Earning dividends with covered calls

Conservative structure will increase the odds of a profitable covered call position.

BY CASEY PLATT

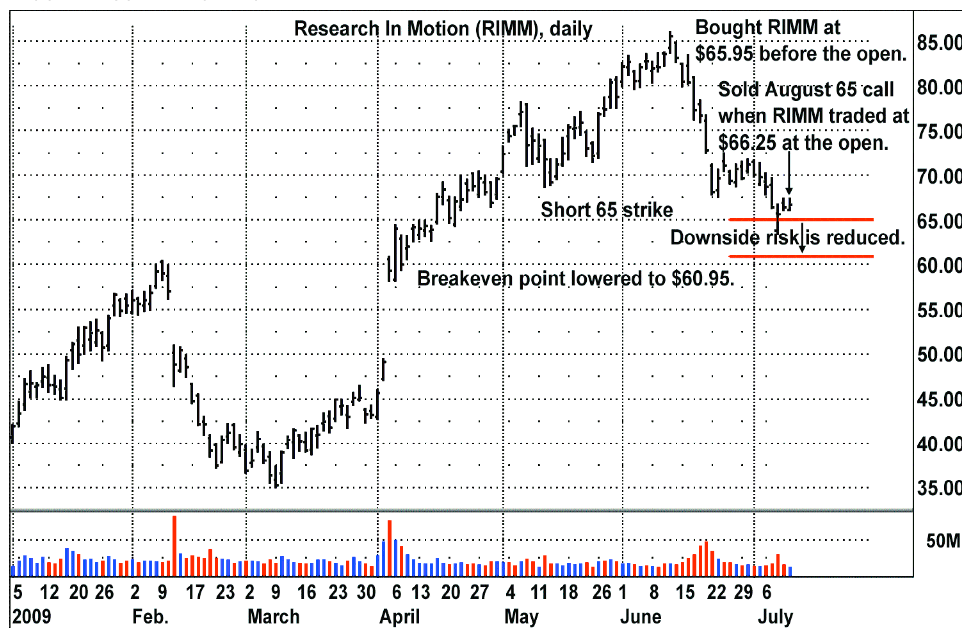
KC *For more information about the following concepts, go to "Key concepts" on p. xx.*

- *At-the-money*
- *Beta*
- *Bid and ask prices*
- *Extrinsic value*
- *In-the-money*

What if the company whose stock you've bought paid out a dividend every other month? Imagine if six times a year the board of directors sat down and cut you a check, sharing some of their salaries. This scenario sounds good, but it's a fantasy — unless, perhaps, you can successfully sell call options against your underlying stock purchase.

The idea of the "covered call" trade is to generate dividend-like income that pays out more often than actual dividends. For example, if you enter covered calls with options that expire in 30 to 60 days, you can earn up to six "dividends" per year. The strategy essentially lets you rent the stock, and it also partially protects the investment.

FIGURE 1: COVERED CALL ON RIMM



RIMM is a volatile stock with a bullish bias. Unlike an outright stock purchase, a covered call offers some downside protection — $5 per share, in this case.

Source: eSignal

There are many ways to trade covered calls, and success depends on selecting the appropriate stock, strike price, and expiration month. The approach described here focuses on high-quality technology and agriculture stocks and sells at-the-money (ATM) calls that expire in one or two months (approximately 20 to 40 days). The position can be held from one week to until the options expire; it's not a day-trading strategy.

Like all options strategies, however, covered calls are no holy grail. The trade may not offer much protection against major market declines, because it is mathematically equivalent

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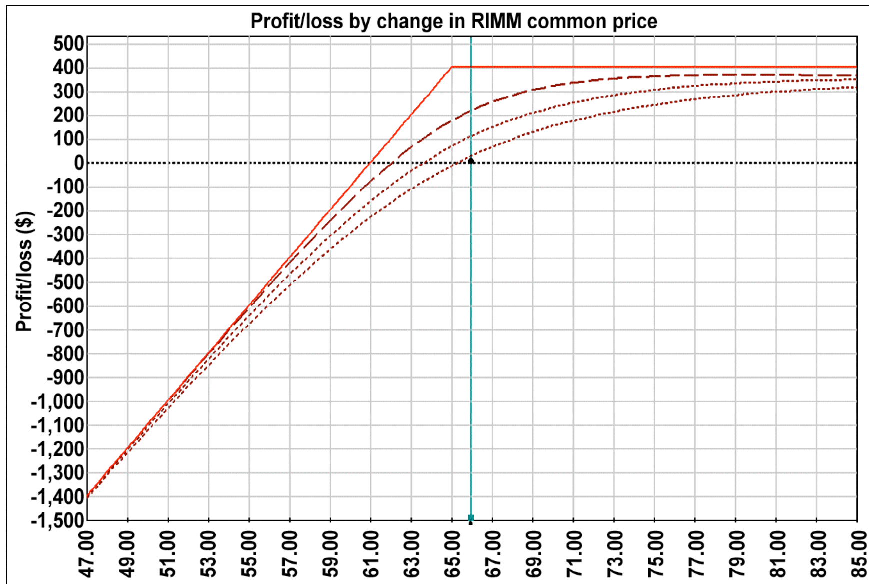
TABLE 1: TRADE ENTRY DETAILS

