

From the Editor, Issue 09. 31/3/09

Covered Call Options Trading

Throughout 2008, markets chiefly went either down or sideways. For those committed to holding blue chip portfolios during this period, covered call options strategies helped harvest additional returns.

There are many different strategies available when it comes to trading options, ranging from the very simple to those that require advanced mathematical skills to understand. In this issue, we will be looking at a basic, yet effective, technique known as the covered call strategy. This strategy is low risk, simple to implement, and has been incredibly rewarding to those using it in the recent market climate.

A covered call strategy simply involves selling call options against one's existing share holdings. These option sales will yield solid returns through the premiums earned; so in a way, it is like receiving additional dividends from your shares.

Can I consistently make money with this strategy?

In short, the answer is "Yes". Let's have a look at why.

Imagine that a share can move in five possible ways (see the table below). The covered call strategy **tends to out-perform the underlying stock in four out of the five markets**. And where the strategy does under-perform, it still makes a profit.

Share price movement	Performance of a covered call strategy
Rising strongly	Under-perform
Rising slowly	Out-perform
Neutral	Out-perform
Falling slowly	Out-perform
Falling strongly	Out-perform

Is the covered call strategy for me?

Let's say there are two investors, Steve and Janet, who each hold 1000 BHP shares. Steve is a longer term, passive investor who is not really interested in selling his BHP shareholding. Janet, on the other hand, is looking to generate additional income and is happy to buy and sell BHP more frequently.

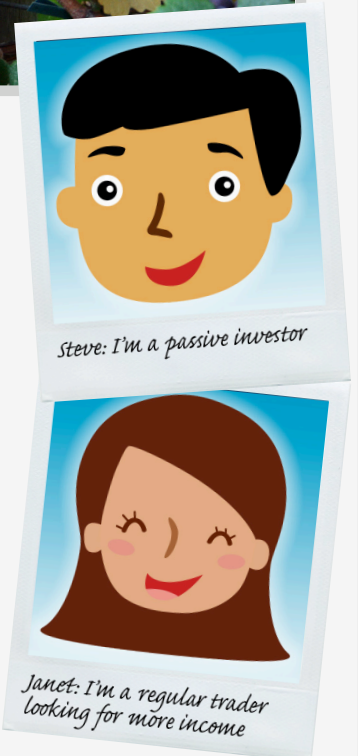


We'll see how Steve and Janet perform in the following examples, so you can see whether being a passive investor or a more active trader is for you.

Example One

We recommended call options be written on existing BHP shares in Issue 578 of The Rivkin Report (12 January 2009). At the time, the stock market had been swinging wildly and BHP had bounced from its November 2008 lows (around \$21) to \$30.72. See Graph One.

At this point, Steve, the passive investor, chose to take no action and simply continued to hold his stock. Janet decided to take up the recommendation, which was to sell (or write) calls that had a strike price of \$35 with an expiry date of 26 February 2009. In return, Janet received a payment of \$720, which is called the option premium.



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Covered Call Options Trading. cont...

If BHP increased to \$35 or more at any time up until 26 February, Janet would be required to sell her shares at \$35 to the option purchaser. This price of \$35 is 14% above the current market price of BHP; Janet is being paid to sell her shares above the current market price. The flipside is that Janet is limiting her upside on BHP to \$35.72 (\$35 per share + \$0.72 for the option premium). One option contract equals 1,000 underlying shares.

Fast forward to 26 February 2009. As you can see on Graph Two, BHP never managed to reach \$35, which is shown on the green horizontal line, meaning Janet got to keep her shares, along with the premium she earned.

Summary of Example

- Steve, the passive investor, holds his shares throughout the period.
- Janet, the more active trader, still held her shares at the end of the period and collected an additional \$720.
- As an added bonus, both Steve and Janet collected a fully-franked dividend of 64.9505c, as the ex date was 23 February.

Example Two

The market outlook was still uncertain at the start of March, so we recommended in Issue 585 (2 March 2009) covered calls again be sold against existing BHP shareholdings. At the time, BHP was trading at \$27.95 and we recommended writing calls with a strike price of \$29 that expired relatively quickly: 26 March 2009. The premium generated was around \$1.17, or \$1,170 per options contract.

