2 Covered Calls

This chapter assumes you are familiar with the basic concepts of options, as discussed in chapter 1.

2.1 Two Ways to Sell An Option

The first and more familiar way is to first buy the option, then sell it. In "broker-speak" you first **buy to open**, then **sell to close**.

The second way is to first sell the option, then buy it back later. There's "broker-speak" for this too: **sell to open** and **buy to close**. Most people call this **shorting** or **writing** options. Both of these terms mean the same thing, and are used interchangeably.

It is the second method we will be talking about today. And while it may seem like you might end up in jail for selling something you don't own, you won't. Done properly, short option positions, unlike short stock positions, are relatively low risk. Selling call options on stock you own is an excellent way to get your feet wet with options and make some money in the process.

2.1.1 Naked vs. Covered Call Option Writing

As the seller of the call, it's important to remember that your counterparty (the call buyer) has the right to exercise the option. Should they do this, you must then deliver 100 shares of the underlying stock to them. You will be paid the strike price for each share, not the current market price. **Naked call selling** is selling a call without also owning enough of the underlying shares to deliver if the call is exercised. This is a very bad idea. It has the same risk profile as shorting stock, but without any of the corresponding potential profits. As an example of what might go wrong, consider selling a call with a strike of $20 and a premium of $5 without owning any shares of the stock. You might wake up one morning to find the shares, which were below $20, are now selling for $100. In this situation, the call buyer will certainly exercise, and to satisfy your obligation, you must purchase shares on the market for $100, and sell them to your counterparty for $20. The comparatively small amount of premium you receive from selling naked calls does not begin to compensate you for the additional risk you take on. To further discourage you from trying this, Figure 2.1 displays the profit/loss graph for naked calls. Note that the maximum you can make (shown by the microscopic green sliver in the graph) is capped by the premium you received from the call, while the potential loss (the ocean of red) is unlimited.

Covered call selling is much safer. To do this, you sell calls while also owning enough shares of the underlying stock to "cover" your calls if they are exercised. Properly done,

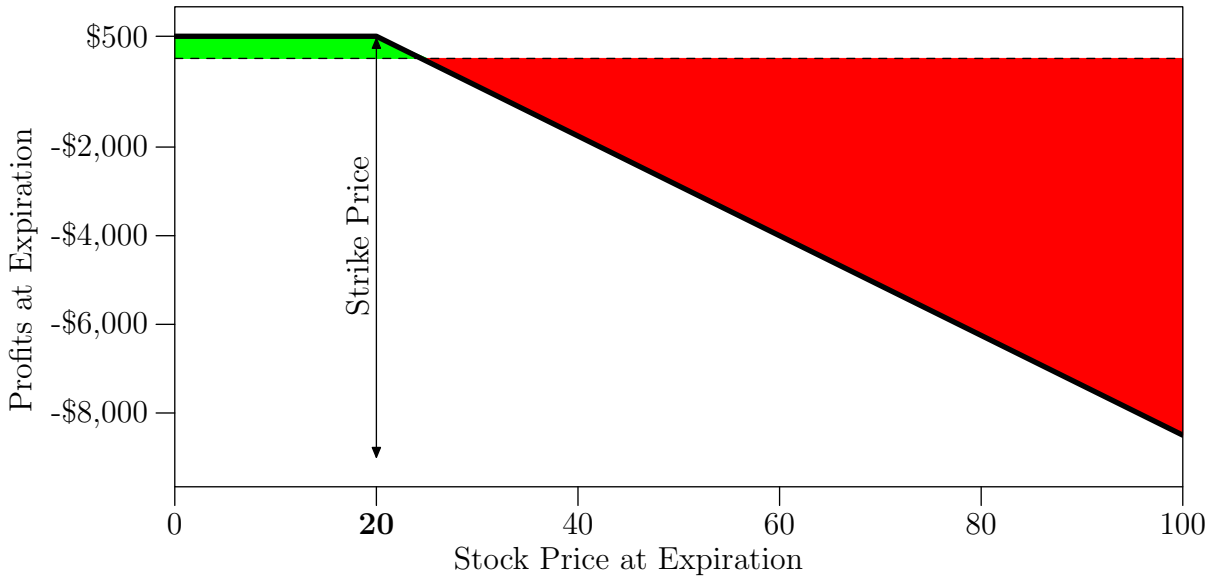

Figure 2.1: Profit graph of a $20 naked call option at expiration, showing potential profits (green) and losses (red).