Position	Debit/Credit
100 shares of RIMM at $65.95 +	-$6,595.00
1 short August 65-strike call at 5.00	$500.00
Total risk:	$6,095.00
Breakeven point:	$60.95

Selling an August 65 call lowered the position's breakeven point to $60.95 — a cushion of 7.6 percent.

FIGURE 2: RISK PROFILE – COVERED CALL



If Research in Motion is above $65 at the August 22 option expiration, the position will earn 6.1 percent. If RIMM drops, the stock's losses are reduced by the short call's gain — an annualized return of 52 percent.

Source: OptionVue

to selling uncovered puts. But if the stock rallies, you can profit from this underlying move and a drop in the short call's time value. And if the stock stagnates or drops gradually, the short call's premium can offer some protection on the downside.

Not all stocks and options are created equal

To make sure the call's dollar value is large enough to justify selling it, start with stocks trading at a minimum $25 (preferably $40 or higher). Ideally, you should sell ATM calls with a extrinsic value of at least $2.50; ATM calls are preferable because they have more extrinsic value than other strikes. And selling calls with large premiums raises the possibility that you can exit positions profitability before the options expire. (For the purposes of this article, in-the-money and ATM are interchangeable; in either case, very near-the-money options are being discussed.)

When selecting the right stock, look for popular stocks with year-over-year earnings growth and high betas, such as Apple Inc.(AAPL), Amazon (AMZN), Google (GOOG), and Research in Motion (RIMM). Agriculture stocks such as Potash Corp. of Saskatchewan Inc. (POT), Mosaic Co. (MOS), and Monsanto Co. (MON) have also worked well this year. Finally, bank stocks are back in vogue, bouncing back strongly in recent months.

Stocks should have daily volume of at least five million shares and options volume of 100,000 contracts. When picking specific options, make sure they have a bid-ask spread no wider than $0.10, which will help you enter and exit the trade. When trading options, always enter a limit order between the bid and ask prices. For example, if a call's bid price is $0.80 and its ask price is $0.90, enter a limit order at $0.85. Wide bid-ask spreads and low volume can lead to slippage that can ruin profits.

Avoid earnings and strong rallies

Avoid holding covered calls in the two weeks surrounding quarterly earnings, because companies tend to view these earnings announcements as "confessionals." Volatility will peak during this period, which offers the greatest chance for a gap price move. Also, read the quarterly earnings reports of stocks you favor carefully. Avoid any company that warns about poor earnings, compressing profit margins, or any uncertainty.

In addition, covered calls aren't ideal strategies if the stock has already rallied strongly. You should enter these positions only when a bullish stock has dropped in recent days. In this situation, the call's implied volatility increases, boosting its selling price. This makes sense if you consider that the position is a synthetic short put, which you don't want to enter unless the underlying trades near a relative low. Of course, if you already own a stock with unrealized gains and you don't want to sell yet, selling a call against those shares can provide income and help you postpone the decision to sell.

