

Utilizing a Covered-Call (Option) Strategy

Adding potential cash flow but with tradeoffs.

What are Options?

An option is a type of derivative. A stock option's performance is dependent on the value of the underlying stock along with other factors. There are also options that trade based on the values of indices as well.

With options contracts there is a buyer who is the holder of the option contract (in an opening transaction) and there is a seller, who is also referred to as the "writer" of the option contract (in an opening transaction). The holder of the option contract has a right, but not an obligation, to exercise the contract when certain conditions may merit doing so, while the writer of the option contract has an obligation to perform under those conditions. The buyer of the option contract pays the writer a certain sum of money, referred to as a premium, in exchange for the writer agreeing to assume the obligation. In the case of a call option, the holder of the option has the right to buy the underlying security from a call writer at a stipulated price, called the strike price, assuming the stock's price is above the strike price—normally around the time of expiration (except for index options which usually settle in cash).¹ Options contracts have finite lives and are usually short-term in nature, e.g., typically less than one year. *(Note, with a put option, another type of option contract, the holder has the right to sell the underlying security.)*

A Covered-Call Strategy

Here is how a covered-call strategy might be deployed: Suppose an investor already owns 1,000 shares of XYZ Corporation.² The investor would like to increase her cash flow if possible. There may be a way to do that with tradeoffs. Suppose XYZ is trading at \$48 per share. Additionally, suppose there are call options trading on XYZ common stock with a strike price of \$50 per share valued at \$3 per share currently (referred to as the premium) that expire in three months. The investor could sell such options in an opening transaction, on a covered basis, and have an immediate cash inflow of \$3,000 before commissions and fees. Options contracts normally involve 100 shares. As such, ten contracts would cover this investor's 1,000-share position, and at a price of $\$3 \times 100 \times 10$ we arrive at \$3,000. The investor (the seller/writer of these contracts) is entitled to keep the proceeds of the options regardless of other events, assuming she doesn't buy back options contracts later to close out of the position.

¹ Holders usually exercise calls right before expiration, but may do so earlier if they choose to do so, assuming that they are American-style options.

² With a covered-call strategy, the writer must own the underlying shares. Selling call options on a security that one doesn't own is called uncovered or "naked" call writing, an act that has considerable risk and is not recommended for most investors.

Possible scenarios

Scenario 1: The markets drop in value in the ensuing three-month period and XYZ stock is now trading at \$44 per share. In this case the option would expire worthless and the investor's obligation to sell the shares at \$50 per share has terminated. The investor's stock is down \$4 per share but she also received \$3 per share (before commissions or fees) from the options transaction. In this scenario, the investor lost a net amount of \$1 per share but if the investor was already inclined to own the stock whether or not she was going to sell an option—the act of writing the option did not increase her downside risk—in fact it reduced it on a net basis. After these options expire, if the investor so chooses she could sell another contract on her shares again. Now we will examine a situation in which the calls are exercised.

