

A time for covered-call writing

What if all your indicators point toward a market surge, but don't show when? Covered-call writing allows a trader to position himself for a rally with minimized risk and earn a profit even if prices stall.

By Rick Thachuk

Covered-call writing is an investment strategy that has great appeal to the stock and futures trader who expects prices to rally, but does not know when that will happen. Rather than attempt to fine-tune timing signals for the outright purchase of a stock or futures (with dubious success), or pay for time premium of a call option (which becomes more expensive the longer the time to expiration) — covered-call writing enables the trader to be profitably positioned for a market rally, yet still earn income even if prices languish.

Covered-call writing consists of buying a stock or futures contract and then selling an out-of-the-money call option on that contract. An out-of-the-money call option is one that has a strike price that is above the market price. For example, with shares of America Online trading at \$44 in mid-October, a call option having a strike price of \$55 per share is out-of-the-money. The option sold is protected or "covered"

by the long stock position, as opposed to a naked option sale, which has no corresponding long position in the underlying contract. Covered-call writing is an advantageous strategy in both stock (that is, when investing in individual stocks) and commodity markets.

How does it work? With a covered-call write, a trader buys a stock or futures contract that will earn a profit if prices rally and will incur a loss if prices decline. The trader also sells a call option and immediately receives the premium from the sale of this option. This premium income



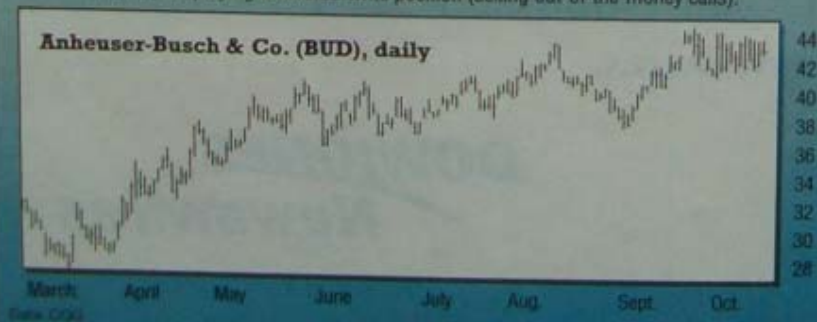
is retained regardless of what happens. If prices range trade or decline up to the time of the option's expiration, then the option will expire worthless and the premium received will help offset the loss, if any, on the long stock or futures position.

If prices rally beyond the strike price of the option by the time of the option's expiration, then the option will be exercised and the long stock or futures position will be closed automatically at the strike price. Although the trader will realize a profit, the maximum profit is limited by the strike price of the option. There is a trade-off between maximum profit and premium income: The higher the strike price of the option sold, the greater the potential for profit, but the lower the premium income initially received.

The revenue received from the sale of the call option enables the trader to set a stop order on the long stock or futures position that is more accommodative than otherwise would be the case with a

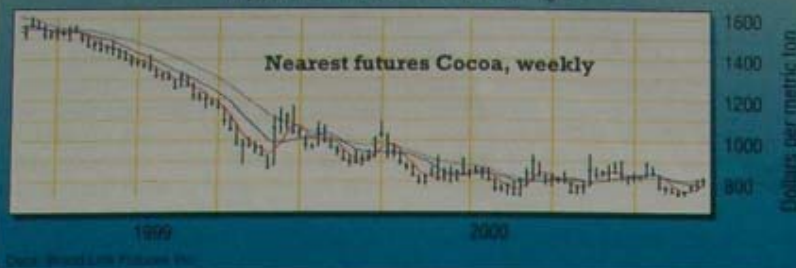
LAST CALL?

A trader could more easily ride the choppy, sideways action seen this year in shares of Anheuser-Busch by employing a covered-write position (selling out-of-the-money calls).



COCOA COVER

Covered-call writing also works well in commodity markets. Here, a trader anticipating a rally in cocoa, but who hasn't pinpointed when that rally may occur, can use a covered-write to profit, even if cocoa does not head higher.



straight stock or futures purchase. So, the position is better able to tolerate random fluctuations and is less likely to be closed prematurely. Following is an example.

