How to generate a monthly income with covered calls

Many investors are interested in strategies that help supplement their income on a monthly basis as a way to complement their portfolio.

Covered calls are widely viewed as a conservative options strategy that can help to achieve this goal. In fact covered calls have been deemed by the ASX to be safer than purchasing stocks alone as they have been proved to reduce the volatility in portfolio returns when used correctly. (www.asx.com.au)

How it works

Investors who hold 100 shares or more in a blue chip company are able to sell 'covered calls' to collect a premium, typically on a monthly basis. The buyer of that call, is buying the right to purchase the stock from you at a pre-determined 'strike price' before the 'expiry month' of the call. These terms are described in more detail below.

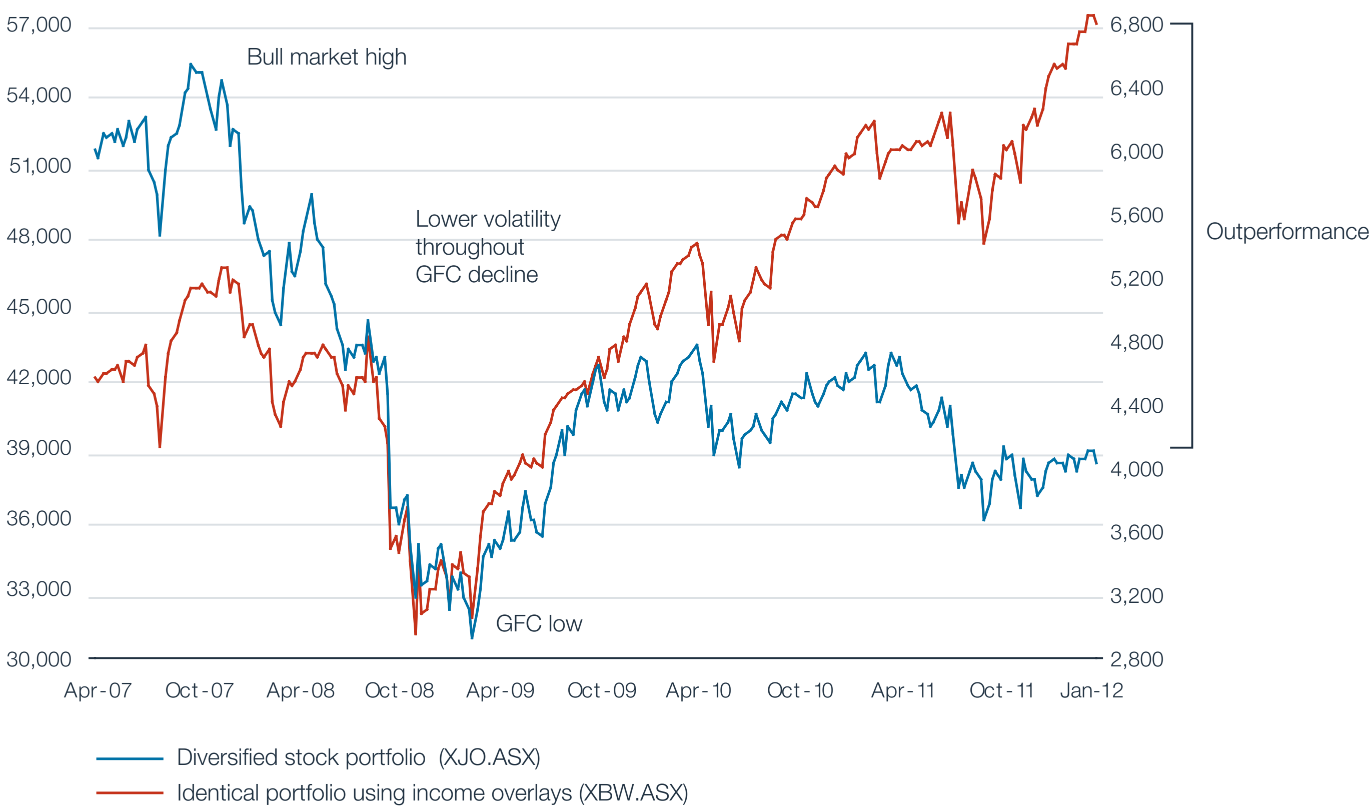
As the seller of the option, you are able to set the terms on the trade. The premium collected from selling calls will depend on three factors:

Strike price: This is the pre-determined price that the underlying shares will be traded at should the option be exercised by the options buyer.

Months to expiry: Sellers can choose to sell options for any number of months, the further out they sell the larger the premium collected.

Number of contracts to be sold: For every 100 units of shares held, investors can choose to sell one call contract.

Buy Write Strategy vs Stock-only Portfolio



Here is an example of how it works

Assume an investor holds 1000 units in XYZ which is trading at $32.50. They can choose to sell 10 calls at a strike price of $35 which will expire in one month's time, for which they will receive a $700 premium.

If XYZ closes below $35 then the sold call will expire worthless for that month and the seller of the option will keep the $700 premium* and continue to hold their stock. They can then choose to sell another call for the following month and collect a similar premium.

Prior to expiry, you may have the option of closing out the position to avoid exercise. However, if XYZ closes above $35 at expiry as the seller of the call, you will be required to sell your 1000 XYZ at the exercise price to the buyer.

Understanding the risks

Covered call writing holds two main risks:

- Just like holding a normal stock portfolio, if the underlying stock price drops in value, the investors holding value will also fall. However, by selling covered calls, investors collect a premium which helps to reduce these falls. In other words in a falling or a flat market covered call writers would do better than someone who holds the same stock on its own.
- If the stock price rises dramatically, the seller of the option will only receive the 'exercise price' of the option that they sell together with the premium received on the option. In a strong bull market investors can miss out on potential upside if they sold the call with a strike price that is too low.

Strategy performance

One of the most common questions posed is how this strategy performs over a lengthy period. Fortunately, the ASX tracks a covered call portfolio under ticker code XBW. The results speak for themselves.

The chart shows you how a portfolio using covered calls (red) has significantly outperformed a 'stock-only' portfolio (blue). The chart shows that this strategy works best in a slow moving market. Over 2011 / 2012 this strategy allowed clients to make new pre-GFC highs from their portfolio despite the overall market remaining stagnant. Even throughout the GFC, the losses incurred were much lower than owning a diversified stock portfolio alone.

What are the main factors that affect the price of the premium received?

For investors who do not want to risk selling their stock, they can choose to sell the option at a strike price much higher than the last traded price. However, this reduced risk will provide a smaller premium.

Likewise, an option which expires in three months' time will collect a larger premium to an option that expires in one month's time. This is because the buyer of that option will have a longer time to choose whether to exercise the option and take up the stock at the pre-determined price.

We can do the hard work

The above guide explains this strategy in an easy to understand manner. However, to implement this strategy in the most effective way, experienced advice is crucial.

Fortunately, we have a number of experienced advisers available to help you utilise this strategy and avoid some of the common pitfalls.

We transact this exact strategy over a range of stocks for our clients on a regular basis. We do not charge any ongoing management fees and are able to structure advice for varying market conditions. Contact us to discuss how to include Covered Calls in your own portfolio today.

Want more information?

We recommend that you speak with one of our ASX accredited derivatives advisers, who may assist you to understand our options strategies that could potentially generate a monthly income.

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* Please note the premium quoted in the above example is for illustration purposes only and the exact amount received will vary depending on various factors including share price, volatility etc.