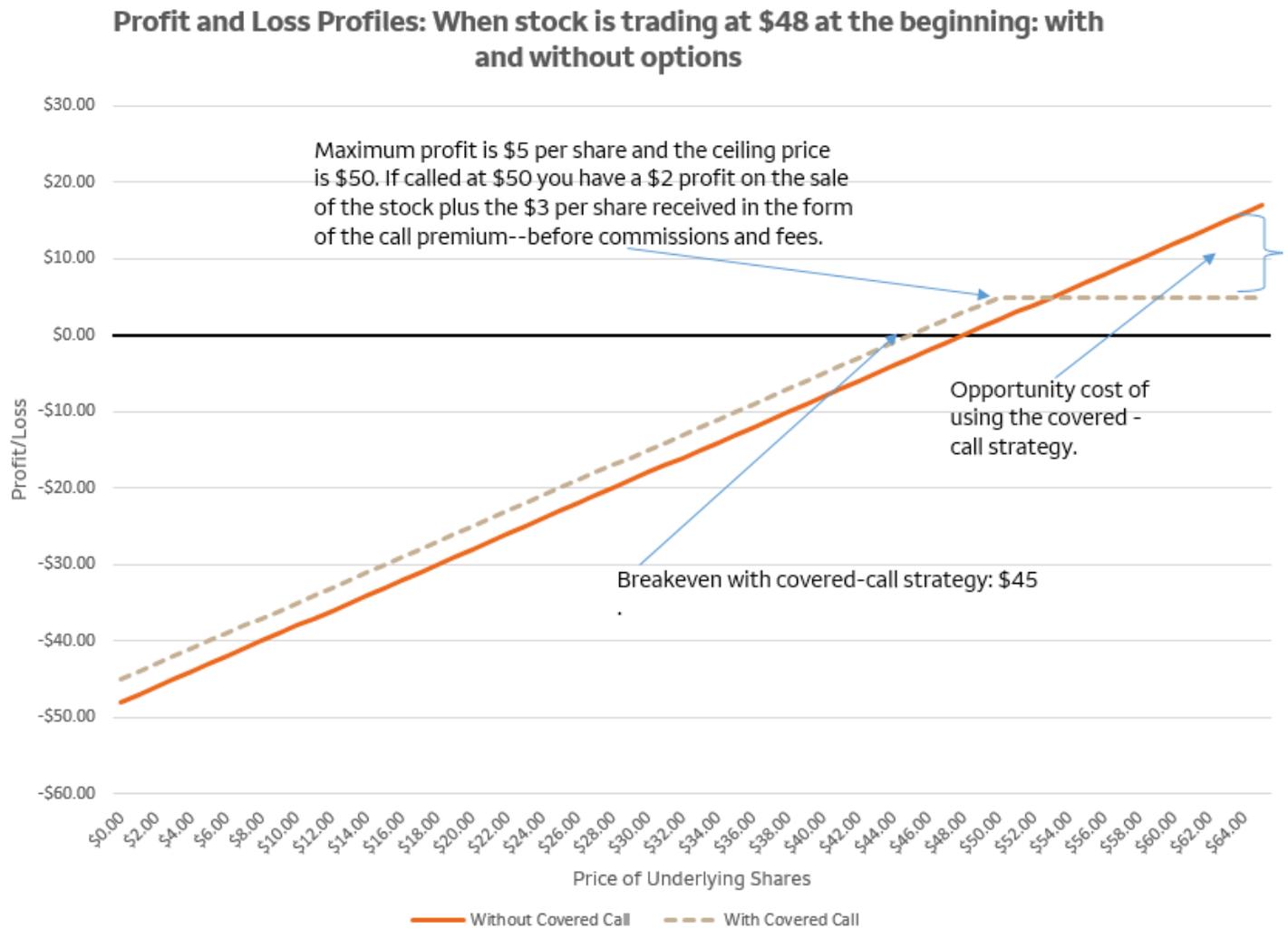
Scenario 2: Suppose that, instead of the price decreasing, it increases to \$51 per share right at expiration. In this scenario, she would be forced to sell her shares at the agreed-upon \$50 value. However, she did receive \$50 per share and also a \$3.00 premium so it could be argued that she really got \$53 per share out of the transactions before commissions and fees. The investor's reaction to this situation will likely be dependent on whether or not she was amenable to selling the shares (covered-call writers should be aware that this can happen before engaging in such transactions). Perhaps she thought there was only a low chance of the stock appreciating to above \$50 before the three-month timespan—this might lead to disappointment, particularly if a taxable gain has to be realized. On the other hand, perhaps she was thinking of selling the stock anyway if it reached a level in the neighborhood of \$50 per share. (Later, we will discuss the action of rolling your options positions in an attempt to prevent the stock from getting called—if desired.)

Scenario 3: We note that the call writer in this example would have to sell her shares no matter how high the price of the stock trades. Suppose one day, the stock stops trading pending forthcoming news. Later in the day it is announced that the company has agreed to be acquired by ABC Corporation and commences trading at \$65 per share—the writer of the contract still has an obligation to sell the stock at \$50 per share and even if she wanted to buy back the contract to close out (if she didn't want to sell the shares) she would have to pay a minimum of \$15 per share (before commissions and fees) to close out of the contract (it would be "in-the-money" by \$15 per share [right to buy the stock at \$50 when it is trading at \$65 per share] plus there may be time value left on the option, which would mean that the premium would likely be greater than \$15).³ However, the \$15 per share value would be offset by the \$3 received in the form of a premium (before commissions and fees), if one considers the entire scenario.

The following chart (Figure 1) illustrates the profit/loss scenarios for the above example assuming different prices of the underlying stock. In these cases it is assumed that the option writer did not close out before expiration by executing a closing trade to purchase the options. Note that while there is the benefit of the incoming cash flow from receiving the premium, it does place a cap on capital gains potential if the stock trades in-the-money and the writer doesn't close out of the position before the shares are called.

