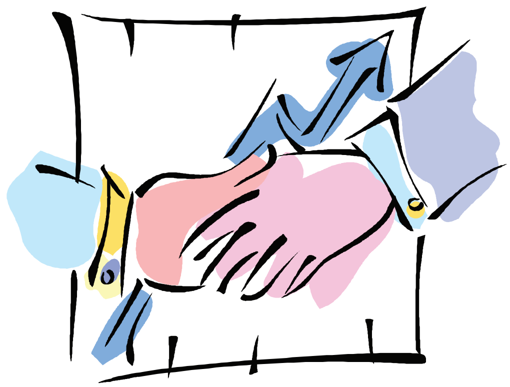
A Comprehensive Approach to Covered Call Writing

By Alan Ellman

Article Highlights

- Becoming an elite covered call writer requires excelling at stock or ETF selection, option selection and position management.
- Including dividend capture and tax-avoidance strategies adds additional layers of complexity to manage.
- Strategies without a minimum yield requirement and using short-term options are preferred.



Setting up a covered call portfolio using securities that generated significant dividend distributions was covered by Ben Branch, professor of finance at the University of Massachusetts, Amherst, in two wonderful articles published in the *AAII Journal* last year.

The articles ran under the titles "Assembling a Covered Call Portfolio on Dividend-Paying Stocks" (June 2014), and "Managing a Portfolio of Covered Calls" (July 2014) and can be found in the AAII.com archives. This article adds information to the key facts highlighted in Branch's articles and presents another perspective as to how and why such a covered call portfolio can be constructed and managed.

Covered call writing is a strategy where individual investors can sell options against securities—stocks or exchange-traded funds (ETFs)—they already own to generate monthly cash flow. In its traditional sense, profits can be gleaned both from the sale of the option and from share appreciation if the option selected has a higher value than the current market value of the stock. (For example, an investor buys a stock for $48 and sell the $50 call option; this known as an "out-of-the-money" strike.) If the option selected had a strike price (agreed exercise price) the same as ("at the money") or less than the current market value ("in the money"), the maximum return would be the time value component of the option premium only.

In Branch's articles, a third component or potential income stream was added by using securities that also generated quarterly dividends. What makes this approach appealing is that it presents opportunities to generate three income streams with each trade: the option premium, the stock price appreciation and the dividend distribution. However, like every other strategy available to investors, there are advantages and disadvantages to consider. Here, I present other perspectives to factor in to your decision as to whether covered call writing is right for you and, if so, how to approach and manage your positions.

Managing the Strategy

I am a firm believer that before an investor puts even one penny of his or her hard-earned money to work, that person must become a master of the strategy they want to use, in this case covered call writing. Mastery is about three levels above being pretty good at it. To become an elite covered call writer there are three areas to excel at:

- Stock or ETF selection,
- Option selection (strike price and expiration date), and
- Position management (exit strategy executions when the opportunities arise).

Being proficient in two of these areas is not adequate to justify using this strategy; it must be all three. Investors must be adept at "juggling all three balls." By adding a fourth ball, dividend capture, the task is a bit more involved and it becomes more challenging. Some investors can take on the challenge

Figure 1. Covered Call Writers Must be Adept Jugglers

and excel in all four areas; others may not be able to. Suffice it to say that the more aspects added to the strategy, the more time and energy an investor must devote to the strategy and the question arises: Is it worth adding another tier to an already multi-tiered strategy?

Tax Issues

I am not a tax expert and do not attempt to address specific tax issues as they relate to covered call writing. However, I certainly appreciate the rationale for the advantages of long-term capital gains versus short-term capital gains in non-sheltered brokerage accounts. The question that then arises is: Should a strategy be tailored for tax avoidance rather than focus like a laser on the appropriate methodology for the strategy being considered? I am a firm believer that investors should maintain their focus on the strategy itself rather than on avoiding taxes, especially if tax avoidance will lead to less-than-favorable covered call writing decisions.

Let me present an example: long-term call options (Long-Term Equity AnticiPation Securities, or LEAPS) that expire in more than one year and one day can be written to construct long-term capital gain (loss) tax positions. There's no question that such an approach will decrease the tax liability, but is it in the best interest of a covered call writing strategy? Respectfully, I say no for three reasons. First, the annualized return for a one-year option is much lower than if monthly options were written—check any options chain on any security. Second, the investor is forced to be in the position through three to four earnings reports, a risky scenario for a covered call strategy. One disappointing earnings report can crush returns for the entire year. The strategy's risk is being increased three or four times a year. Finally, a long-term commitment is being made. Why did the investor enter the trade to begin with? Well, there were fundamental, technical and commonsense reasons for doing so, and the returns met their goals. If those terms were met in August, will they still be met in November? By writing shorter-term options, the investor can navigate around earnings reports and re-evaluate the positions on a monthly basis.