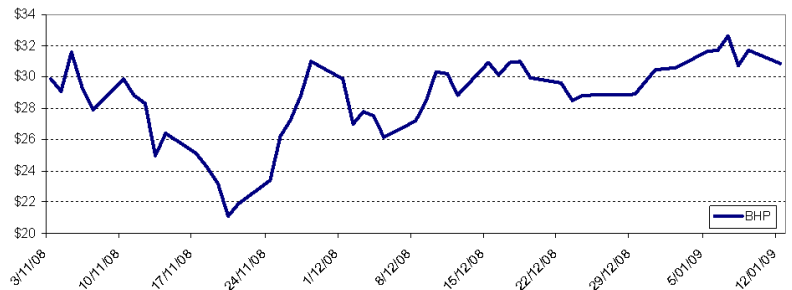
Janet decided to sell the recommended options, while Steve was happy again to just sit back and hold his shares.

Over the course of March, world share markets rallied from the bear market, lifting the share price of BHP along with it. Graph Three shows the share price of BHP over March, along with the \$29 exercise price in green.

As you can see, BHP moved beyond the \$29 strike, the options were exercised and Janet was required to sell her shares at \$29. Janet still kept the \$1.17 premium.

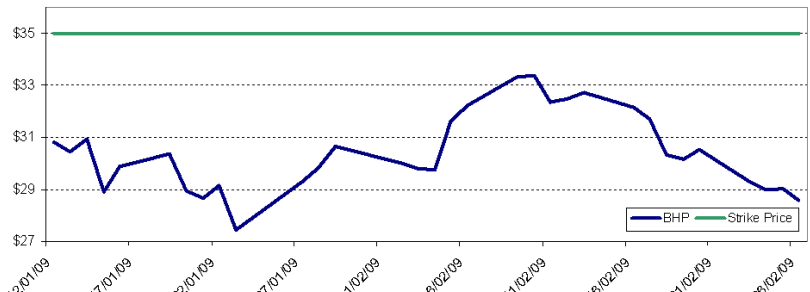
This example highlights the main risk with covered calls, which is to be exercised and required to sell at a lower price than market. It is crucial before entering the trade to be happy to sell the shares at the exercise price should that scenario

Graph One



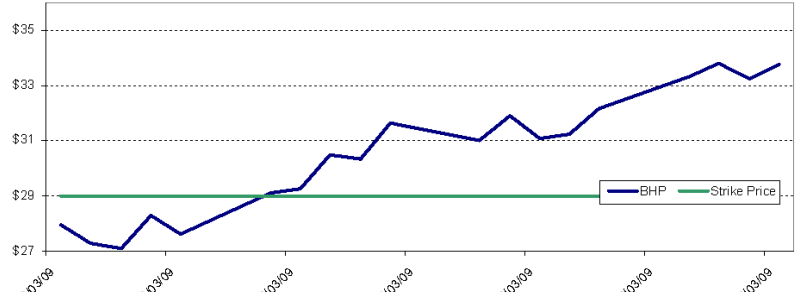
Source: IRESS

Graph Two



Source: IRESS

Graph Three



Source: IRESS

'There is a definite advantage in selling call options over a share portfolio...'

eventuate.

Summary of Example

Given Janet's fundamental view on BHP, she was content to sell the shares at \$29 and look for a cheaper re-entry point should the rally fade. Steve continued to hold his shares.

So What Happens If We Write Options Regularly?

The Securities Industry Research Centre of Asia-Pacific (SIRCA) performed some research on systematically selling call options over the S&P 200 index. Each calendar quarter, they sold call options at a strike price just above the price of the index. From 1987 to 2002, the strategy produced 11.83% p.a. compared to 9.59% p.a. for the S&P200 index. That equates to a 23% out-

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Covered Call Options Trading. cont...

performance of the index over a 25 year period. **Furthermore, the returns were more consistent each month and the strategy outperformed the index in 87% of cases.**

There is an S&P index that tracks the performance of the covered call strategy over the S&P 200 index; its ticker code is XBW. The XBW index assumes that the nearest out-of-the-money call option is sold and the nearest expiry date is chosen. Graph Four shows the return of \$1000 invested in the Buy-Write Index versus the S&P 200 Accumulation index.

