Leveraged

The professional's choice

Covered calls

Generating an additional income from your portfolio

Key features

- Enhance the yield from your blue-chip portfolio
- Suitable in a flat or gradually rising market
- Cushion losses in a falling market

A covered call involves owning or buying a share and then selling a 'call option'.

The seller of a covered call needs to determine what price they are prepared to sell their shares at (the strike price). If they are comfortable to commit to a sale price today for a predetermined date in the future (the expiry date) they will receive a credit for that commitment (the premium/income).

If the underlying share continues to trade below the nominated strike price, the sold call would expire worthless, and they will keep the premium received and may continue to hold the share. The following month they can choose to sell another call with a new strike price and expiry date. This can be repeated as long as the investor holds the underlying share to generate an ongoing income.

Case study

Cleo buys 1000 shares in Company A through his margin loan, which is trading at $76.50. Giving him a total investment value of $76,500

Cleo decides that he is prepared to sell his shares in company A at $80. He sells a call with a strike price of $80, which expires 30 days from today. In return for the commitment to sell at $80 he received a credit of $0.70 per share, in total $700 for the 1000 units held.

If Company A is trading above $80 at expiry Cleo will most likely need to give up his shares at $80. If the stock is trading below $80, the sold call will expire worthless and he can choose to sell a new call at a new strike price.

Factors to keep in mind

If Company A trades above $80 on any day before the expiry date he may not be exercised, which means he will continue to hold the share. It is up to the buyer of the call whether or not the call is exercised. The option is often automatically exercised if it is trading above $80 after the expiry date.

If Cleo does not want to carry the risk of being exercised prior to expiry, he can choose to sell a 'European' style call instead of an 'American' call. As the European call can only be exercised at expiry, this is especially beneficial for investors who want to sell a call before a share goes ex-dividend, but do not want the risk of being exercised on the call before the share goes ex-dividend.

You can also sell a call for a period longer than one month which will give you a larger credit amount. For clients not looking to actively manage/trade in their portfolio they can look at selling a much longer dated call.

What happens if the share remains flat or increases gradually?

Let's assume the share closes anywhere between $76.51 and $79.99 on expiry. This is the most ideal scenario with a covered call, because Cleo is profiting from his underlying position in Company A as well having the sold call expire worthless, which means Cleo will keep the $700 premium with no further obligation to the sold call. In a flat market, covered calls tend to outperform a long only portfolio.

Cleo will also have the ability to sell another call at a new strike price where he would be prepared to sell the shares at a new expiry date. This can be done as often as the investor chooses.

What happens if the Company A share increases in value dramatically?

If the share increases to $82 at the options expiry, Cleo will most likely be exercised on the call, which means he will need to sell the share at $80 (the chosen strike price).

Here Cleo has still profited from the trade, as he will keep the $3.50 profit from the share, which increased from $76.50 to $80. In addition, he will keep the $700 premium from the sold call along with any other dividends or franking credits he may be entitled to.

The downside in this scenario is Cleo will not benefit from any further increase in the share price above $80. In a quickly rising market, coved calls tend to underperform a long only portfolio.

What happens if the Company A share declines in value?

Let's assume that, at expiry, the shares for Company A are trading at $72.00.

Given that Cleo purchased his shares at $76.50, he will be down $4.50 per share if he does not sell the call, being a total loss of $4500 on the 1000 shares held.

Given he sold the call and received a $700 credit, his loss would be reduced to $3800 ($4500 loss in the share less the $700 credit from the sold call premium). While this is still a loss, he is still in a better position than if he had not sold the call at all. If Cleo had been receiving a number of credits from the months prior his net loss would be even less. In a falling market covered calls tend to outperform a long only portfolio.

While this is still a loss, it has put him in a better position than if he had just purchased the share without selling a call.

Is this strategy right for you?

Investors need to choose whether they prefer to aim for growth or income from their portfolio. Historically, covered calls have been shown to produce more consistent returns in a flat, slowly rising or even a falling market but tend to underperform in a quickly rising market.

Investors may also choose to use this as a tool to diversify their investment strategy by allocating a portion of their portfolio to covered calls so they can benefit from a flat or slowly rising market, while leaving a portion of their portfolio for growth.

More information

Ask your financial adviser whether Exchange Options Plus is right for you, or contact us.

Call 1300 307 807
Email info@leveraged.com.au
Visit www.leveraged.com.au

How has the strategy performed over the last 12 months?

Below is a chart which shows how the covered call index (XBW in green) tracked in comparison to the ASX200 index (XJO in blue). Here we can see that the covered call index has outperformed the XJO index by approximately 42% over the last 5 years.

Source: IRESS