

## **How Covered Call Options May Work to Build Income Wealth and Lower the Risk of Investment in Securities**

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None of the examples given to illustrate how covered call option transactions work should be construed to imply that they are illustrative of actual or potential results. Actual results may be substantially different from the assumptions illustrated.

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### Why should most people invest in equities of some amount ?

In a word: INFLATION. Inflation is the “silent” tax on rich and poor alike in its erosive effect on buying power. It is “silent” in the sense that the Congress doesn’t have to pass a law to order it increased, but the laws and policies that they do pass and pursue affects economic production and the amount of money available to chase the goods of that production. So, if it costs more dollars to buy the same loaf of bread or same car that was available last year at a lower price, my buying power for my dollar has eroded. I need more dollars of income to maintain my buying power, even though I may only be standing still in terms of real wealth accumulation.

During stock market corrections or crashes, like the most recent one we’ve experienced, there is a great urge to “protect ourselves” by getting out of the market and putting everything in

CD's or savings—even though the interest rates are nil or extremely low and 2% or 3% below the inflation rate for goods and services purchased. From a buying power standpoint, your interest is negative and you are losing wealth; you will have less future buying power, but since it may be only be 2% or 3% negative, we are lulled into thinking we're better off than being invested in equities. But what happens, if the multi-trillion "stimulus" monies actually get into the hands of businesses and consumers instead of the bank vaults shoring up bank balance sheets? INFLATION ! In addition to the bail out money overhang, the government continues, almost daily, to announce enormous dosages of monetary medicine. In an August 18, 2009 New York Times article by one of today's most successful long-term investors, Warren E. Buffet, Mr. Buffet states that except for the war years 1942-1946, the largest U S deficit incurred since 1920 was 6% of Gross Domestic Product. This year, it will be 13% of GDP ---an astronomical \$1.8 Trillion. In his usual greatly understated style, Mr. Buffet says, " Fiscally, we are in uncharted territory." He goes on to point out that even under the best of conditions, with other nations ( notably, China) lending us \$400 Billion and U S Citizens opting to buy another \$500 Billion of U S Treasuries, "the U S Treasury will have to find another \$900 Billion to finance the remainder of the \$1.8 Trillion of debt it is issuing. Washington's printing presses will need to work overtime." INFLATION ! Some of us can remember the Jimmy Carter days with its stagflation and combined interest and inflation rates of upward of 20%. Our present "uncharted waters" could make those Carter days seem like "the good ole days".

The stock market with its over 100 hundred year upward trend, with about three times as many upward growth times (bull markets) as downward times (bear markets) and with the bear times usually much shorter than the bull times, the evidence weighs heavily that the equities markets are the best way to stay even with or surpass the inflation rate and maintain or improve our buying power currently and to accumulate wealth.

### Which Equities?

Your equity investments will be no better than the advice and information you follow in the selection process.

Find a competent Registered Investment Advisor ( RIA) firm and let them advise you on a fee-only basis. In this arrangement no commissions or transaction costs are incurred as the security trades are placed on your behalf. Furthermore, an RIA has a fiduciary responsibility to the investor, to not make investments for the client that would enrich the advisor to the detriment

of the investor. For smaller accounts (usually under \$25,000 in assets), a transaction fee basis may be the best approach for the client until the account grows to sufficient size.

Select an advisor that is able to give or obtain for you **competent tax advice** with respect to your investments. It's not just about making profits on the investment, but also minimizing taxes to be able to "keep" more of what you've earned.

