

Investing with Options - The Covered Call

Over the years I have taught many friends and co-workers about stocks and options. This was actually one of many impetuses for me to start this blog. Too many people are fooled into believing that options are too risky and complicated. This just isn't the case and I want to help take your investing to the next level.

If you truly want to be a self-directed investor, you need to understand how to use options in your portfolio. Even the great Warren Buffet uses options in his investing activities and that's from a guy that likes to keep things simple. I am going to show you how investing with options can be very simple.

In February I laid out [rule number 1 of 10](#) of the investment rules I use to guide my participation in the financial markets. In that post I proposed that options are not nearly as risky as the financial media and the so called experts make them out to be. Although they can be risky if you use them in the wrong way, so can stocks. Risk is a function of education in anything that you do. If options are used correctly, they will reduce your risk, increase your probability of profit, and give you more than one way to profit.

In the follow up post to rule #1 I also gave an example using a covered call. So I thought it would be a good time to circle back to give you the basics of the covered call so you could start using it in your own arsenal of strategies.

Where do we start?

I will assume that everyone know what a stock is and what it represents.

But let me define what a call option is:

A call is a financial contract between two parties- a buyer and a seller. The buyer has the option but not the obligation to buy a certain quantity of the stock (underlying) from the seller for a defined price (strike price), by a certain date (expiration date). The seller has the obligation to sell the underlying if the buyer exercises his right. The seller collects a payment (premium) from the buyer in

return for taking on such an obligation.

Note: in almost all cases we want to be the seller of the option. The reality is that 80% of options expire worthless, which as you will soon see is a good thing for the covered call strategy.

Example: *Let's look at an analogy that will make this easier to understand. Let's say that you are in the market for a used car. You find a listing on craigslist that you want to check out. It is a 2011 Hyundai Sonata with 60,000 miles on it and it is listed for \$10,000. This could be the perfect car, so you call up the seller to go check it out. You check the car out in person and take it for a test drive and decide this is the car for you. The only problem is you don't have \$10,000 on you to pay for the car.*

You tell the seller you want the car but you won't have the money until the end of the week. However, you are willing to give him \$500 now and \$10,000 at the end of the week (\$500 more than asking). The seller agrees to hold the car until the end of the week in return for the non-refundable deposit of \$500. Even if someone came along and offered him \$12,000, he is obligated to reject that offer until the end of the week.

This is exactly how a call option works. You locked in the price of \$10,000 (strike price) for the car, regardless of someone else offering him more money (or if the stock goes higher). You have until the end of the week (expiration) to exercise your right that you paid \$500 for. As the seller, you collected a premium for taking on the obligation of selling your car for \$10,000.

Does that make sense? Feel free to ask me questions below to help clarify anything that is still a little fuzzy.

The Covered Call

In my opinion, after you have a basic understanding of call options the first strategy to deploy is the covered call. Even if this was the only strategy you ever employed you would have an edge over 80% of the other retail investors out there.

The covered call is a natural “first” strategy because it is the closest thing to doing what most people understand well – and that’s buying stock with only one difference. Now we are going to sell a call against that stock that limits our upside, while at the same time providing us with a reduction in cost basis and an increased probability for success. I like to call the reduction in cost basis the “cushion” or “downside protection.”

Don’t worry, we are not giving up all of our upside! You get to decide how much upside you are willing to give up. As you will see in the example below, whenever you initiate a covered call, you will always know the maximum profit you can make. Remember though, there is always a tradeoff. In this case we are willing to reduce risk, increase our probability of profit, and give our position more than one way to win. The tradeoff to all of this is a defined upside. You will not be giving up as much as you think. How often do stocks really explode to the upside?

Let’s take a look under the hood and see what is really going on with the covered call. We will use INTC as the example, which is actually a real covered call I did back in March of 2013.

To provide a little context, INTC was trading right at \$21/share and was looking to sell the March 2014 (expiration) call for \$1.15 at the \$22 strike. Additionally, INTC pays a 5% dividend. Ok, so what does all this mean?

We all understand that if we buy a stock that we make money if it goes up in value and we lose money if it goes down in value. I think we can all agree on this.