What is best for tax avoidance may not be best for covered call writing, the focus strategy. Plus, by adding a focus on avoiding taxes, the investor would now be juggling five balls (Figure 1). Covered call writing is one of the few options strategies that most brokerages will permit in IRA accounts. If a sheltered account can be used, there are no tax issues. This reminds me of the time Indiana Jones came face-to-face with a terrorist who was wielding two humongous swords and the situation appeared hopeless, much like paying short-term capital gains tax. As I sat at the edge of my seat thinking that there was no way he would overcome this bleak situation, Indiana took out a gun and shot him. He put his trades in a sheltered account. If an investor is not in a position to use a tax-sheltered account, so be it; he or she will pay the taxes due. Covered call writing should be a short-term strategy.

Which Stocks to Select

If an investor focused specifically on covered call writing, the best underlying securities are the ones that have modest implied volatility (market expectation of price movement) and are most likely to appreciate in value, or, at the very least, not go down in value. These equities will generate significant returns as long as the price declines slightly, remains the same or appreciates in value. Therefore, the focus should be on stocks with strong earnings and sales growth and bullish and confirming chart technicals, as well as those that comply with guidelines such as avoiding the release of earnings reports and requiring minimum trading volume. When stocks that meet these three rigorous screens are located, then "gold" is found as it relates to covered call writing.

By focusing in on stocks that have a certain dividend yield as a primary criterion, a myriad of growth stocks that do not distribute dividends will be missed out on. On my current watchlist for covered call writing I would estimate that about half distribute dividends, but very few yield more than 2% annually.

Another factor to consider when deciding how to construct a covered call portfolio is that when an ex-dividend date is prior to contract expiration, the call premium will be lower due to the anticipated share depreciation by the dividend amount. Given that the option holder may exercise early to capture that dividend, he or she may be victimized by a lower call premium plus no dividend capture as well. It is important to realize that early exercise is most likely (but not guaranteed) when the strike is in the money, the ex-dividend date is near expiration of the contract and the time value of the option premium is less than the dividend about to be distributed.

Which Options to Select

The selection of the most appropriate option is just as critical as the selection of the underlying security. There are two aspects of the options contract that need to be evaluated before executing the trade: the "moneyness" of the option and the time to expiration. For a covered call writing portfolio that incorporates dividend capture and tax avoidance, out-of-the-money LEAPS (options that expire in more than one year and one day) that have strike prices higher than the current market value of the underlying security are preferable. Let's focus on the two aspects of options selection as they relate to traditional covered call writing: moneyness and time to expiration.

Moneyness

Most covered call writers only sell out-of-the-money strikes. The reason is that these strikes afford the opportunity to generate two income streams: One from the sale of the option and the other from stock price appreciation from current market value up to the strike price. In normal and bull market situations where chart technicals are bullish and confirming, these are the best strikes to choose and an investor should absolutely take advantage of these opportunities to capture both income streams. However, in bearish or volatile markets or when chart technicals are mixed and of concern, in-the-money strikes should be given priority because of the protection afforded. Here's an example as to how this works:

- Buy Company XYZ at $32/share.
- Sell the in-the-money $30 call option for $3 ($300 per contract; options are sold in blocks of 100 shares).
- The time value or initial profit is $1; the intrinsic value (amount the strike is in the money) is $2.
- When the trade is first initiated, use the intrinsic value to "buy down" the cost basis from $32 to $30.
- The initial return is then $1 ÷ $30 = 3.3%.
- This initial profit is guaranteed as long as share value does not dip below $30.
- The downside protection of the time value initial profit is $2 ÷ $32 = 6.25%.

This means that a 3.3% return is guaranteed as long as share value does not decline by more than 6.25%. Is it not better to sell in-the-money strikes in bear or volatile market environments or when chart technicals may reflect a red flag or two?

Time to Expiration

As discussed earlier in this article, selling long-term options does have tax advantages, but it also has some serious disadvantages.

The first is that annualized returns will be lower with LEAPS. At the time this article is being written (December 2014), Facebook (FB) is trading at $78.43 and the one-month (five weeks) $80 call is trading at a bid price of $2.10, which annualizes to 27%. The 13-month $80 call option (LEAPS) has a bid price of $10.45, which annualizes to 12.3%, less than half the annualized return of the five-week option.

