Covered Call Options

In this volatile market, clients need portfolios that generate income. The average Dow dividend yield is 3.12%. Most retirement portfolios require a return of about 6% to 8%. To capture the extra return needed, we utilize a Covered Call option strategy in our client portfolios.

Many investors fear options trading mainly due to negative media hype and the lack of knowledge behind options trading. Covered Calls are the safest and most conservative options strategy. In fact, writing Covered Calls is the only option strategy allowed in retirement accounts by the Internal Revenue Service.

What is a Covered Call Option?

It is where an investor holds a long position in an asset and Writes (Sell) a call option on that same asset in an attempt to generate income from that asset. Covered calls can be an effective investment strategy for portfolios that require income.

Covered Call Options

Covered Call Terminology

Contract – represents 100 shares of the underlying stocks

Premium – cost of an option contract per share (paid by the Call Buyer)

Strike Price – is the price at which a Covered Call can be exercised

Expiration Date – the day on which the Covered Call contract is no longer valid

At the Money – is when the strike price of the option equals the market price of the underlying stock

In the Money – is when the strike price of the option is lower than the market price of the underlying stock

Out of the Money – is when the strike price of the option is greater than the market price of the underlying stock

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Example

Joe wants to generate some extra income so he wants to write a Covered Call option on his Caterpillar position (CAT). As the writer, Joe can choose to write a call for all the shares or for a partial amount of the shares.

Joe Smith's Current Portfolio Holdings (as of January,2010)

COP	10,000 shares	@	$ 50.84
SLB	15,000 shares	@	$ 66.04
APD	15,000 shares	@	$ 83.58
CAT	20,000 shares	@	$ 54.51
MCD	10,000 shares	@	$ 57.50

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Call Premiums are delivered into the portfolio at the time of writing the call and not at the Expiration Date of the call or when the Call Buyer decides to redeem the shares.

A Call Written Out of the Money for CAT (10,000 shares) at $65.00 that expires in January of 2011, will earn a premium of $5.20 per share. Client's account will be credited with this amount when the call is written. The account will be credited with $52,000. At a market price of 54.51, that will be a 9.54% return from the Premium, alone.

The following scenarios are based upon the information provided below:

CAT – Caterpillar Inc.

Current Price - $54.51

Current Dividend - $1.68

Current Call Option Premium @ $65 expiring in January, 2011 - $5.20

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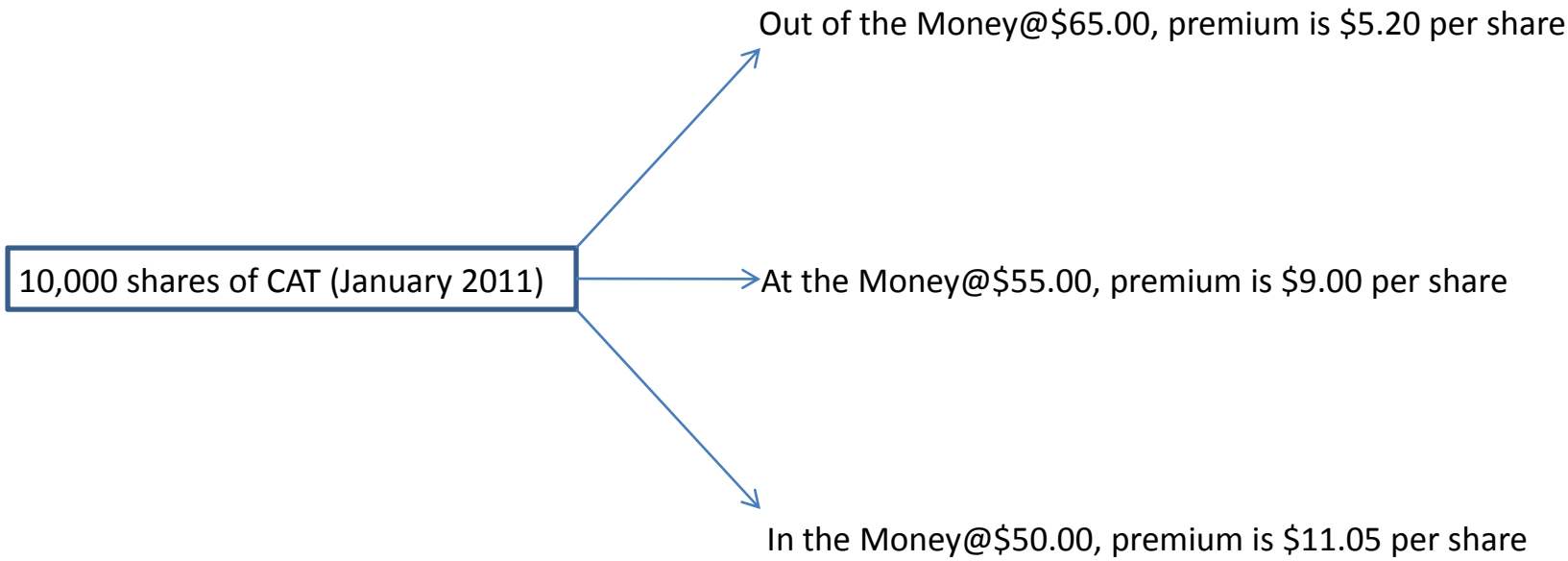
Writer can set the Strike Price At the Money, In the Money, or Out of the Money. Premiums are higher for In the Money. They are lower for Out of the Money. We normally write 12-month calls that are 20% above current market price of the underlying stock.



