SELLING COVERED CALLS

Clients who hold concentrated positions in publicly traded securities and who are looking to reduce risk while collecting income may want to consider selling covered calls.

What is a covered call?

A *covered call* gives the owner of publicly traded stock (on which options are also publicly traded) the option to sell an investor the right to purchase 100 of the owner's shares at a specific price until a specific date. The specific price is known as the *strike price*, and the specific date is known as the *expiration date*. The right to purchase the stock is known as a *call option*.

By agreeing to sell a call option upon the shares, the owner collects a premium. The premium amount depends on the price of the underlying security in relation to the option strike price, as well as on the time remaining until the expiration date.

The purchaser of the call option has the right to exercise the option to purchase the owner's shares until market close on the expiration date, regardless of the price of the underlying security. If the option is exercised, the owner of the shares must deliver the shares to the option purchaser. The purchaser must pay the owner an amount equal to the strike price per share (each option represents 100 shares).

What are the benefits of selling covered calls?

- The premium collected is a source of income for the shareholder.
- The risk associated with the shares is reduced by the amount of premium collected.
- The time value associated with the call option continues to decline until the expiration date, which works in the favor of the shareholder.
- When options expire and are worthless, the shareholder can sell call options on the shares and collect another premium.

What are the downsides of selling covered calls?

- Risk protection is limited only to the amount of premium collected. Significant downside risk, including the loss of the total cost of the purchase minus the premium collected, remains in continuing to own the shares.
- When shareholders sell a covered call, the appreciation potential of the shares is capped at the call option strike price. Any price appreciation above the strike price is lost to the shareholder.

An example of a covered call

Ms. Doe owns shares of ABC, which she purchased for $50 per share. ABC is currently trading at $100 per share. Ms. Doe would like to increase her income without selling her shares of ABC, so she decides to sell call options against her position.

On July 15, Ms. Doe sells calls against ABC, with a strike price of $115, which will expire on the third Friday in November. For selling the call option, she will receive $3.25 per contract ($325 received for every 100 shares subject to the option contract). The buyer of the call option has the right, through the third Friday of November, to "call away" the shares from Ms. Doe at $115 per share, regardless of the actual trading price of ABC at the time the option is exercised.

If the price of ABC does not reach $115 during the option contract period, the option will expire worthless, and Ms. Doe will retain ownership of her shares. She can then sell more options to generate additional income from the premiums to be collected.

Considerations

Selling covered calls can be an effective strategy for holders of concentrated stock positions to generate additional income and nominal risk protection. But for shareholders primarily focused on risk protection and diversification, other strategies should be considered.

Please note that options are not suitable for all investors. Typically, commissions are charged for options transactions. Please contact your financial advisor for a copy of the Options Disclosure Document (ODD).

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