³ For call options, in-the-money means that the stock is trading at a price higher than the relevant strike price. The amount by which an option is in-the-money gives it intrinsic value. From the call-option buyer's standpoint, if there is an opportunity to exercise a call to buy a stock at say \$50 when the stock is trading at \$52, we would say there is intrinsic value of \$2 per share (by the way, there is no such thing as negative intrinsic value; calls that are out-of-the-money have zero intrinsic value). However, the option may trade for a higher premium than its intrinsic value if there is time-value left. Time value is the value an option has in addition to possible intrinsic value. If there is relatively more time left before the option expires, the possibility that the underlying security may move in a favorable manner increases. The more time left on the contract, the higher the premium, all other factors held constant. Other factors affect time value such as the volatility of underlying security, interest rates, etc. The intrinsic value plus time value = premium price of the option.

Figure 1



Source: Wells Fargo Advisors. This example is not intended to depict any actual scenario. Assumes the writer does not close out the contract before expiration.

Rolling Your Covered-Call Positions

What if I have a covered-call overlay on a stock and it is now in-the-money but I don't really want to let the stock get called away? An investor can roll options by 1) buying back the option and 2) selling a different option (typically one with a higher strike price and also possibly a later expiration date). If a significant portion of the time value of an option has eroded (again, the more time to expiration the higher the value, all other factors held constant), you may be able to purchase the option back for less than you sold it for earlier—even if the underlying stock has increased somewhat in price. On the other hand, even if you have to buy back the option at a higher price than that at which you sold it, it may still be worthwhile. Let's look again at our Scenario 2, the case in which the stock rose in value to \$51 per share. Suppose the options are trading at \$3.50 (assuming changes in time value as well as intrinsic value). We could buy those options back and then perhaps sell options on the stock with a \$55 strike price with a later expiration date (hence receiving more time value in the premium). Suppose the investor does that and receives a premium of \$2.50 per share on the newly-sold options. Strictly from the options standpoint, the investor has netted \$2.00 per share before commissions and fees (received \$3.00 premium, then bought it back for \$3.50, and then sold another for \$2.50). Also, the contingent obligation to sell has been moved up to a price of \$55 per share. There are other reasons also to possibly buy back options in a covered-call scenario that are beyond the scope of this report.

Other Considerations

Note that in order to have an options-overlay be considered as a true covered-call position, the options have to be based on the underlying security. In other words, if an investor has a portfolio of different stocks and elects to sell a certain number of option contracts that are for an index or the like, that is not a covered-call situation because you can't deliver those stocks to cover if the options are in-the-money and are called (index options normally settle in cash).

Sometimes an investor will purchase the stock and sell calls on the stock simultaneously. This is sometimes referred to as a buy-write strategy.

Appendix (for those who want an analytical review):

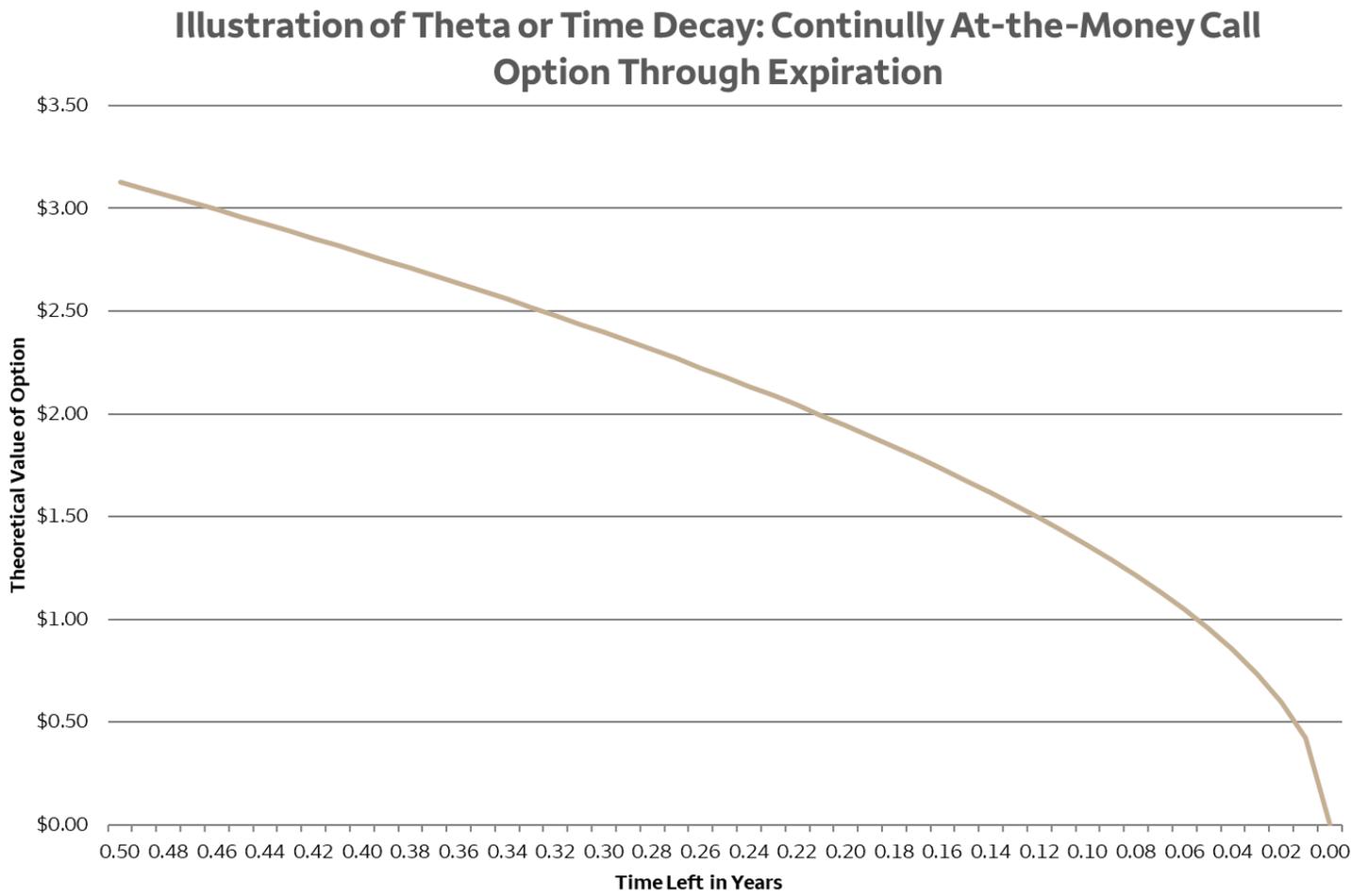
Time erosion is on your side when writing covered calls.