Trade example

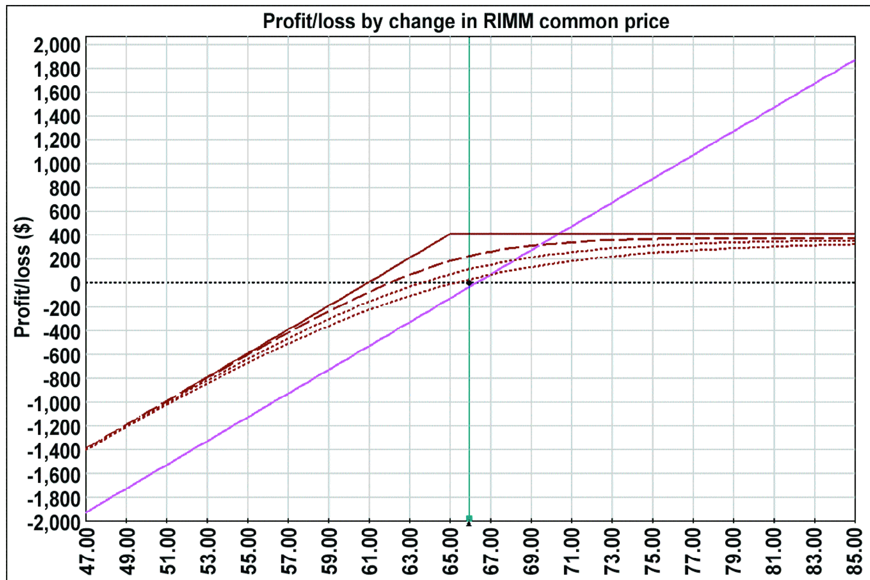
Blackberry manufacturer Research in Motion has been an ideal covered call candidate in 2009. RIMM is an attractive technology stock with a hot product, a 2.15 beta value, average daily volume of

15 to 20 million shares, and average daily options volume of roughly 155,000 contracts in June 2009. Moreover, RIMM's first-quarter earnings per-share (EPS) beat analyst estimates on June 18 — a positive sign — although its earnings forecast was "lukewarm."

Figure 1 (p. xx) shows a daily chart of RIMM from Jan. 1, 2009 to July 10, 2009. After climbing 145 percent off the March 9 low, the stock fell 26 percent to $63.36 around its June 18 earnings report. A covered call on RIMM was entered on July 10 by purchasing 100 shares at $65.95 before the open and selling a September 65-strike call for $5.00 after the open. This call was slightly ITM with a extrinsic value of $4.05, meaning you would still keep that extrinsic value even if RIMM dropped to

continued on p. x

FIGURE 3: COVERED CALL VS. OUTRIGHT PURCHASE



Notice the outright purchase (purple line) outperforms the covered call only if Research in Motion rallies above $70.50. If RIMM drops, the position's losses can be as much as $5 less than with the outright purchase.

Source: OptionVue

$65 by expiration, which is an advantage of selling near-the-money calls.

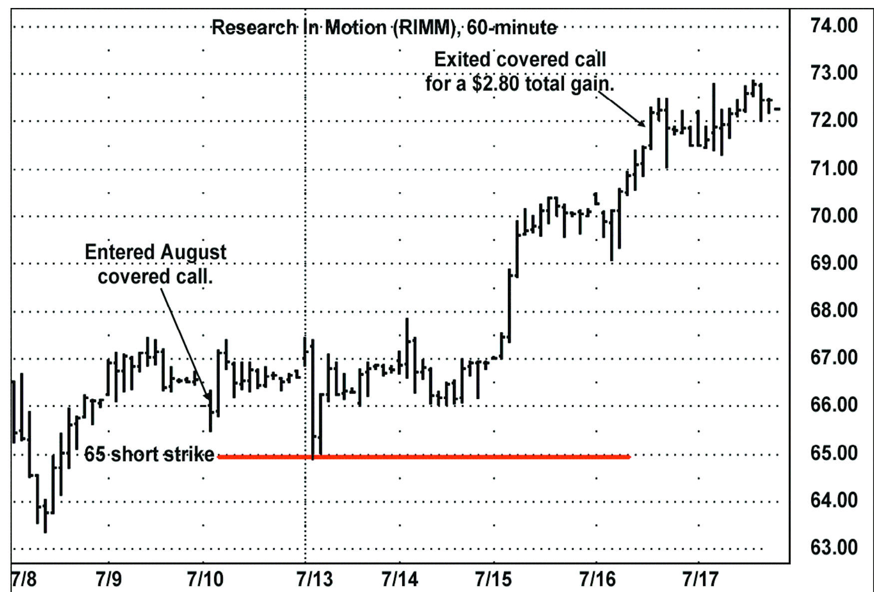
Table 1 (p. xx) shows the trade's details. Buying 100 shares costs $6,595, but when you sell the 65-strike call, that cost is reduced to $6,095. Figure 2 (p. xx) shows the covered call's potential gains and losses at the Aug. 22 expiration (solid line) and three interim dates (dashed lines). Selling the call for $5 protects the position down to $60.95 — a 7.6-percent drop — until expiration.

