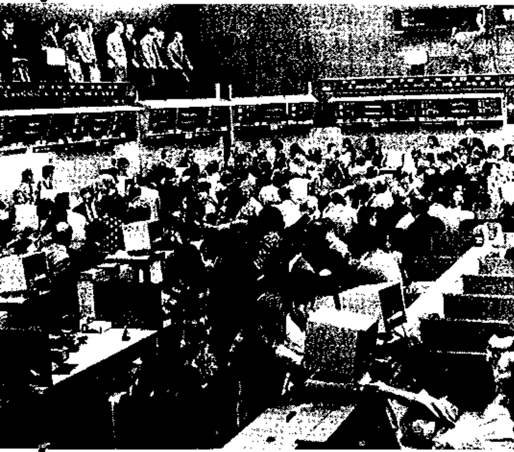
Inside Wall Street

Jeffrey Madrick / November 3, 1975

Reaping profits from covered options

Will options trading—booming on the Chicago Board Options Exchange and the American Stock Exchange—stay a red-hot area, or will investors tire of the market and seek richer profits elsewhere?

Some observers—Harry Turner, for example, who is developing a pilot options writing program for Stanford University's endowment fund—thinks that with all the trading in options lately, chances of finding an abnormally high or low premium (the cost of the option) have been markedly reduced. Premiums, of course, fluctuate once the option is written and starts trading: Buyers seek low premiums, sellers want high premiums. Myron Scholes, an economics professor at the University of Chicago, also believes that profitable price aberrations are harder to find.



Business is booming on the CBOE.

But Sheen T. Kassouf, president of Analytic Investment Management Inc. in Newport Beach, Calif., and one of the most respected options writers around, has recently completed research that demonstrates that at least one type of options investing—selling covered calls—can remain quite profitable even if price aberrations vanish. "It's going to startle a lot of people when I publish the findings," says Kassouf, who is also a professor of economics at the Irvine Campus of the University of California.

Better returns. Writing (selling) call options appeals to the few individuals and the many institutions that hold substantial quantities of equities in their portfolios. The buyer of the call pays a premium—usually 10% to 12% of the market value of the underlying stock—for the right to buy the stock at a predetermined price, at some point in the future (generally three months). Writing covered options works to reduce fluctuations in the investment performance of an equity portfolio because the premium the option writer receives will partly offset any loss incurred if the stock falls. Kassouf says, and many experts agree, that at traditional premium levels, the option writer can get a better return—and still keep the risk down—than if he merely held onto his stocks.

Kassouf insists that the option writer can make a nice profit even if the premiums he receives fall considerably below their traditional average. In fact, Kassouf argues, the premium can fall 20% below the actuarial "real" price of the option, and the option writer will probably make as much money as if he merely bought and held the securities—and with less risk.

Kassouf has constructed a mathematical proof of his assertion, but he has also tested the hypothesis historically. To see how much money an ordinary covered options writing program could earn, and at what risk, he simulated such a program, over a 25-year period beginning in 1950, using the Dow 30 industrials as his portfolio. Because no options exchanges existed then, he took the premiums being charged in the over-the-counter options markets and modified them.

A $1,000 investment in the 30 stocks, with dividends reinvested and including transactions costs, would have grown to $11,800 by the end of 1974. If the owner of the portfolio had also written a call against each issue every three months, the portfolio would have grown to $55,000. Moreover, the risk was less when options were written, with a Beta (a widely accepted measure of risk) of 1 when no options were written and a Beta of 0.7 when options were written. Even when the premiums were cut by 20% the optioned portfolio did as well as the nonoptioned portfolio, and at a lower risk.

Call writers have an edge in bear markets because they earn their premiums while everyone else loses money as stock prices fall. Kassouf's study shows that covered call options can do well in an up market. The S&P 500 was up 42% in the first half of 1975; Kassouf's firm, writing covered call options still turned in a 28% gain.

Stock-option trading can be a good way to hedge your bets in a wide-swinging market like that of the past few years. The $6.5-million pooled-option fund at the Bank of Commerce of Fort Worth, Tex., returned 17.6% in the past 27 months. During that time, the Standard & Poor's 500 dropped 9.2%. Even in July's stock market plunge, the bank fund dipped only 1.7% vs. a 6.7% decline in the S&P.

"I've never seen a more explicit example of the prudent-man rule," says Jerry M. Traver, the Bank of Commerce trust officer who runs the fund. "Options trading gives you consistency of performance." The bank has not bought options but only sold them. Traver, in fact, is leaving the bank to set up an independent options-trading fund with more flexibility to utilize all options strategies.