STEPHEN COX

THE COVERED CALL STRATEGY

How to generate monthly income from shares

About the Author

My name is Stephen Cox. I am the Managing Director of Share Navigator, a global online training company that makes stock market investing easy to understand.

We teach people how to make money from stocks in a safe and supportive environment.

Here is a small bit about me:

- **Full Time Trader and Investor:** I trade a real life portfolio and share all my investments and trades with my subscribers. In 2016 the portfolio delivered returns of just over 19%.
- **Stock Market Trainer and Mentor:** I train people from all walks of life. I work 'one to one' with investors and mentor them during the investment process.
- **Education and Qualifications:**
    - First-class Honours MBA majoring in Finance
    - Registered Stock Broker
    - Graduate member of the Institute of Bankers

This eBook is a beginners guide to the 'Covered Call' strategy. This eBook is not an exhaustive explanation of the strategy. Instead, it is meant to give you a good idea of how the covered call can reduce risk and increase returns for you. The language is kept simple for you.

If at any stage you have any questions please contact me via email:

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Enjoy and happy investing!

Stephen

1. Introduction

The ‘Covered Call’ strategy is one of the best kept secrets for stock investors. It allows you to generate additional monthly income from your shares and also helps you to reduce the risk in your stock investments.

Put simply, if you own stock or are about to buy stocks, you need to know about the ‘Covered Call’ strategy.

The ‘Covered Call’ strategy involves you agreeing to sell your shares to another investor, at an agreed price, by some agreed date in the future. The other investor may or may not decide to buy the shares from you, they have a choice but are not under any obligation. In essence, you are locking up your shares for the other investor for a period of time. In return, you get paid a fee immediately and upfront. It is yours to keep!

The ‘Covered Call’ strategy should be applied to:

1. Stocks that are trending sideways and/or
2. Stocks that you own and are considering selling.

The covered call will help you to generate additional income and reduce risk. We will use real life examples to explain the strategy in an easy to understand way.

First, we need to explain some of the basics of ‘Call’ options.

2. Basics of 'Call' options…………

What is a Call Option?

Here is the definition:

A 'Call' option gives the owner <u>the right but not the obligation</u> to buy a stock at an agreed price (Strike Price) by an agreed date (Expiry Date).

Call option owners have 'Rights'

When an investor buys a call option they have the **<u>right to buy</u>** the stock by some pre agreed date in the future. The investor will only buy the stock if the share price is above the agreement 'buy' price at or before the expiration date of the 'Call' option.

Call option sellers have 'Obligations'

When an investor sells a call option they are **obligated to sell** their stock by some pre agreed date in the future. The investor will be forced to sell their shares at the agreed price if the share price rises above the agreed strike price at or before the agreed expiration date.

Selling 'Covered Calls'

When an investor sells a call option against stock that they own, it is known as a 'Covered' call. The best way for you to visualise this is that you have 'locked up' your share certificates for the investor that you sold the call option to.

Covered Call Premium

Because you have effectively tied up your shares for another investor and could lose out if the stock jumps above the strike price, you will demand a **'premium'** from the other investor. This premium goes straight into your trading account and is yours to keep irrespective of where the share price goes.

Why would an Investor 'Sell' a Covered Call option?

An Investor will sell a covered call option when they want to sell their shares at the agreed price or when they notice that a stock is trending sideways and unlikely to rise above a certain price level.

Note: 70% of the time stocks are trending sideways!

Why would an Investor 'Buy' a Call option?

An Investor will buy a call option if they believe the share price will rise substantially. Rather than buying the stock, they will buy the 'right' the buy the stock by some date in the future. This means that they do not have to pay a big capital amount upfront to participate in the stock. Instead, the investor can 'control' the stock by paying a small premium to buy a call option. If the share price rises substantially they will make a profit with a smaller capital outlay.

This is explained further in one of my courses call the 'Long Call'.

Share Control

Call options are bought and sold in contracts and 1 contract controls 100 shares of stock. This is important for you to know as it means that you need to own at least 100 shares of stock in order for you to sell a covered call.

Let's explain with real life examples.

3. Real life example with Apple...getting ready to sell the stock.

Imagine that you own 100 shares of Apple. You bought the stock at $90 sometime ago. The share price has risen to $153. You are currently in profit by $63 ($153-$90) per share or $6,300 ($63*100) in total.

Nice!

You intend to sell the stock at $155. This will make a nice $65 profit on the stock or $6,500 ($65*100) in total.

What if you could make an even greater return on this investment and also reduce your risk at the same time? Is there anyway you can start generating income while you are waiting to sell the stock? The answer is yes. Welcome to the covered call strategy!

You decide to look at the call option market and notice the following quote:

Strike Price: $155 (this is the agreement price for selling/buying Apple)
Expiry Date: June 16th (37 days from now)
Premium: $2.11 (This is the price per share the call option seller receives)

Here is a summary of what a covered call on Apple would look like:

1. We have agreed to sell our Apple stock at $155 (Strike Price).
2. On or before June 16th 2017 (Expiry) which is 37 days from now.
3. We received $2.11 per share or $211 in total ($2.11*100). This goes straight into our trading account.