selling covered calls is a low risk strategy that decreases the risk of owning the stock and can also generate considerable income. *Owning the stock and selling calls on it will outperform just owning the stock if the stock falls, stays the same, or rises slightly.* Covered call selling will not do as well as stock ownership if the stock price moves substantially upwards. This is particularly important since history shows that stock prices, when they increase, do so in sudden spurts. If you have written calls against stock that suddenly heads for the sky, your potential profits may be reduced. Careful selection of the underlying stock and the calls you sell can reduce this risk, but it can never be completely eliminated. For this reason, some investors avoid selling covered calls. This leads us to rule number one:

Rule Number One: Never sell a call against shares that you really want to keep.

There are techniques that can be employed when the stock rises too high or or falls too low, and we will cover them later. But the fact remains that your shares may be called from you before you have a chance to adjust your position.

2.2 Selling Your First Covered Call

It's January, you own 100 shares of Gorski's Goldworks, and you decide to sell a covered call. Gorski's is selling for $28, and you bought it at $20. You find a March $30 call which is selling for 3-points. You log-in to your brokers website, and select "sell to open" the March $30 call on Gorski's Goldworks. The order executes, and your online statement now looks something like this:

DESCRIPTION	QUANTITY	COST	CURRENT PRICE	PROFIT
GORSKI'S GOLD SHARES	100	2,000	28	800
GORSKI'S GOLD CALL	-1	-300	3	0
CASH	300			

Note that your broker records your short call sale with a negative number for the QUANTITY and COST. This makes sense, because you sold something you don't own, and now you have one less of it. Since you were paid for selling it, your cost for this transaction is a 'negative cost' — what you and I would call a payment. You can see that you also have $300 in cash from the sale of the call.

Moving along to February, we see that Gorski's Goldworks shares are now $32, so your short call will be more expensive — it's selling for 5-points now:

DESCRIPTION	QUANTITY	COST	CURRENT PRICE	PROFIT
GORSKI'S GOLD SHARES	100	2,000	32	1,200
GORSKI'S GOLD CALL	-1	-300	5	-200
CASH	300			

Note that as a short positions price goes up, your unrealized profit goes down. If this were a short-sale of stock, you might be a little worried. But since this is an option, you won't lose any money unless you decide to buy it back. The call is in-the-money at the moment, so if it were to be exercised and your shares called away, you will make a profit of $200 in the stock (since you must sell it at the strike price of $30). You still keep the $300 from sale of the call, for a total profit of $500. Exercise prior to expiration is unlikely, but it does occur.

Fast forward to the last trading day before expiration in March. Gorski's Goldworks is now $29. Your call is out-of-the-money again, and most of the time value you sold is gone. The call is now selling for 0.05-points

DESCRIPTION	QUANTITY	COST	CURRENT PRICE	PROFIT
GORSKI'S GOLD SHARES	100	2,000	29.0	900.0
GORSKI'S GOLD CALL	-1	-300	0.05	295.95
CASH	300			

On Monday, when you login to your brokers site, the call will have disappeared but not your profits. Since the call was not exercised, you still have your shares, and can repeat the process for more income.

Note that what you have done here is sold time value, and simply waited for it to evaporate. When it did, you kept the money you were paid for it, and can repeat this process as many times as you like.

2.2.1 Accounting for your Covered Call Profits

Your profits from the covered call reduce your cost basis in your stock. You first need to adjust your call profits for commissions and any taxes you would pay. Let's say your commissions were $10 and you will pay $90 in taxes on your covered call profits of $300. So your net profit is $200, or $2 a share:

Description	Cost	Adjusted Cost
Gorski's Gold	$20	$18

By profiting from the covered call, you have reduced your risk in owning Gorski shares. They can now drop as low as $18 a share before you have a loss of capital. Note that this is not the cost basis you have to report to the IRS when you sell your shares — you will still report the original purchase price for capital gains tax purposes.

2.3 More Examples of Covered Call Writing

Of course, the stock may not cooperate as nicely as it did in the previous example:

Example

If your Gorski shares drop below $25, you will have an overall loss in this combined position of stock plus call options. Whether this is something to be concerned about depends on the reasons for the price decline of the stock, and the amount you spent on the stock.

