Covered Calls:

A Conservative Idea for Conservative Times

By Tony Chapelle

IF YOU BELIEVE THE BULLISHNESS OF THE YEAR'S first half will continue, read no further. But if you foresee the market's direction as being more sideways — or even lower — over the near or medium term, you may want to learn more about writing covered calls.

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"Covered call writing is a way to create a synthetic income stream," says Benay Curtis-Bauer, a broker at Portsmouth Financial Services in San Francisco, who spent 11 years at Dean Witter and Morgan Stanley. "Calls generate or enhance cash flow. That's something my income-oriented clients need."

Clients who have owned stocks for years and who require more income than ultra-safe Treasuries and bank investments now provide may benefit from covered call writing. The strategy, of course, is nothing new. And as a Series 7-licensed broker, you had to learn the mechanics in order to pass your exam. But fewer than 10 percent of brokers use the strategy currently, says call writing expert Richard Lehman, and few firms encourage their brokers to employ it.

So what is covered call writing exactly and how can you use it profitably?

Simply, covered call writing consists of selling (or "buy-writing") call options on stock you own. Call options, of course, are the right, but not the obligation, to buy a specified security at a specified price for a specified time. Writers of call options, also called "buy-writers," are considered to be short in options parlance, even though they own the underlying stock. The buy-writers receive money for selling the right to another party to buy their shares at a specified price at a specified time in the future. The amount they receive depends on the prevailing price for the option, which trades on an options exchange, such as the CBOE or the American Stock Exchange. "Covered" refers to the fact that the client actually owns the shares on which he or she is writing the call.

12 GOLDEN RULES

WANT TO DO IT RIGHT? Michael Schwartz, chief options strategist at Oppenheimer & Co., a division of Fahnestock & Co., says the following are the 12 Golden Rules of option writing:

1) Diversify. Don't invest more than 10 percent of available capital in a particular buy-write position.

2) Only purchase stocks for a buy-write if you're willing to own them on their investment merits.

3) Don't be lured into a buy-write by high premiums. A high premium may indicate high volatility and a risky stock.

4) Write slightly out-of-the money calls that let you participate in some of the upside profit potential. Try to write calls where the strike price and premium may equal or exceed the analyst's target price prior to expiration.

5) Write middle and far-out expiration calls for higher dollar premiums. Higher premiums give you more downside protection and longer expirations require fewer roll-over decisions. In addition, writing longer and for higher premiums simplifies record keeping.

6) Don't make buy-writes for fractions of a dollar. Those are for floor traders and are not economical for retail investors. Write for a minimum premium.

7) Don't focus on annualized returns. Stock selection is primary, premium is secondary. You rarely can earn regular, high annualized returns. Stocks that seem to have them may include low initial premiums, short expirations and far out-of-the money strike prices.

8) Don't be influenced by theoretical value. Models that identify overvalued and undervalued options suggest that calls are to be written if overvalued and purchased if undervalued. A small fractional price change or a stale quote can influence evaluation. So don't waste time looking for deviations from the norm; options that are overpriced or underpriced tend to stay that way. The auction place is an efficient pricing mechanism.

9) Don't first execute a call, then wait to buy the stock at a better price. That's known as a "naked" option, which means it's not covered by underlying stock, and it exposes your client to unlimited market risk.

10) If there is any change in underlying fundamentals, do not hesitate to close out the entire position. Either sell the stock, or buy the call.

11) An exercise is one of the best sale decisions you did not have to make. An options writer should be happy if the market and their stocks are rising. This means he has a strong probability of seeing his stock called away.

12) If you change your investment opinion after your covered call position is in the money, see rule 11. Otherwise, you can roll up to a higher strike price. This is done by buying back the call you originally sold (which is now in the money) prior to an exercise and selling a slightly out-of-the-money call with a more distant expiration to replace it. This will let you get some more time premium, some added stock appreciation and some downside protection.

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If one of your clients writes a covered call and holds the option until its expiration, one of two things can happen. If the stock hasn't moved to the exercise price, the call will expire worthless, which means that the buyer of the option did not exercise it. Your customer still owns his or her shares and earned extra income by writing the call. On the other hand, if the price of the underlying shares rose sufficiently and the option is exercised, the shares are called away and your firm deposits funds in the client's account.

The downside of covered call writing from the writer's perspective is that the writer gives up any upside appreciation in the stock above the strike price. During bull markets, therefore, fewer investors write covered calls because they prefer participating in the expected capital appreciation than enjoying current income. But choppy and bearish markets prompt brokers to seek new ways to improve investment performance, and covered call writing — which can include complex and sophisticated tactics — fits the bill.

Before the recent market upturn, 29-year veteran rep Ralph Presutti was actively selling calls. In fact, it was "like stealing candy from a kid," he says.

"In a sideways market, the odds favor the call seller against the call buyer because the stock isn't volatile," says Presutti, with Advest Group in Hartford, Conn. "(About) 80 percent of call buyers lose their money. So the odds are way in my favor as a call writer. That's what makes call writing such an interesting strategy."

Brokerage firms haven't been too encouraging of the tactic, however, because it requires familiarity on the part of brokers. Since an entire generation of brokers has matured during a bull market when income-boosting techniques were ignored, relatively few brokers are comfortable with covered call writing. In addition, options, in general, are perceived to be risky, even if actually used to hedge, not speculate.

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"When options came out, brokers were running amok and doing all kinds of crazy things," says Richard Lehman, co-author with Lawrence G. McMillan of "New Insights on Covered Call Writing" (Bloomberg Press, Princeton, N.J., $39.95. The book is available at www.onwallstreet.com/pmi). "All the firms were getting sued. Clients lost money, and said their brokers had not told them how risky all options were, not just covered calls."