Stock example

Period: Mid-October

America Online stock price = \$44 per share

January \$50 call option price = \$4 per share

Establishing the covered-call position

Buy 100 shares of America Online and sell a January call option having a strike price of \$50 per share. (Each call option covers 100 shares.) The trader then places a good-till-canceled protective stop order to sell the 100 shares of America Online at, let's say, \$36 per share.

Scenario 1: America Online shares rise

The trader receives \$400 in premium income (less commission and fees) from the sale of the option. If the price of America Online shares rallies beyond \$50 per share by the time of the option's expiration, the option then will be exercised automatically, thereby obliging the trader to sell 100 shares at \$50 per share. Total maximum profit in this case is \$600 on the stock position, calculated as $(\$50 - \$44) \times \$100$, plus the \$400 premium income for a total maximum profit of \$1,000 (less commission and fees).

Scenario 2: America Online shares decline

If the share price of America Online falls below \$36, then the long position will be stopped out at a loss of \$800, calculated as $(\$36 - \$44) \times \$100$ not including commission and fees and any slippage on the execution of the stop order. However, the trader has received the premium income of \$400 from the option sale so the net loss has been cut in half (less commission and fees). If the

option has not expired, the trader then will need to close the short option position by buying the option back. Because America Online shares have fallen and because the time premium has decayed, the option value will be much lower than \$4, say \$1.50. In this case, the net option premium received is \$250, so the net loss on the entire covered-call write strategy is \$550.

Scenario 3: America Online shares trade in a range

If the share price of America Online trades in a range between \$36 and \$50, then the option will expire worthless and the trader realizes the full \$400 value of the call option (less commission and fees) as profit. The net gain or loss on the stock position depends upon the market price but in any case, the trader has realized profit from the sale of the option.

The covered-call strategy in this example risks \$400 to earn \$1,000 (less commission and fees) and is an advantageous risk/return profile. Note that if the trader desired to risk the same \$400 but was buying only the stock, then the stop price would have to be set at \$40 per share. This fairly tight stop

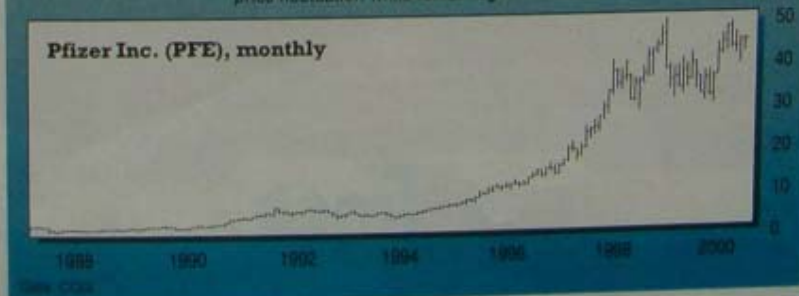
makes the risk high that it would get filled and thereby close the trade at a loss. With a covered-write, the trader is able to set a more accommodative stop on the stock position while still risking the same dollar amount and this, in turn, allows the position to tolerate greater price fluctuation without being prematurely closed.

When to do it? A covered-call write is a bullish strategy, so it should be established when prices are expected to rise. It is not as risky as an outright purchase of a stock or futures contract and, as described in the example above, enables the trader to set a more accommodative protective stop order that may be necessary to carry the trade through random price fluctuations. The covered-write also does not require the expense of an outright purchase of an option. There are several cases when a covered-call write may be the preferred strategy over a long stock or futures position (or a call option purchase):

Case 1: Consolidation in an uptrend After rising, prices have entered a period of range trading. The trader expects the rally to continue, but he doesn't know when. If the trader buys a stock or futures contract, he may need to risk more funds than otherwise would be the case due to the increase in price volatility associated with range trading. The trader may not be willing to risk such additional funds. If the trader buys call options, the premium (what was paid for the option) will be lost if prices do not rally by the time the options expire. This becomes more expensive the longer prices range trade. The

PFIZER FRENZY

Most traders do not have the capital (or stomach) for an uptrending market that has become volatile. But, once again, a covered-write can minimize risk and allow for greater price fluctuation while remaining in the trade.



➔ covered-write enables the trader to set a more accommodative stop order (without risking additional funds) and thus to carry the position throughout the range trading period. Also, there is no up-front cost as with an option purchase.