The trade's upside potential isn't shabby either. If RIMM is above $65 at expiration the position will earn 6.1 percent — an annualized return of 52 percent. If this happens, you effectively bought RIMM at $60.95 and sold it at $65.

Figure 3 (p. xx) compares the position's potential gains and losses to simply buying 100 shares of RIMM (purple line). Notice the outright purchase outperforms the covered call only if Research in Motion rallies above $70.50.

However, too many people focus on an option position's possible gains at expiration. Waiting until then doesn't always make sense, especially if the underlying climbs sharply and allows you to capture most of the position's potential gains within just a few days. For example, when RIMM jumped to $71.92 on July 16 the covered call position was exited at a profit of $2.80 within six days (RIMM was sold at $71.92 and the short 65-strike call was covered at $8.17). This represents 70 percent of the $4.05 total potential gain at expiration (Figure 4 and Table 2). The $2.80 profit translates to 4.6 percent of the purchase price, and few companies offer that kind of dividend in six days.

FIGURE 4: CAPTURING QUICK GAINS



When RIMM jumped to $71.92 on July 16, the covered call was exited with a $2.80 profit.

Source: eSignal

TABLE 2: TRADE EXIT DETAILS

Position	July 10 entry	July 16 exit
100 RIMM shares +	-$6,595	$7,192
1 short August 65-strike call	$500	-$817
Total cost:	-$6,095.00	$6,375.00
Total gain:		**$280.00**

By exiting the covered call after a strong rally, the trade earned $2.80, or 70 percent of its potential gain at expiration. Although the short call was repurchased at a loss, the $6 gain in RIMM pushed the trade into positive territory.

A silver lining in down markets

But what happens if RIMM trades sideways or finishes below $65 when options expire on Aug. 22? At this point, you can sell another 65-strike call that expires two months later to protect the underlying stock position. You can repeat the process until RIMM finally trades above the short call's strike price at expiration and the underlying shares are called away by a long option holder.

What if RIMM drops? Let's say 37 days have passed, stock analysts are questioning RIMM's future earnings power, and the stock drops to $62.50. At this point, you can buy back the original 65 call and sell a 60-strike call that expires in another two months. The original August 65 call that sold for $5 should now be worth $0.70 (if you use straight-line depreciation for the call and assume it loses roughly $0.12 per day). Although you've lost $3.45 per share, you've earned $4.30 from the short call, which lowers the stock's purchase price to $61.65 from $65.95.

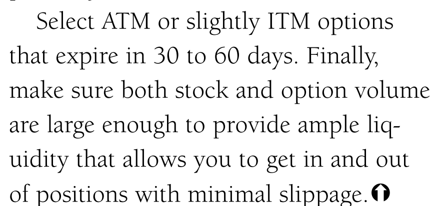
Now you can either exit the covered call at a $0.85 profit ($4.30 call gain minus $3.45 per-share loss) or exit and sell another ITM 60-strike call that expires in another month. Selling another call defends the position, creates more income, and keeps you in the game.

Final considerations

A covered call resembles a short uncovered put, which can generate large losses

if the underlying drops sharply and unexpectedly. However, if the underlying rallies after you enter a covered call, you can always take profits and repeat the process with a higher-strike call in a later-expiring month.

A conservative covered call can benefit from time decay and positive underlying price movement. By only selling calls with an extrinsic value of at least $2.50, you boost the odds that time decay will work for you. But if the underlying stock grinds lower, these variables will help protect your investment.



Select ATM or slightly ITM options that expire in 30 to 60 days. Finally, make sure both stock and option volume are large enough to provide ample liquidity that allows you to get in and out of positions with minimal slippage.

For information on the author see p. 6.

Related reading

"Covered calls vs. naked puts," *Active Trader*, February 2009.
A practical look at the differences between covered calls and naked puts. Find out why these aren't the diametrically opposing strategies they're often portrayed to be.

"Covered calls vs. cash-covered short puts"
Futures & Options Trader, July 2007.
A comparison of two strategies uncovers guidelines for choosing between them.

"Managing covered call positions"
Active Trader, February 2009.
Comparing different ways to actively manage a covered call trade highlights the positions flexibility and the importance of matching market conditions with the appropriate strategy.

"Rolling profitable covered calls"
Futures & Options Trader, April 2007.
Taking profits on a winning covered call is tempting, but extending the trade another month could generate additional profits.

"Repairing a losing covered call"
Futures & Options Trader, May 2007.
Covered calls are rarely a lost cause, even if the stock falls. Before taking a hit, consider these alternatives.

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