The second, and just as critical, concern for long-term obligations is that the investor is required to hold the positions through multiple earnings reports. Earnings reports can be risky. They can miss market consensus. They can miss the "whisper number" or the statistic that traders are looking for. Negative guidance can result in the market punishing the price of a stock. I submit that this represents too much risk for this type of strategy. *Never sell a covered call option when there is an upcoming earnings report prior to expiration.*

Mastering strike selection is a key requirement to becoming an elite covered call writer.

Dividend Capture

I love to capture dividends, but I make no covered call writing decisions based on dividend capture. As stated earlier, my focus is on three elements: Fundamental analysis, technical analysis and commonsense principles. If a stock also distributes a dividend prior to expiration, great. The date we will be eligible for that dividend is called the ex-dividend date. If the shares are owned on that date, the dividend is received even if the shares are sold prior to dividend distribution.

The option holder controls the shares and has the right to exercise the option and buy the shares prior to the ex-dividend date. If this occurs, it will usually be on the day prior to the ex-dividend date and is most likely when the strike is in the money and expiration is close (selling LEAPS makes early exercise less likely until expiration approaches). Also, the time value remaining on the option premium should be less than the dividend to make early exercise most likely to occur.

I view dividend capture as "gravy" and not part of my covered call writing strategy. If I receive the dividend, great. If the option is exercised early and the shares sold prior to the ex-dividend date, I have generated a maximum return on my trade and now have the cash available from the sale of those shares to reinvest and generate another income stream. Focusing on dividend capture is one approach to covered call writing; I am presenting another.

Position Management (Exit Strategies)

Stock and option selection have so far been discussed, the first two of the three balls we are juggling. Position management is the third and equally as important. The appropriate management actions for traditional covered call writing may not be well-suited for dividend capture and tax avoidance.

What if the stock price depreciation dictates that the short options position or even the long stock position be closed? The investor may now miss out on that dividend.

What if share price accelerates exponentially, the trade is maxed out, and there is an opportunity to close the position and use the cash to initiate another income stream? That would go against the tax avoidance ball the investor may be juggling.

Let's consider two general hypotheticals.

Stock Price Declines Significantly Early in the Contract

When the share price declines, so does the option value. Although the amount originally generated under all circumstances is kept, the option can be bought back (buy-to-close) at a deeply discounted price so that the investor no longer has an option obligation.

Since the investor is early in the contract (I sell one-month options), he or she can wait a few days to a week to see if the price recovers. If it does, the same option can be resold in the same month on the same stock, thereby generating a second income stream. Preparation + opportunity = cash! If avoiding short-term capital gains is a priority, this would not be considered as an opportunity. (See Figure 2 for an example of this type of scenario.)

Stock Price Accelerates Significantly Early in the Contract

One of the characteristics of an option is that as the strike price moves deeper in the money (share price appreciates), the time value component of the premium approaches zero. When an option is trading at its intrinsic value only, it is known as trading at parity. This knowledge can be converted into cash.

Let's say a stock is bought for $48 and the $50 one-month call is sold for $1.50, or $150 per contract. The price of the stock then moves up to $60 in one week. The trade is now maxed, generating $150 per contract from the option premium and another $200 per contract from share appreciation. This represents a one-month return of 7.3%. Keep in mind that the shares can only be worth $50 as long as they are bound by the option obligation. The value of the $50 call is checked and it is trading at $10.10, near parity ($10 of intrinsic value and $0.10 of time value).

If the short options position for $10.10 is closed, the shares can then be sold for $60, not the $50 option obligation. [The options position is short because the call option contract was sold ("written").] This leaves an options debit of $10.10 and a share credit of $10 or a net debit of $10 per contract. If the cash freed up from the sale of the shares can generate more than $10, why not institute this exit strategy? If the main concerns were dividend capture and tax