An example of this situation is the share price of Anheuser-Busch. In "Last call?" (page 38), the uptrend that began last spring has been punctuated with periods of sideways consolidations with higher volatility. During these times, con-

verting an outright long stock position into a covered-write position (by selling out-of-the-money calls), would have enabled the trader to set a more accommodative stop order to tolerate greater swings in prices. The trader still would earn income and participate in gains from a resumption of the uptrend.

Case 2: Buying during a bottom formation Prices have declined to historic lows and the trader feels confident that they will recover. However, the

trader does not know when this will occur and it is possible that prices may temporarily reach even lower levels before rallying, suggesting the need for an accommodative stop. A covered-write will enable the trader to set an accommodative stop order (without risking more funds) and still earn income even if prices languish for a considerable period of time.

An example of this situation in the commodity market is cocoa (see "Cocoa cover," page 39). Over the last year, cocoa has drifted to historically low levels and appears to have found solid support around the 750 to 800 level. It has, however, remained near these low levels for a considerable period of time and it is uncertain when cocoa will begin moving higher. A covered-write will allow the trader to profit from a rally in cocoa, and earn income (by earning the time premium of the sold option) even if cocoa remains flat.

Case 3: Uptrending market with increased volatility The trend of a market is up, but the market has become volatile, meaning that the high-to-low range of daily prices is much larger than average. Buying a stock or futures outright requires risking a greater amount of funds in terms of setting a stop order that can accommodate the increased volatility — the trader may not be willing to risk this greater amount. The increase in volatility has driven option premiums to high levels, making it too expensive to buy call options. Again, the covered-write has the advantage of enabling the trader to set a more accommodative stop on the stock or futures position without risking more.

An example of this situation is the stock price of Pfizer Inc. over the last several years (see "Pfizer frenzy," page 39). Pfizer shares have trended steadily higher in the 1995-99 period and since have become especially volatile. A covered-write would have enabled a trader to earn the (inflated) premiums that would have, in turn, enabled a more accommodative protective stop order on the stock position — necessary during times of heightened volatility.

Tips for covered-call writing

1. Execute the option sale first using a limit order. (Some broker-

Simulated Trading in "Real-Time" Scenarios

age firms may not permit option transactions to be executed via limit orders; in that case, a market order will need to be done.) In almost all cases, the underlying stock or futures market is more liquid than the options market. The best way to establish a covered-write is to enter a limit order to sell the call option first. Wait until it is filled and then enter a market order to buy the stock or futures contract. For this reason, it is best to enter the limit order near the start of the day to increase the likelihood of it being filled. If the trading day is approaching a close and the limit order on the option has not been filled yet, then the trader can change it to a market order to execute the covered-write before the day is out. This would be advisable, for instance, if the market is closing on strength and the trader does not want to miss out on further price movement by not having the position established.

2. Place a protective stop on the open stock or futures position. A covered-write is a bullish strategy. If the market direction changes, then the position should be closed. The same day that the open stock or futures position is stopped out (closed), the short call option should be bought back. This is especially true if there remains considerable time to expiration. If the option is sufficiently out-of-the-money and if the time to expiration is short, then the trader may decide to leave the option position exposed hoping it will expire worthless. Most traders, however, will not wish to assume this risk.

3. When taking profits on the position, close the stock or futures position first, and then buy back the option. Because most of the equity is tied up in the stock or futures position, this should be the first thing that is closed. Once the position is closed, the trader can attempt to liquidate the call option with a limit order. If it is not filled by the end of the day, though, the trader then should change the order to market to close the option position that day.

Managing the covered-call write A covered-call write can be managed as prices move for increased performance. For example, if stock or futures prices rally, the original call

option that was sold can be bought back (its price will have increased in value) and another call option having a higher strike price can be sold instead. Even though the trader will incur a loss on the first option (it was bought back at a higher price than it was initially sold at), this will be somewhat offset by the premium income received from the sale of the second option. Plus, the higher strike price of the second option allows for greater profit on the long stock or futures position.

For traders with less-than-perfect timing skills, covered-call writing is a solid strategy for entering a long position in either the stock or futures market. Covered-call writing also allows for profit when prices languish, making this option strategy timeless.

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