In the following scenarios, we have set the Covered Call option Out of the Money at $65.00.

Covered Call Options

Different Possible Scenarios for a January 2011 Covered Call of CAT at $65

Price of CAT is at $60 on Expiration Date

The Covered Call will not be exercised thus leaving Joe with the following benefits:

- Earned a premium of $5.20 per share ($52,000)
- Earned a dividend of $1.68 per share ($16,800)
- Earned a capital appreciation of $5.49 per share ($60 - $54.51 = $5.49 x 10000 = 54,900)
- Joe will still own the underlying stock at the expiration of the contract

With a cost basis of $545,100 (10,000 x $54.51), and with a gain of $123,700 ($52,000 + $16,800 + $54,900). Joe's portfolios will yield Joe a return of **22.69%.**

Covered Call Options

Different Possible Scenarios for a January 2011 Covered Call of CAT at $65

Price of CAT is at $50 on Expiration Date

The Covered Call will not be exercised thus leaving Joe with the following benefits:

- Earned a premium of $5.20 per share ($52,000)
- Earned a dividend of $1.68 per share ($16,800)
- Joe will still own the underlying stock at the expiration of the contract

Portfolio will have a capital loss of $4.51 per share ($54.51 - $50 = $4.51 x 10000 = 45,100). With a cost basis of $545,100 (10,000 x $54.51), and with a gain of $23,700 [($52,000 + $16,800) – ($45,100)]. Joe's portfolios will yield Joe a return of **4.35%.**

Covered Call Options

Different Possible Scenarios for a January 2011 Covered Call of CAT at $65

Price of CAT is at $75 on Expiration Date

The Covered Call will be exercised thus leaving Joe with the following benefits:

- Earned a premium of $5.20 per share ($52,000)
- Earned a dividend of $1.68 per share ($16,800)
- Earned a capital appreciation of $10.49 per share ($65 - $54.51 = $5.49 x 10000 = 104,900)

With a cost basis of $545,100 (10,000 x $54.51), and with a gain of $173,700 ($52,000 + $16,800 + 104,900). Joe's portfolios will yield Joe a return of **31.87%.** However, in this scenario, Joe will no longer own the 10,000 shares of CAT and will not benefit from the price appreciation of the stock beyond the $65 mark.

Covered Call Options

Different Possible Scenarios for a January 2011 Covered Call of CAT at $65

Price of CAT is at $75 before Expiration Date

The Covered Call will be exercised by Call Buyer thus leaving Joe with the following benefits (assuming Call was exercised 6 months into the contract):

- Earned a premium of $5.20 per share ($52,000)
- Earned a dividend of $0.84 per share ($8,400)
- Earned a capital appreciation of $10.49 per share ($65 - $54.51 = $5.49 x 10000 = 104,900)

With a cost basis of $545,100 (10,000 x $54.51), and with a gain of $165,300 ($52,000 + $8,400 + $104,900). Joe's portfolios will yield Joe a return of **30.32%.** However, in this scenario, Joe will no longer own the 10,000 shares of CAT and benefit from the price appreciation of the stock beyond the $65 mark.

Please keep in mind that numbers used are hypothetical numbers for illustration purposes. Individual returns will vary.