**While no advisor can guarantee results based on past transactions or future expectations, the advisor should be able to explain his rationale in selecting stocks for your portfolio and for preserving capital in downturns. Since there are usually some sectors of an economy that are performing well or better than others, even during general market downturns, your advisor should have an understanding of the economics driving those key sectors and be able to help you profit from them. Much of investment management and advice is "science" in that past earnings and investment performance is measured and analyzed mathematically, but superior results quite often depend equally or greater on the "art" of applying tools and techniques that can enhance earnings and monitoring progress and making adjustments as needed. One of the tools and techniques you should become aware of is the use of "covered call option selling" in conjunction with carefully selected equity shares.**

#### What are covered call options?

First, let's examine what a "call option" is. It is the contractual right (but not the obligation) to buy a security (or, perhaps, land or some other asset) by some future date (the "expiration" date) at a definite future price (the "strike" price). The length of time to the future date is the "period" of the option." The party who grants an option to another is the "seller" (or "writer") of the option. The person receiving the "option to buy" is the "buyer" and pays the "seller" an amount that is a relatively small percentage of the present value of the optioned security or asset or, more accurately, a percentage of the "strike price". This payment is called the option "premium." The stock against which an option is sold is called the "underlying stock".

Options on stocks are traded in a public securities market just as the underlying stock is. It is important that the underlying stock be of a market capital size such that there is a broad liquid market for the stock and for any option sold against it. Market liquidity helps assure the best pricing and the ability to open and close trades in the stock and the options.

Option prices move up and down in relationship to their underlying stock's price but not necessarily dollar for dollar until the strike price is reached. Additionally part of option prices for options that have not reached the expiration date is "time" premium that depreciates as the expiration date nears. It is this depreciating factor for time premium that makes it profitable for the SELLER of options, because historically about 80% of stock options expire worthless to the buyer, and the seller gets to keep 100% of the premium received on the sale.

If the option buyer lets the option "expire" (Does not buy the stock at the future strike price within the option period) the seller retains the entire "premium" as "profit" and the option buyer incurs a "loss". If the option buyer exercises the option, he pays the option seller the "strike price" and the option seller is obligated to deliver the security or asset referenced by the option contract to the buyer. The option seller has a profit on the transaction equal to the difference between what the option seller originally paid for the security just sold to the option buyer and the "strike price" just received PLUS the "premium" amount received when the call option was sold. Again, notice that the option **seller** never gives up the premium received.

Options **may** be bought and sold without owning the underlying stock, but this is somewhat more speculative. When the option owner owns enough stock to meet the exercised option delivery obligation BEFORE he sells a call option to an option buyer, he has sold a "Covered Call"—that is, his POSSIBLE future delivery obligation of the actual stock can be met by what he has on hand presently. It is this feature of being "covered" that makes "covered call" SELLING a conservative technique in that the stock is available from the beginning of the transaction AND the Seller never returns the "premium" to the Buyer. For the BUYER of the option, the transaction is much less conservative. Although the risk of loss on the transaction to the option Buyer is limited to the amount of premium he pays, he runs the possible risk of losing the entire premium, if the option contract expires unexercised. If the Buyer does exercise the option, the premium adds to his cost of buying the stock. By the way, ONE option relates to ONE HUNDRED shares of the underlying optioned stock.

So why would anyone want to **BUY** a call option? In his analysis, the option buyer may believe, for example, that a stock that is selling for \$20 has potential in the future of rising to \$30 or \$35 in 6 months, so he may be willing to buy an option with say a \$25 "strike price" good until 6 months in the future for a premium of \$2 per share. The option buyer pays the covered call "seller" \$200. (One option represents 100 shares. 100 times the \$2 premium = \$200.) To have purchased 100 shares of the actual stock would have cost him \$2,000 rather than one option costing \$200 (10:1). If the buyer is wrong in his assumption, he loses a maximum of only \$200. If correct and the stock moves to \$32, he may exercise the option,

buying the stock for \$25 per share and perhaps selling it immediately for the current price of \$32. He would make a profit of \$5 per share (\$32 minus \$25 minus \$2 premium) for a total on 100 shares of \$500. He only had \$200 invested in the option, so his profit is 250% in 6 months or 500% annualized. If, instead he had invested \$2,000 for 100 shares of actual stock he would have \$1200 profit ( \$32-\$20 times 100 shares) or 60% or 120% annualized. The potential percentage of return versus risk for the option compared to the expected return for investing in the actual stock may be attractive to the investor. The potential for the loss of his \$200 premium, however is 100% for the 6 month period.