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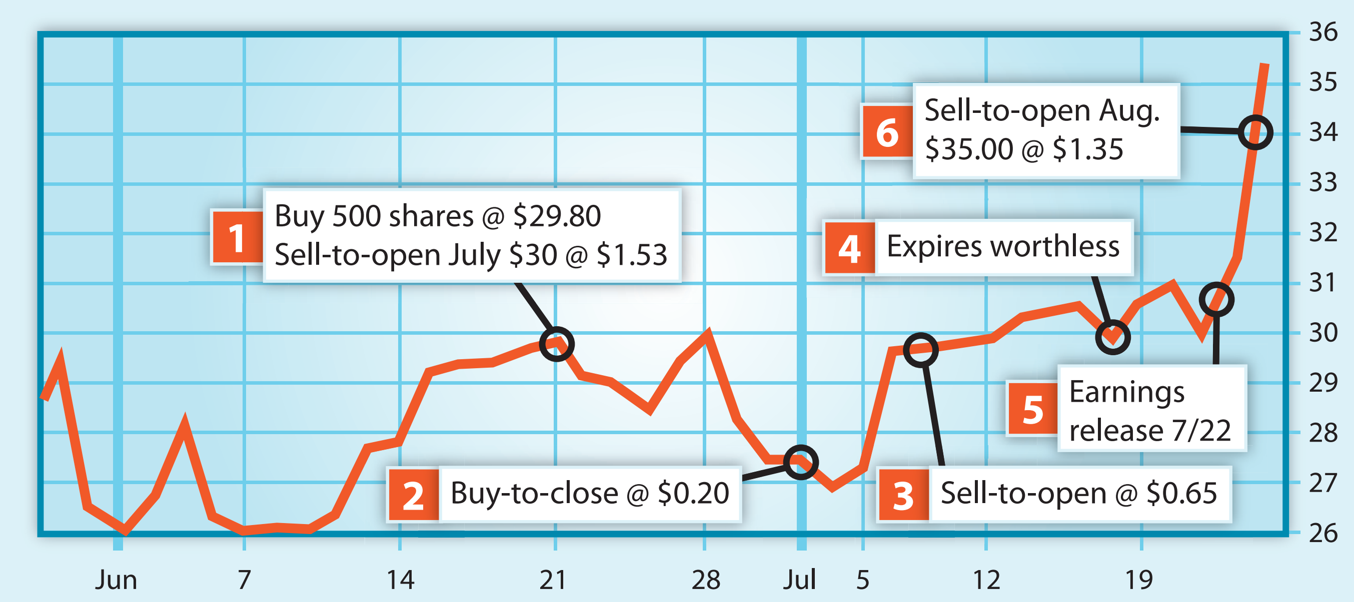
Figure 2. Execution of a Covered Call Strategy When a Stock Falls and Then Rises



Profit:

$765	initial option profit for the July contracts
$225	net credit for trades #2 and #3
$675	initial option profit for the August $35.00 contracts
$2,600	share appreciation from $29.80 to $35.00 for 500 shares
$4,265	**total profit**
$14,900	initial investment
28.6%	two-month return ($4,265 ÷ 14,900)

professional management, which should include detailed credit work and the best possible trade execution. Most individual investors are not equipped to perform the rigorous credit work required to accurately judge the merits of an issuer. Additionally, they may lack the skill and resources necessary to ensure that bonds are being purchased at a price that adequately compensates them for all types of risk.

Owning individual bonds provides one advantage, specifically geared to the buy-and-hold investor. Assuming that there is no credit default, bonds mature at par. An investor participating in the municipal market with no current cash needs can simply wait out any market disruptions, whereas a mutual fund investor would be subject to any impact that liquidity issues would have on the fund's net asset value. This caveat assumes that the investor has other sources of liquidity, or will have no liquidity needs for the life of the bond.

Conclusion

The dynamics of 2014 being a banner year for municipal bonds, with low supply and high demand, has led to investor complacency as I write this. Just because liquidity isn't currently a risk in the market doesn't mean tomorrow won't bring liquidity issues. This is particularly true in a market environment characterized by several individual credit stories as well as interest rate increases.

The discussion of liquidity isn't as riveting as the debates over the bonds issued by a particular state or U.S. territory or debates about potential forthcoming macroeconomic risks, but the ramifications of a liquidity event could be every bit as painful for investors.

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avoidance, it may not be considered an opportunity.

In the above two scenarios, I am not attempting to present the "only" way to execute covered call writing, but simply another, more traditional, and in my view, a more lucrative approach to this strategy.

Alternate Strategy

Should the investor be juggling three, four or five balls? I hope it is clear from this article that I am in the three-ball juggling camp. However, no one can argue the benefits of dividend capture and tax avoidance. So allow me to present this approach as food for thought: How about constructing a portfolio consisting of two portfolios? One could be dedicated to traditional covered call writing and the other to dividend capture and tax avoidance. In one portfolio, three balls are being juggled, in the other only two. This will allow the investor to focus like a laser on the specific strategies being employed and at the same time perhaps simplify the process.

Conclusion

There is no one strategy that is right for every single investor. Investors all learn from each other and none know everything. My hope is that this article has made some points that will be helpful, just as the articles written by Ben Branch were for me.

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