hours and days trying to get a slightly better price on their execution i.e. you just want to get the Long Stock position on for the medium to long term but you want to get on with your day job. Let's say you have a fundamental pre-disposition that a \$100 stock is going to go from \$100 to \$140 over the next year BUT, you really do not know whether it could be \$98 or \$102 two weeks from now. Let's just say you are not confident that you are going to buy "at the bottom." Well in the vast majority of cases you would be right to assume this. No-one ever picks the bottom (when buying) or the top (when selling). Someone obviously does BUT for it to be you and for it be you all the time is just totally unrealistic. The great thing about a Covered Call strategy is that it can be put on immediately from scratch. So, let's say when you go long the \$100 Stock you decide at exactly the same time to Short the 4% Out of the Money \$104 Call Options for \$1 with a \$105 break even with an expiry date 3 weeks from now. You are basically saying to yourself that you know your timing might not be perfect (and it usually isn't) so in the first few weeks because I know my timing is usually or probably going to be off, I might as well bank some premium in the near term and add value to my execution. This is a very effective way of building into a Long Only pensions position over time. If you are position building, especially in a bear market, putting on a Covered Call from scratch can obviously be a helpful strategy as an immediate Stock Repair strategy to eliminate bad timing on going Long the Stock. It works exactly the same way as the other hedge explanations of being either positive or negative P/L, except you are creating it from scratch to enhance execution from the outset of creating a new Long Stock position to add value to your timing. At the time your P/L is \$0. So, you do not have to worry so much about trying to "pick the bottom." Retail Traders with full time jobs and / or who run businesses can't sit at a screen all day trying to bottom tick every stock they go long in their pension. Remember as a Retail Trader you have Opportunity Cost of time too. Every hour spent sitting at your screen trying to save 10c on execution is an hour lost at work doing something else i.e. making \$50, \$100, \$200, \$300 per hour.

Risks of the Covered Call Strategy - There are two main risks when using this strategy. First, it offers very little protection if the stock should fall in value. Any losses incurred from a drop in the value of the underlying stock will be offset only by the credit received for writing the options. If the Stock falls further than that you are not protected / hedged. This is why we have given the given the Covered Call strategy a "medium" rating in "Usefulness."

It could be argued, of course, that you would incur those losses just from owning the Stock anyway and the covered call does at least give you something in return. You should be very clear, though, that this isn't a suitable strategy if you think there's much chance that the Stock will drop significantly in value.

The second main risk is that you won't make any further profits if the stock should rise above the strike of the options written. Although this would still mean a profit is made, you would have made more if you had simply held on to the stock and not applied the covered call. As such, this isn't an ideal strategy if you think the price of the stock may increase by a significant amount, although you can always buy back the options written if at any point you believe the price is going to increase by more than originally expected.

## Break Even

Break-even point is when **Price of Underlying Security = (Starting Point - Price of Option)**

## Profit Calculations (Maximum Upside)

Maximum profit is made when **Price of Underlying Stock = Strike of Options**

Profit is also made when **Price of Underlying Stock > or = Starting Point but < Strike of Options**

Profit, per share owned/option written, is **(Price of Underlying Stock – Starting Point) + Price per Option**

The profit calculation does not apply when **Price of Underlying Stock > Strike of Options**

**It should be noted that there's a school of thought that says that any profit made from an increase in the price of the underlying security would have been made even without applying the covered call, and it shouldn't be included in the profit calculations.**

## Risk Calculations (Maximum Downside)

Maximum loss on the Options is limited because you are supposed to be perfectly hedged with a Long Stock position. So, if the Stock goes to "infinity" your Profit on the Stock will too, but your loss on the Short Call Option will be the same.

Of course, if the Stock goes to Zero you will lose the value of the Long on the Stock side of the equation, however your \$ upside in the Calls is limited to the Premium you collect.

## **Strategy Example**

An example of establishing a covered call is as follows.

- You own 100 shares of Company X stock, which is currently trading at \$50. We shall refer to this price as the Starting Point (See above).
- You believe that the price will not move over the next few weeks, and want to profit / bank some premium whilst your Long Stock position trades sideways / around \$50.
- You notice that Out of The Money calls with a strike of \$52 and the closest expiration date are trading at \$1.
- You write 1 Call Option contract (each contract contains 100 options) and receive a credit of \$100.

### **Profiting**

The Max' profit is made when, at the time of expiration, the price of the shares increases to the strike of the options written. In the above example, this would be when Company X stock is trading at \$52. Should this scenario occur, the options written would expire worthless and you would keep the credit received for writing them and have no further obligation. Therefore, your profit would be \$100. You would, of course, also profit from the shares that you own increasing in value, in this case \$2 per share multiplied by 100 shares for a \$200 profit. Your total Max' profit would be \$300.

The Covered Call strategy would also return a profit if the price didn't move at all, or increased to a price lower than the strike of the options written. Again, the written calls would expire worthless and you would keep the credit as your profit. You would also still profit from the increase in the value of the stock, if there was any.