A few things become apparent from the graph:

- The XBW significantly outperformed the S&P 200 from 1992 – 2003 when the market was mildly bullish to neutral.
- From 2003 – mid 2007, the XBW made a consistent profit, although it under-performed the general market, which was strongly bullish.
- In the recent bear market, selling calls options managed to reduce the draw down from 48% to 35%

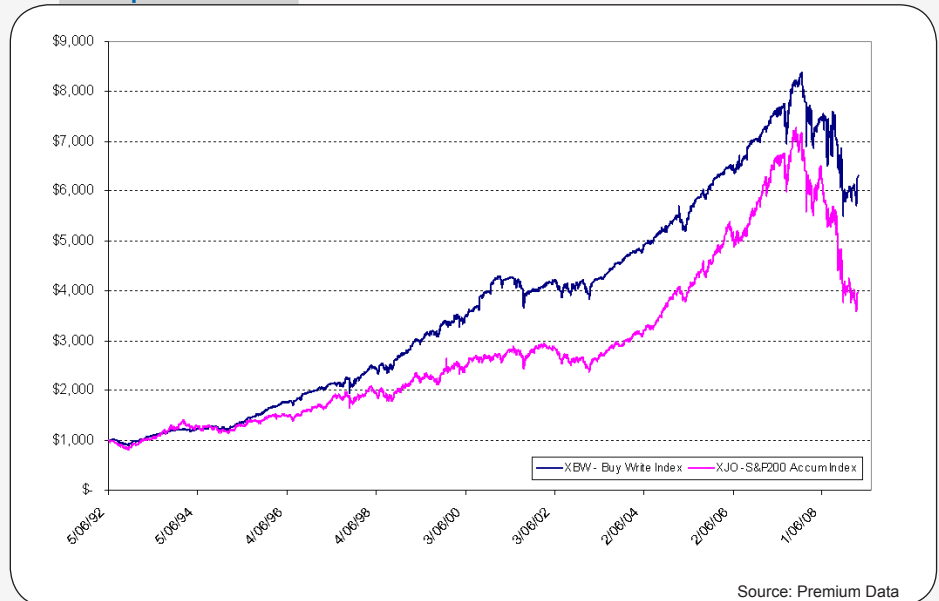
There is a definite advantage in selling call options over a share portfolio, given adequate diversification and a long-term view.

What Else Do I Need to Know?

The covered call strategy is one of the best ways to get started in the options market. Here are a couple of things to keep in mind when executing the strategy:

- You typically need to own 1,000 shares for each option contract. Doing this on “high” priced stocks (such as RIO) may be prohibitive for some traders, but there are others that may be more appropriate.
- Only apply this strategy if you are neutral or slightly bearish on the stock and you’d be happy to sell your shares at the option strike price. In a very bearish market, it is more worthwhile just selling the shares outright.
- Brokerage is typically around \$50 on an option trade, so we suggest that you aim to collect at least \$500 of option premium to make it worthwhile.
- Option prices are very sensitive to the daily underlying share price movement. You will get more option premium if you write the call option when the market is having an “up” day.

Graph Four



- The time decay on options is greatest in the last month to expiry. We generally suggest selling options that are less than 60 days to expiry to take advantage of this.
 - Don't sell your shares before the expiry date of the option.
 - There are approximately 30 stocks with options on them, and they are typically blue-chip stocks. Check the ASX website or the Australian Financial Review for details. The big four banks and the large resources companies have the most liquid options market.
- To the newcomer, trading options can be bewildering and it is useful having some guidance to lead you through the first few trades. If you have any questions, please feel free to contact our in-house Option Specialist and our Stock Consultants, who can walk you through the trade.

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