The time value of an option erodes over the life of the options contract. This perhaps will become intuitive from looking at an example. You have a right to buy a stock at \$30 per share via a call option when the stock is trading at \$30 per share (we would say the stock is trading at-the-money when the strike price equals the price at which the stock trades). If the option has six *months* before expiration the option buyer would be willing to pay a higher price for the option than he/she would if it expires in six *days*—because with the former you have a half year of time during which the price of the stock may swing to a favorable level (from the standpoint of the option buyer), whereas with the latter situation you have only six days for it to possibly accomplish that. Also, the call writer would require a relatively higher premium to assume a contingent obligation to sell, if over a longer period of time, all other factors held constant.

To illustrate further, suppose a stock is trading at \$30 per share and we are looking at a call option with a strike price of \$30 per share. Assume the option has six months left to expiration, the expected standard deviation (a measure of volatility) of returns for the underlying stock is 35%, and we will assume the risk-free rate is 2.5% (the yield of a nearly riskless short-term Treasury bill—we are using a fictional rate for illustrative purposes). Based on the Black-Scholes Options Pricing Model,⁴ the theoretical value of this option at six months to expiration is approximately \$3.13 per share. It is helpful if we assume the stock continues to trade at \$30 to isolate the effect of time erosion. The value of the option would eventually go to zero at expiration as there would be no value to having the “right” to buy the stock at \$30 through exercising the option when it is trading at \$30 in the market. The effect of time decay is sometimes referred to as “Theta.”

⁴ The Black-Scholes Model is a mathematical model used to determine the theoretical value for a call or a put option.

Figure 2



Source: Wells Fargo Advisors. Assumes option is constantly at-the-money until expiration. This illustration is for educational purposes only and is not intended to depict any actual scenario. Uses Black-Scholes Options Model to arrive at theoretical valuations.

Options involve risk and are not appropriate for all investors. Before opening an option position, please read “Characteristics and Risks of Standardized Options” carefully before investing. This document is available from the Options Clearing Corporation, 125 S. Franklin Street, Suite 1200, Chicago, Illinois 60606. Supporting documentation for any claims, comparison, recommendations, statistics or other technical data will be supplied upon request.

Other Considerations

All investing involves risk including loss of principal.

Commission, dividends, margins, taxes and other transaction charges have not been included in the examples. However, these costs can have a significant effect on expected returns and should be considered. Because of the importance of tax considerations to all options transactions, investors should consult a tax advisor as to how taxes affect the outcome of contemplated options transactions.

Options may not be appropriate for all investors. Contact your Financial Advisor for more information on this and other strategies.

Risk Considerations

Different investments offer different levels of potential return and market risk. The level of risk associated with a particular investment or asset class generally correlates with the level of return the investment or asset class might achieve.

Purchasing and writing options are highly specialized activities and entail greater than ordinary investment risks. The successful use of options depends in part on the ability to manage future price fluctuations and the degree of correlation between the options and securities markets.

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