Eventually, Wall Street compliance officers discouraged clients and brokers from most options trading.

"Covered call writing was the baby that got thrown out with the bath water," says Lehman, a Registered Options Principal who runs CoveredWriter.com, an options investment management and education Web site. He says retail executives determined that it was better for professional money managers to invest clients' money, both for the sake of performance and to help untether brokers from their Quotrons so they could talk to more clients. In addition, while all reps learn about options (they comprise about 20 percent of the questions on the Series 7 exam), brokers have to file extra paperwork to show they've educated clients on how to use the style.

"So you have a huge retail brokerage population that in the last 10 years does very little options," Lehman observes.

Despite having fallen out of favor with brokers, covered call writing actually has become easier and cheaper for retail clients to implement. In today's fee-based accounts, covered call writing can be "free" for clients who keep the required assets at the firm and don't trade excessively. Clients who understand the process (and who can't find a knowledgeable broker to give them the advice they might want) can buy-write contracts themselves through an online brokerage firm.

Given the dearth of knowledgeable brokers and the abundance of investors looking for ways to boost returns, covered call writing can be a productive prospecting tool. Here's what the experts suggest:

First, understand that this strategy is not something you would want to employ for just one or two clients. For the amount of work involved — which can entail researching stocks, following options markets and creating worksheets — and the low level of income it's likely to generate, you should leverage the effort across a number of customers.

Lehman, who once served as the options coordinator for the New York region of E.F. Hutton & Co., suggests that brokers who want to use covered calls as a prospecting tool should concentrate on self-directed investors who manage their own six-figure portfolios. Most of them are retired and have rolled over their 401(k) money into Individual Retirement Accounts. Rather than holding mutual funds, many of the investors hold stocks, which they trade at discount firms.

To land these prospects, Lehman recommends offering them the attractive long-term, lower-risk

returns that are possible with call writing. Most individuals, even those that do day trading, generally need help doing covered call writing. In fact, this is one way to recapture clients who've left full-service firms for discounters. In a fixed-fee account, buy-write clients could wind up paying you less and receiving more than if they did it themselves at a discounter.

Employees and former employees of public companies constitute another group ripe for the strategy. If they have held company stock for years, they could be writing calls and receiving cash from their investment instead of nervously watching every jiggle of their stock price.

Finally, call writing encourages greater broker-client dialogue. After all, with options expiring and decisions to be made on a frequent basis, there is always some reason for a broker to call a client with information or an update.

James Bittman, a former options market-maker and now senior instructor at the Chicago Board Options Exchange Options Institute, said that clients could start doing basic covered call writing with a portfolio of $25,000.

Lehman and the other experts agree that covered call writing isn't advisable for every rep. A broker using the strategy should become familiar with options herself, and then call on the options strategist at her firm. The options departments at most large firms can help brokers calculate the expected rate of return on calls that are in the money (priced below the current market price of the stock), out of the money (priced above the current stock price) and at the money (right around the current price).

In selecting stocks to use with covered call writing, Curtis-Bauer favors those that have at least some volatility.

"If there's less volatility, there's less return," she explains. And she's found that covered calls let her gradually move her clients out of stocks their emotions won't permit them to sell.

"Some of my clients hold a stock and expect it to go to the moon. They may not want to hear that it's peaking or moving up at a slower rate," she says. "I have them sit down in advance and agree that if they can achieve a total return (cost basis plus call premium) of 15 percent or better — or whatever we determine is reasonable — by a certain date, such a return would be satisfactory. I can help them move toward that goal by selling a call. The nice thing about covered call writing is that it's based on real, logical numbers."

But not all investment minds think so highly of covered call writing.

One wirehouse branch manager, a 25-year veteran of the industry, said he used the technique in earlier down markets, but today it's not all that profitable.

"There are fewer inefficiencies in today's markets," he says, explaining that option premiums have come down, resulting in lower income to call writers.

"The most important point to be made for investors is that they're not getting something for nothing," warns Jonathan Berk, an associate professor of finance at the Haas School of Business at the University of California at Berkeley. "If they think that by doing this, they'll somehow get a higher return and yet get lower risk, that just violates the rule in life that you don't get something for nothing. If there were a way to increase returns with lower risk, there'd be a lot of people taking advantage of it. That's clearly not the case. Sometimes the (stock) is going to go up by more than the strike price, and you're going to miss that extra return. And a person who invests with full knowledge of that gets the investment premium."

Berk doesn't think that even astute brokers can beat the market by assiduously managing their clients' stock picks and calls. "Most academics would be hard-pressed to believe that brokers can somehow time the markets. They could make a hell of a lot more money by being hedge fund managers."

But the professor advocates the technique for those who know its basic purpose. "Used correctly it's a great idea. Some people want to lower the risk of their portfolios and are happy to take a lower return." OWS

AN INDEXED WAY TO COVERED CALLS

LEAVE IT TO THE Chicago Board Options Exchange (CBOE) to come up with a way to do covered call writing with a CBOE product. Last year, the exchange — in cooperation with Standard & Poor's — created the CBOE Buy-Write Monthly Index (BXM) as a benchmark index to track the performance of a hypothetical buy-write strategy on the S&P 500 Index. According to the CBOE, "the BXM is a passive total return index based on buying an S&P 500 stock index portfolio and writing the near-term S&P 500 Index covered call option, generally on the third Friday of each month."

Back-testing the BXM over the past five years ending in 2002, found that the index would have beat the S&P by 28 percent to a negative 9 percent. Last year, the BXM handily won out by reaching a negative 6.7 percent showing compared to the 23.4 percent drop in the S&P. Investors can use an S&P 500 buy-write strategy by investing in stocks and SPX options.