Scenario 1: no options involved

Let’s first take a look of what the risk/reward potential looks like with being long or buying 100 shares of INTC at \$21.

Risk: \$2,100 price you paid for the 100 shares (21×100), stock could go to zero (theoretically)

Reward: Unlimited Upside & a 5% dividend

Break Even: \$19.95/share. Assuming you hold for one year and collect the full dividend for a year. ($\$21 - (5\% \times 21)$)

In this example, you basically have a 5% cushion from the dividend and unlimited

upside potential.

Scenario 2: using the covered call strategy

Now let's take a look at the covered call and how it changes the dynamics of the position. We will now buy 100 shares and sell 1 \$22 strike for \$1.15/share

Risk: \$1,985 price you paid less the premium you collected for the call ($21 \times 100 - 1.15 \times 100$) (notice that your risk is \$115 lower in this scenario)

Reward: \$215 & a 5% dividend = \$320 max gain if called away or 16.1%.

Break Even: \$18.80/share. Again assuming you hold for one year and collect the full dividend. ($\$21 - (5\% \times 21) - (1.15 \times 100)$)

There are major two differences between the two examples that I just outlined above:

1. By selling a call against your shares you are capping your upside at \$22/share in return for \$1.15/share. So you are collecting 5.5% for obligating yourself to sell your shares at \$22 should INTC trend higher above this strike by expiration. So you have essentially locked in a max gain of 16.1% (not a bad annual return if you ask me)
2. By selling the call you have not only doubled your cushion or downside protection from 5% to 10.5% you have also increased your probability of success, giving you an edge over the majority of other market participants. What I mean is that the stock could fall 10.5% by expiration in March of 2014 and you still would not be down any money.

Note: In most cases you will want to sell a call that is 'out of the money,' which means the strike price of the call is greater than the current price of the stock.

I don't know about you, but I am willing to cap my gains at 16.1% for the extra downside protection. And there is also a very possible scenario that INTC does not trade higher by expiration, which would allow you to both keep your stock and the premium you collected. Then you can turn around and do it again. I have had some stocks where I have done this so many times that my cost basis is getting really close to zero.

Note: At the time of this investment, the call had a 65% probability of expiring out

of the money by expiration. Meaning there was only a 45% chance that I would ultimately have to sell my shares to the buyer of the option. And in reality the buyer is not likely to exercise his option unless the stock is at least \$1.15 in the money (based on the premium he paid you). This is because his breakeven is \$23.15 (\$22 strike price + \$1.15 premium paid). He is better off to sell his option back in the open market to close his position.

By the way, you can sell options monthly if you want. I just gave the annual example because it made it easy to put things in terms of an annual return.

Take away

Like I said above, if you do nothing else but the covered call, you are going to do better than 80% of the investors in the market place. I look at covered calls as a way to enhance my returns. And if a stock doesn't pay a dividend, this is a way to create a synthetic dividend.

When initiating a covered call you are effectively buying the stock for less than the market price because of the premium you received.

Let me know what questions you have in the comment section below. I know there are plenty of questions out there. And my hope is that you will ask your questions and I will be able to use that to expand on this strategy further in future posts. I also promise to reply to each comment. I appreciate you taking the time to read this and leave your comment below.

- Gen Y Finance Guy

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Gen Y Finance Guy

Hey, I'm Dom - the man behind the cartoon. You'll notice that I sign off as "Gen Y Finance Guy" on all my posts, due to the fact that I write this blog anonymously (at least for now). I like to think of myself as the *Chief Freedom Officer* here of my little corner of the internet. In the real world, I'm a 30-something former C-Suite executive turned entrepreneur turned capital allocator. I am trying to humanize finance by sharing my own journey to Financial Freedom. I believe in total *honesty* and *transparency*. That is why before I ever started blogging, I decided that I would share all of my own [financial stats](#). I do this not to brag, but instead to inspire motivate, and also to hold myself accountable. My goal is to be a beacon of hope, motivation, and inspiration for *you*, the reader, by living life by example and sharing it **all** here on the blog. My sincere hope is that you will be able to learn from me - both from my successes and my failures! [Read More](#)