Covered Call Strategies 101

by Mark Bentley, Executive Vice President, BTS Asset Management, Inc.

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"Balancing the desire for income with the potential for capital appreciation."

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COVERED CALL STRATEGIES — BALANCING INCOME WITH THE POTENTIAL FOR CAPITAL APPRECIATION

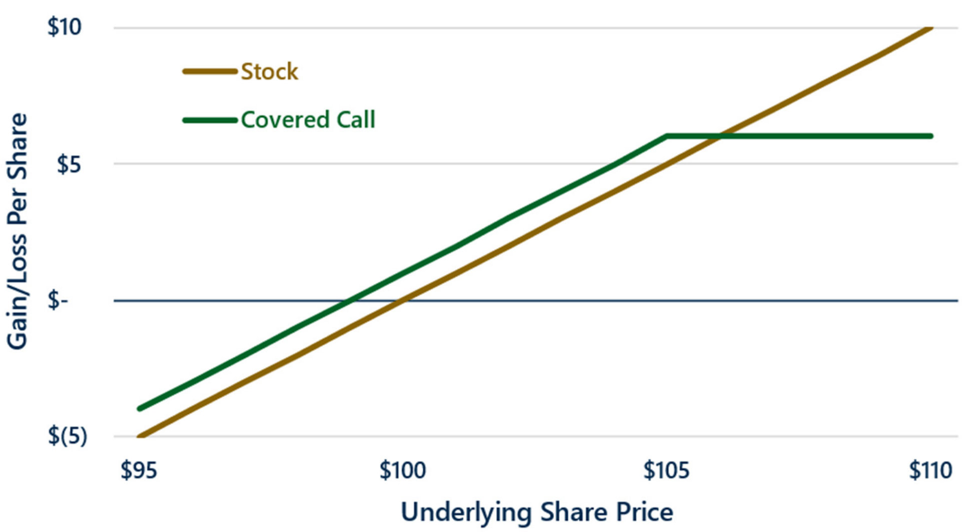
Covered call writing, where an investor purchases a stock or a basket of stocks while simultaneously selling call options on those same stocks, was once a tactic that was mostly limited to sophisticated options traders. Today, with the advent and widespread proliferation of ETFs that may employ a wide range of investing strategies, it has become easier than ever to benefit from these approaches within a portfolio. But as with any investment, it's important to understand the risks and opportunities these strategies entail, the relationships they have with different macroeconomic conditions, and when and how they fit into a portfolio.

When an investor with a long position owns the stock in a particular asset sells a call option on that asset, with a strike price above the current share value, they are essentially selling a portion of the potential upside in that asset. This allows the investor to receive income, in the form of an option premium, from an equity position even if the stock pays no dividend. It also allows the investor to participate in some capital appreciation of the stock, up to the strike price of the option, at which point their gains are capped. On the downside, the investor will participate in any losses in the asset, however these losses will be dampened by the option premium they received.

Definitions

- **Call Option – an option to buy an asset at an agreed price on or before a particular date**
- **Strike Price – the price at which the buyer of the call option can purchase the shares**
- **Premium – the current market price of an option contract. It is the income received by the seller (writer)**

The illustration below shows the gain/loss profile of a stock purchased at $100, versus purchasing that same stock for $100 while simultaneously selling a call option with a $105 strike price for a $1 premium. At any price below the $105 strike price, the covered call writer outperforms the stock by the $1 premium received. At any price above the $105 strike price, the option will be exercised, and the covered call writer will earn a maximum gain of $6.



Source: https://horizonsetfs.com/covered-call-strategies-the-horizons-etfs-advantage/

In the last 60 years, there have only been five sustained gold bull runs, the most recent of which is still taking place today. The ends of these runs have historically led to substantial selloffs, but within these bull runs there are many times where there are 10% or greater declines. Conversely, during bear markets, there are periods of time where the market rallies greater than 10%. This inability for the market to operate in a straight line highlights the need for tactical management.

For an income-focused investor, it's important to understand the factors that affect the price of the call premiums, and thus the income that a covered call writer may receive from their position. Since options are market-traded, their premiums are dictated by supply and demand, which is essentially determined by the perceived likelihood that the buyer will be able to exercise the option. There are three main factors that tend to influence call option premiums:

1. Implied volatility – When the volatility of a stock or basket of stocks is higher than the historical average, call premiums tend to be higher.
2. Time until expiration – The longer the time remaining until expiration, the greater the opportunity for price fluctuations, and the more that call option buyers will be willing to pay in premiums.
3. Strike price – A call strike price that is above the current price of the stock is considered "out-of-the-money". The closer that strike price gets to the current price, or the "at-the-money" price, the higher the premium will tend to be.

With these dynamics in mind, one must then consider the macroeconomic conditions that may determine whether a covered call strategy is appropriate for inclusion in a portfolio. We'll look at four particular environments and how covered call strategies tend to perform under those conditions.

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In a bear market, volatility tends to be high and while markets are generally trending downwards, bear market rallies often produce some of the largest short-term gains in the stock market. Because of this, call option premiums tend to rise in these environments and covered call strategies may generate excellent yields. This yield helps to offset unrealized losses in the portfolio as markets trend downward, often resulting in outperformance of a covered call strategy compared to buying and holding the underlying asset alone.

Sideways, or range-bound, markets are also characterized by high volatility and thus, typically result in higher call option premiums. Another benefit of a range-bound market is that with smaller price fluctuations than a bear market, call options are more likely to expire "out-of-the-money". This benefits covered call strategies and tends to result in outperformance.

In a moderate bull market, stocks tend to rise slowly and volatility is relatively low. The call premiums a covered call writer receives in these markets will be relatively low, but they will be able to participate in most if not all of the stock's price appreciation. A covered call position will generally outperform the underlying asset in these conditions because even as the income gained from writing calls declines, it will still add to the total return of the underlying stocks.

A powerful bull market is one scenario where an investor may want to reduce exposure to covered call strategies. When prices are surging upwards, the underlying stocks blow past strike prices and call options tend to be exercised. The covered call investor will be able to participate in some price appreciation, but those gains will be capped and the investor may miss out on a great deal of upside. The premiums received in these markets may be substantial but will likely be insufficient to compensate for the missed upside, and the covered call position is likely to underperform.

While covered call strategies offer many benefits and can outperform in many market scenarios, they do have some drawbacks and periods of underperformance that may make them inappropriate at certain times and for certain investors. Thus, it is prudent to strategically position these strategies within a well-diversified portfolio. Please reach out to your BTS Regional Director for more information.

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A Covered Call refers to a financial transaction in which the investor selling call options owns an equivalent amount of the underlying security. To execute this, an investor who holds a long position in an asset then writes (sells) call options on that same asset to generate an income stream. The investor's long position in the asset is the cover because it means the seller can deliver the shares if the buyer of the call option chooses to exercise. Implied Volatility refers to a metric that captures the market's view of the likelihood of changes in a given security's price. Investors can use implied volatility to project future moves and supply and demand, and often employ it to price options contracts.

ETF is an exchange-traded fund (ETF) is a pooled investment security that can be bought and sold like an individual stock. ETFs can be structured to track anything from the price of a commodity to a large and diverse collection of securities.

Strike Price - Options contracts are derivatives that give the holders the right, but not the obligation, to buy or sell some underlying security at some point in the future at a pre-specified price. This price is known as the option's strike price (or exercise price).

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BTS:

- Seeks to defend capital
- Aims to offer upside potential
- Strives to reduce volatility while delivering consistent long-term returns

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