Now let's see how the same example would affect the **option SELLER**, assuming that he owns 100 shares for which he paid the present price of \$20 per share or \$2000 total. If the option expires unexercised, the seller retains the \$200 as ordinary income for a 10% return in 6 months (\$200/\$2000) or 20% annualized. He could then sell a new option against the same shares to enhance his annual income further perhaps garnering nearly an actual 20% return , not counting any change in the actual underlying stock. If the stock moves to \$ 32 as in our example above and the option is exercised by the option BUYER as assumed above, the option seller would surrender the stock and receive the \$25 strike price or \$2500 PLUS he would retain the \$200 premium previously received, for a total gain of \$700 or 35% for 6 months or 70% annualized, and now the gain would be capital gain—short or long-term.

Another way of viewing this from the option Seller's viewpoint, is that , upon receiving the \$200 option premium, the cost of his investment was reduced to \$1,800 from \$2,000, so selling covered call options, reduces investment risk for the option SELLER. Viewed like this, the option seller's gain of \$500 on the underlying stock surrendered at the \$25 strike price yields a 28% return on investment for 6 months ( \$500/\$1800 net investment )

#### But what if the underlying stock of a covered call transaction moves downward ?

Assume the same illustrative facts as above, except the underlying stock moves downward. Since \$200 premium was received, the at risk investment for the option seller was lowered to \$1,800 or \$18 per share when the covered call option was sold. That means the underlying stock can move downward to \$18 per share and still breakeven. There is, then, a conservative expectation of results for covered call selling. But, another factor comes into play.

When a call option is sold, it is sensitive to expiration of time and to downward (or upward) movements of the underlying stock that covers the call. As indicated earlier, there is an active market for buying and selling options just as there is a separate active market for buying and

selling the actual stock. So if today an option's market value is \$2 per share, if the underlying stock does not move at all, in a few days, with time to exercise date getting closer, market value of the option will decline as it loses "time value". Similarly, if the underlying stock value moves downward and further away from the option's "strike price", the market value of the call option will decline and is said to be losing "intrinsic value". **This does not mean that any of the original premium is being lost by the option seller.** So, if the stock moves down to our new breakeven point of \$18 ( \$20 minus original \$2 premium), perhaps the market value of the call option will decline to say \$0.25.

We could close out our option obligation by re-purchasing it for \$0.25 then seeking to sell a new call option with a strike price of perhaps \$22.50 at a premium of perhaps \$1.75. If successful, our new breakeven point would be \$16.50 ( \$20.00 minus \$2.00 original premium plus \$0.25 repurchase minus \$1.75 new premium). Thus we have lowered our investment at risk from \$20 per share to \$18 then to \$16.50 ---WITH THE MARKET MOVING DOWN. That further shows that covered call selling can be conservative in up or down markets and can help us preserve capital. In a market crash situation, close monitoring of the covered call conditions, could call for liquidating positions more precipitously to conserve capital for the next upturn, but in an orderly correction , covered call selling can give us staying power by lowering breakeven points and reducing investment risk.

### Conclusion

Covered call selling is an investment technique coupled with artful application and monitoring that may enhance wealth growth and conservation of capital. By enhancing gain on underlying stocks that don't move at all or that move upward and perhaps enhancing potential gain after a market downturn by reducing the breakeven point, we have the best effort to outpace inflation and maintain and improve buying power. It gives us more staying power in down markets so that we are less likely to miss the next upturn by being out of the market—as many have done by missing the 30%-45% increase in the general markets since March 31, 2009.

Finally, it is an excellent technique for IRA investment, since there is no immediate taxation of the income generated from premiums, and in a ROTH IRA can become forever non-taxable.