

Covered Calls

Generating additional income from your portfolio

If you have Exchange Options Plus activated on your Margin Loan, you can explore covered calls as a potential options strategy.

Using a covered call strategy, you may be able to:

- Generate additional income on a portfolio with existing holdings.
- Cushion or offset losses in a falling market.
- Apply the strategy in a flat or gradually rising market.

How does it work?

A covered call involves owning or buying a listed security and then selling a 'call option' over that same security.

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 committing to a sale price today for a predetermined date in the future (the Expiry Date), they will receive a payment for that commitment (Premium).

If the underlying share trades below the nominated strike price on expiry, the sold call will expire worthless, and the seller will keep the Premium and may continue to hold the share.

The following month they can choose to sell another call option with a new strike price and Expiry Date. This can be repeated as long as the investor holds the underlying share.

If the underlying security trades above the nominated strike price, the seller may need to sell and deliver the shares to the buyer on or before the Expiry Date at the strike price, depending on the type of call.

Case study

David buys 1000 shares in Company A through his margin loan. Each share is worth \$76.50 giving David a total investment of \$76,500.

David decides that he is prepared to sell his shares in company A at \$80 selling an 'out of the money' covered call. He sells a call option with a strike price of \$80 which expires in 30 days. In return for the commitment to sell at \$80 David earns a \$0.70 Premium for each call option, giving a total of \$700 (ignoring any commission or brokerage).

If Company A trades above \$80 at expiry of the call option, David will most likely need to sell his shares at \$80 to the option holder (buyer). If the share is trading below \$80, the sold call option will expire worthless, and he can choose to sell a new call option at a new strike price.

A covered call strategy may be able to be used with securities held on a margin loan, as part of the Exchange Options Plus feature.

Factors to keep in mind

Even if Company A trades above \$80 on any day before the

Expiry Date, the buyer of the call option may choose not to exercise the call. It is up to the buyer whether or not the option is exercised. In this case, David will continue to hold the underlying shares.

If Company A trades above \$80 at the Expiry Date, the call option may automatically exercise.

If David does not want to carry the risk of the call option 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 may suit investors who want to sell a call option but do not want the risk of being exercised before the ex-dividend date, thereby retaining the dividend themselves. Usually however, this will be reflected in the premium and there will be a difference between premium amounts of both types of option depending on factors such as dividends, volatility, time to expiry and lack of flexibility to exercise the option before expiry. Low exercise price options (LEPOs) are not permitted to be written under the Exchange Options Plus feature.

You can also sell a call option for a period longer than one month which will earn you a larger Premium. For clients not looking to actively manage/trade in their portfolio, they can look at selling a much longer-dated call option, bearing in mind the market may be less liquid for long-dated calls.

What happens if the share remains flat or increases gradually?

Referring to the earlier case study, let's assume the share price of Company A is anywhere between \$76.51 and \$79.99 on expiry. David has benefited from the covered call strategy as he has profited from the share price increase of the underlying securities while also earning a \$700 Premium with no further obligation to sell the call option.

In a flat market, covered calls tend to outperform a long-only portfolio.

David will also be able to sell another call option at a new strike price and Expiry Date. This can be done as often as the investor chooses.

What happens if the Company A share increases above the strike price?

If the share price increases to \$82 at expiry, David will most likely be exercised on the call option, which means he will need to sell the share at \$80 (the strike price). The call option is now 'In the money'.

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

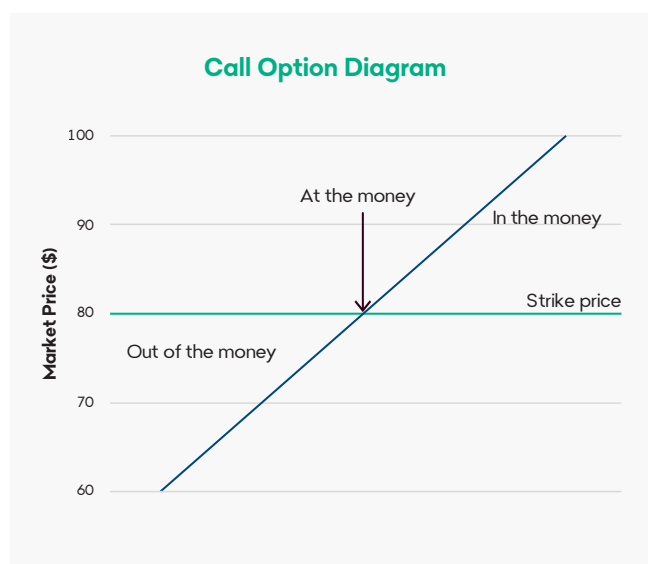
The downside in this scenario is David will not benefit from any further increase in the share price above \$80. In a quickly rising market, covered calls tend to underperform a long-only portfolio.

What happens if the Company A share declines in value?

Let's assume the share price has fallen to \$72 at expiry.

If David had not sold a call option, he would be down \$4500 (being \$4.50 per share). But given David sold the call option and earned a \$700 Premium, his loss reduced to \$3800.

While this is still a loss, he is still in a better position than if he had not sold the call option at all. If David had been receiving a number of Premiums from the months prior, his net loss would be even less. In a falling market, covered calls tend to outperform a long only portfolio.



Risks in using covered calls combined with gearing

When using a covered call strategy, you risk missing out on potential gains if the share price rises above the strike price. If the option is exercised, you will have to sell your shares at the strike price even though the market price may be higher.

However, there are other risks which should also be considered, including the cost of having to buy back an option should there be the need to liquidate the position (for example, due to a Margin Call).

There is also the risk that the strategy may not perform as expected, or the Premium earned through selling a call option may not cover interest and operational costs of the margin loan.

Investors should consider any interest payable after buying shares and the impact on any returns, inclusive of any options positions written.

It is strongly recommended a financial adviser licensed in derivatives is consulted for advice on the strategy and taxation advice before embarking on an any options strategy.

About Leveraged

Established in 1991, we're proud to be a margin lending specialist in Australia, and a wholly-owned subsidiary of Bendigo and Adelaide Bank.

We offer a choice of multiple margin loan solutions and additional features, a diverse and frequently reviewed investment list and we connect with most major online platforms and selected brokers.

More information

Ask your financial adviser whether a Leveraged Equities Margin Loan with Exchange Options Plus is right for you or contact us if you would like to find out more.

Call 1300 307 807 **Email** customerservice@leveraged.com.au **Visit** leveraged.com.au

Gearing involves risk. It can magnify your returns; however, it may also magnify your losses.

Case study and graph example is for illustrative purposes only and do not indicate any view of, or expectation about, the Margin Loan or any investment or transaction.

They do not cover all the possible outcomes and are not intended as a recommendation, are simplified and may not reflect actual outcomes, market prices or movements or taxation treatment.

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