Now we simply wait. There are two possible scenarios at expiry:

1. **The share price of Apple stays below $155:** Nothing will happen, we keep the covered call premium and the call option will expire worthless. The investor who bought the call option from us will not buy the shares at $155 because they can buy them cheaper in the open market.

   But we have benefitted in two ways:

   a. **Reduced Risk:** We have reduced our risk in the stock by $2.11 per share. We originally paid $90 for the Apple shares. But now that we have taken in $2.11 per share from the covered call we have effectively reduced the purchased price by $2.11 to $87.89. The Covered Call has reduced our risk in the stock!
   b. **Generated Income:** We have generated an additional return on investment whilst we are waiting to sell the shares. This additional $2.11 per share in income is the equivalent of generating an additional 2.34% in 37 days! If we were to annualise this return it would be the equivalent of: **23.08%** (2.34%/37*365)

   The best thing is that we get to keep our shares of Apple and do the same trade for the following month (assuming we still want to sell the stock at $155).

2. **The share price of Apple rises above $155:** If at expiry the share price of Apple is above $155, we keep the covered call premium but our shares of Apple will be sold ‘assigned’ at $155 to the investor who bought the call option from us.

   Our total profit in this scenario will be:

   1. $6,500 on the stock position ($155-$90)*100
   2. Plus $211 for the income from the Covered Call
   3. Total profit is $6,711 ($6,500+$211)
   4. This yields a return on investment of 74.56%. If we didn’t place the

covered call we would have made a 72% return on investment.

	Apple $155 Covered Call	Apply - Just hold the Stock
Net Cost of share purchase	$8,789	$9,000
Profit if shares reach target sell price $155	$6,711	$6,500
Break-even price	$87.89	$90.00

No matter way you look at the covered call strategy, it reduces risk and increases reward. See the matrix above:

1. Net cost of share purchases is reduced from $9,000 to $8,789
2. Profit increases from $6,500 to $6,711
3. Our break-even price reduces from $90 to $87.89

What are the downsides of the Covered Call?

There is only one downside to the covered call strategy. If the share price of Apple jumps substantially over $155 you will not benefit from that upside. You will still have to sell at $155. For example, if Apple jumped to $160, you will not be able to sell your shares at $160, you will sell them at $155.

My counter argument here is that you have already made your mind up to sell at $155. If you follow through and sell at $155 you will not be in the stock to benefit above that price. This is why I always encourage investors to have realistic target prices for stocks.

Also, even though risk is reduced with the covered call, it will not stop losses if the share price drops suddenly.

Now let's look at the covered call for a sideways trending stock.

4. Real life example with Merck...sideways trending stock

Look at the chart of Merck below:

As you can see from the above chart of Merck it has pretty much traded for the most part between $60 to $65 in the past 12 months. In fact, 70% of the time, stocks are trending sideways!

The covered call is an excellent strategy to profit from sideways trending stocks.

Merck (MRK) is part of the Dow Jones Industrial Average (DJIA). The company is worth $173 billion (at time of print). The stock would be considered a safer haven for more conservative investors and pays about a 3% dividend.

Just because you might be a conservative investor doesn't mean that you cannot generate additional returns on your investments. Imagine that you own 100 shares of Merck. You bought the stock at $60 sometime ago and are happy to take the dividend and hold the stock. As the stock approaches $63 you decide to sell covered calls at the $65 strike and repeat the process throughout the year. You decide to look at the call option market and notice the following quote:

Strike Price: $65 (this is the agreement price for selling/buying Merck)

Expiry Date: June 16th (37 days from now)

Premium: $0.76 (This is the price per share the call option seller receives)

Here is a summary of what a covered call on Merck would look like:

1. We have agreed to sell our Merck stock at $65 (Strike Price).
2. On or before June 16th 2017 (Expiry) which is 37 days from now.
3. We received $0.76 per share or $76 in total ($0.76*100). This goes straight into our trading account.

Two possible scenarios at expiry:

1. **The share price of Merck stays below $65:** Nothing will happen, we keep the covered call premium and it will expire worthless. We have gained two benefits:
   a. **Reduced Risk:** We have reduced our risk in the stock by $0.76 per share. We originally paid $60 for the Merck shares. But now that we have taken in $0.76 per share from the covered call we have effectively reduced the purchased price by $0.76 to $59.24. The Covered Call has reduced our risk in the stock!
   b. **Generated Income:** We have generated an additional return on investment. This additional $0.76 per share in income is the equivalent of generating an additional 1.27% in 37 days! If we were to annualise this return it would be the equivalent of:

      12.5% (1.27%/37*365)

   The best thing is that we get to keep our shares of Merck and do the same trade for the following month. For sideways trending stocks like Merck we call this a *return based strategy*. This is a great way for you to collect your dividend from a conservative stock and also generate an additional monthly income from the stock.

