13. Covered Calls.

In covered call strategy call options are written against a holding of the underlying security. Using, this strategy the investor gets to earn a premium writing calls while at the same time appreciate all benefits of underlying stock ownership, such as dividends and voting rights, unless he is assigned an exercise notice on the written call and is obligated to sell his shares. However, the profit potential of covered call writing is limited as the investor had, in return for the premium, given up the chance to fully profit from a substantial rise in the price of the underlying asset.

Covered Call (OTM) Construction

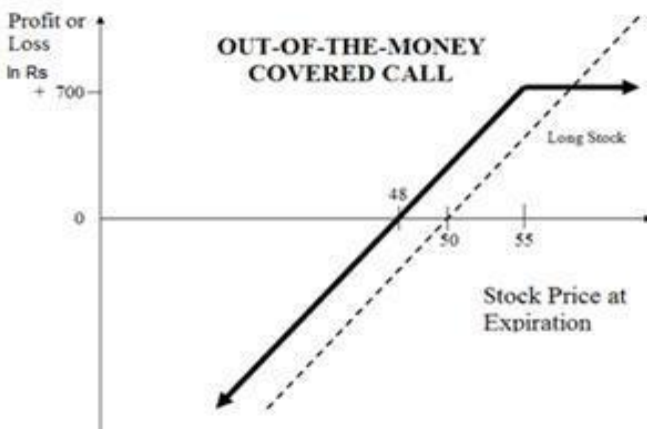
Long 100 Shares; Sell 1 Call

In construction of covered call we are assuming 1 lot size is consist of 100 shares.

Example

An options trader purchases 100 shares of XYZ stock trading at Rs.50 in June and writes a JUL 55 out-of-the-money call for Rs.2. So he pays Rs.5000 for the 100 shares of XYZ and receives Rs.200 for writing the call option giving a total investment of Rs.4800. On expiration date, the stock had rallied to Rs.57. Since the striking price of Rs.55 for the call option is lower than the current trading price, the call is assigned and the writer sells the shares for a Rs.500 profit. This brings his total profit to Rs.700 after factoring in the Rs.200 in premiums received for writing the call. It is interesting to note that the buyer of the call option in this case has a net profit of zero even though the stock had gone up by 7 points. However, what happens should the stock price have gone down 7 points to Rs.43 instead? Let's take a look. At Rs.43, the call writer will incur a paper loss of Rs.700 for holding the 100 shares of XYZ. However, his loss is offset by the Rs.200 in premiums received so his total loss is Rs.500. In comparison, the call buyer's loss is limited to the premiums paid which is Rs.200.

Covered Call Payoff diagram:



Out-of-the-money Covered Call

It is a covered call strategy where the moderately bullish investor sells out-of-the-money calls against a holding of the underlying shares. The OTM covered call is a popular strategy as the investor gets to collect premium while being able to enjoy capital gains (albeit limited) if the underlying stock rallies.

Limited Profit Potential

In addition to the premium received for writing the call, the OTM covered call strategy's profit also includes a paper gain if the underlying stock price rises, up to the strike price of the call option sold.

The formula for calculating maximum profit is given below:

Max Profit = Premium Received - Purchase Price of Underlying + Strike Price of Short Call - Commissions Paid

Max Profit Achieved When Price of Underlying >= Strike Price of Short Call

Unlimited Loss Potential

Potential losses for this strategy can be very large and occurs when the price of the underlying security falls. However, this risk is no different from that which the typical stockowner is exposed to. In fact, the covered call writer's loss is cushioned slightly by the premiums received for writing the calls.

The formula for calculating loss is given below:

Maximum Loss = Unlimited

Loss Occurs When Price of Underlying < Purchase Price of Underlying - Premium Received

Loss = Purchase Price of Underlying - Price of Underlying - Max Profit + Commissions Paid

Breakeven Point(s)

The underlying price at which break-even is achieved for the covered call (OTM) position can be calculated using the following formula.

Breakeven Point = Purchase Price of Underlying - Premium Received

In next session we will revise all bullish strategies which we have discussed till now. For more details or any query related to today topic kindly contact us on knowledge@grovalue.in