2. **The share price of Merck rises above $65:** As we mentioned, 70% of the time stocks are trending sideways. However at some point the stock may breakout in

one direction or the other. If at expiry the share price of Merck trades above $65, we keep the covered call premium but our shares of Merck will be sold 'assigned' at $65 to the investor who bought the call option from us.

Our total profit in this scenario will be:

1. $500 on the stock position ($65-$60)*100
2. Plus $76 for the income from the Covered Call
3. Total profit is $576 ($500+$76)
4. This yields a return on investment of 9.6%. If we didn't place the covered call we would have only made a 8.3% return on investment. **Note:** We haven't included any dividends received in our calculation.

	Merck $65 Covered Call	**Merck- Just hold the Stock**
Net Cost of share purchase	$5,924	$6,000
Profit if shares reach target sell price $65	$576	$500
Break-even price	$59.24	$60.00

No matter way you look at the covered call strategy it reduces risk. See the matrix above:

1. Covered call reduced net cost from $6,000 to $5,924
2. Profit increases at target selling price from $500 to $576
3. Breakeven price is reduced from $60 to $59.24

The real benefit of using a return based approach with the 'Covered Call'

As with any investor the balance between risk and reward needs to be addressed. We all want to make as much money as possible from our investments but the relationship between risk and reward is equal. The more you want to make the more you have to risk and vice versa.

The covered call strategy offers conservative stock investors a way of generating additional returns from conservative sideways trending stocks. It reduces the risk profile of the stock even further and also increases returns.

Downside of the 'Covered Call' in this example…...

There is only one downside to the covered call strategy. If the share price of Merck jumps substantially over $65 you will not benefit from that upside. You will still have to sell at $65.

But this was a return based strategy and you can always re-enter the stock when it falls back into the trading range!

5. Other things you need to know about the 'Covered Call'

You can close the covered call before expiry

Before expiration, you can close the covered call position. You may have changed your outlook for the stock and do not want to be committed to selling at the covered call strike price. In this case, you can buy back the call option. This might be for a loss or a profit depending on:

1. What you received when you sold the call option
2. What you pay to buy the call option back

Early assignment & dividends

When you sell a covered call option, the investor can at any stage 'exercise' their right to buy the stock from you until expiry. 99% of the time options are not exercised until the expiry date. But assignment can happen before the expiration date.

Early assignment usually happens when the stock price is above the strike price and when the stock goes ex-dividend and the dividend amount exceeds the 'time' value of the call option. **Note:** This is a beginners guide to the 'Covered Call'. We haven't covered the pricing of options. This is something you will learn when you decide to take the next step in learning about the covered call strategy.

Online Brokers do it all for you

Any decent online broker will offer the ability to buy stock and sell covered calls. The great news for you is that if there is an assignment the broker will automatically sell your shares (commission free) for you.

Example of placing a covered call with an online broker.

Contact us if you would like to practice the covered call strategy on a trading simulator.

6. Covered Call - Summary

For those who want to own shares and generate additional monthly income or maximise the potential sale of stock, it is excellent. For the novice option trader, covered calls are a great way to begin learning about options. It reduces risk and increases reward.

However, there are limitations to the covered call strategy. If a stock jumps or rallies you will most likely miss that profit opportunity. Also, even though your downside risk is lower, the covered call will not protect you from significant falls in the share price.

Get a target price for the stock….

The reason I love trading options so much is that they give you choice and the ability to reduce risk. You can create bullish, bearish and sideways strategies at a fraction of the risk. But these strategies are absolutely useless if you do not establish a realistic target price for the stock in the first instance.

Too many novice investors buy stocks but don't really have any idea why they bought them! Worse still they have no *exit strategy*. Having a target price for a stock is critically important, this will help you avoid disappointment.

I always start mentoring and teaching people about how to value stocks before they start trading options. It is the key to successful investing and will help you identify the right investment strategy to meet your objectives.

7. Get Educated…..

Education lasts a lifetime and knowledge is power. I would like to invite you to take a FREE TRIAL for 1 month of my online training service. No credit card required. You will get:

1. **Access to a simulated trading account** - practice trades in a risk free environment
2. **Online Courses** - Access to my online courses which are available 24/7. Learn how to trade stocks and options in your own pace and time. Video, PDF, quizzes and more.
3. **Stock and option trade alerts** - During your trial you will get access to all of my stock and options trades. You will learn how, what, when and why from experienced investors.
4. **Support** - We offer support Mon-Fri via phone, email, chat during from 9 am to 9 pm (GMT)

All of the above is FREE for 1 month. You do not have to provide a credit card and there is no obligation to purchase thereafter.

Click Here if you would like to take a free trial.

I hope you enjoyed the Covered Call eBook,

Please feel free to contact me with your questions.

Happy Investing
Stephen