And it can also happen that Gorski's shares would increase enough in price that your call is in-the-money by expiration:

Example

Instead of falling, shares of Gorski's rise to $40 near expiration. At this point, you have two choices. You can do nothing and let the stock get called. Your counterparty will pay you $30 a share for the stock, and you received 3-points call option premium. Since the stock was selling at $28 when you established the covered call, this gives you 5-points of profit, for a total of $500.

However, you may wish to hold on to your shares of Gorski if you feel it is poised for more growth. To do this, you must buy back the call you sold. This will cost you $1,000, for a net loss of $700 (remember that you were paid $300 for selling the call). But since you still own the stock, you have an unrealized gain of 12-points per share since you established the covered call. Thus your net profit, including realized and unrealized gains and losses, is $500.

In this example, both decisions yield the same profit (this will not always be the case). The significant difference between these two decisions is not that one gives you realized gains and the other does not. Of more importance is that when you buy back the call, you still own the stock. It is not always easy to decide which course is the best. In the end, your own evaluation of the future potential of the shares is what must guide you in a case like this. If you feel the company's stock price is fairly valued, or over valued, then allowing the shares to be called from you is probably the best course. If the companies shares are undervalued and likely to move much higher, then you are better off owning shares.

This example also illustrates how covered calls can limit your potential profits from a steep upward movement in the stock price. The covered call seller will still make money if the stock climbs, but it may not be as much as he would have made without selling the call.

2.4 Profit Graph of the Covered Call

Figure 2.2 shows the profit graph for the Gorski's Goldworks examples in the previous section.[1] Even though the graph shows the numbers for our examples, all covered call profit graphs have the same shape and characteristics shown here.

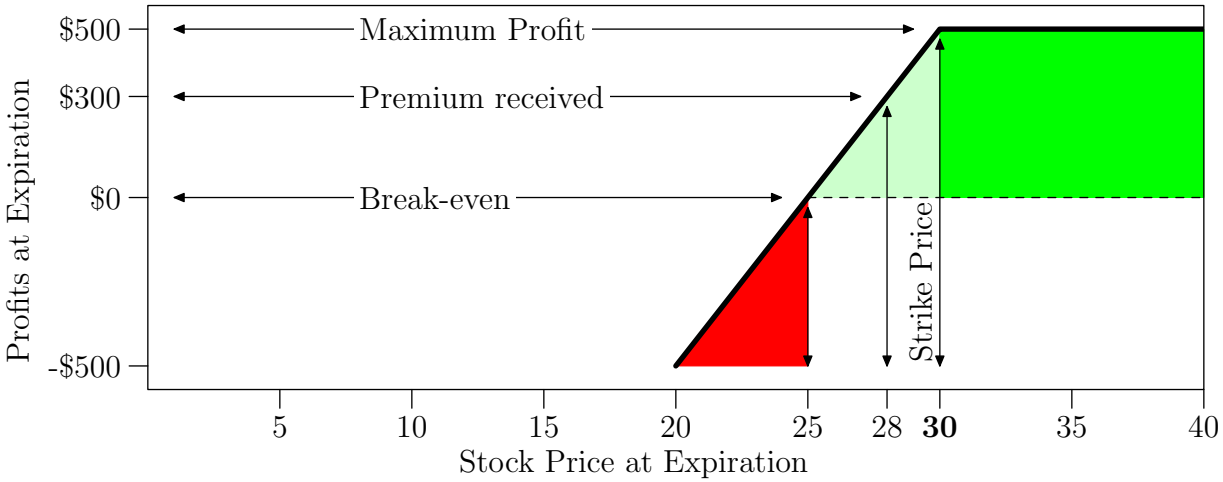

Figure 2.2: Covered Call Profit Graph showing maximum profit region (dark green), risk region (red) and intermediate profits (light green).

There are several points of interest. The **break-even** point is where there are zero gains and zero losses. Here it is at the stock price of $25. All the risks are below the break-even point, and all the profits are above it. The **maximum profit** always occurs when the stock reaches the strike price of the call. In this example the maximum profit is $500. It is obvious from the graph that no matter how high the stock may go above this point, the

[1]The graph makes the assumption that the call is bought back at parity.

maximum profit is not changed. You can also see that if the stock does not change at all, the covered call writer still makes $300.

There are ways to mitigate the problems caused by stock prices rising and falling too much. These will be discussed later.

2.4.1 Calculating the Maximum Profit and Break-even Points

These important points are easy to calculate:

Maximum Profit Per Share = Strike Price - Stock Price + Call Premium

Break-even Point Per Share = Stock Price - Call Premium

The stock price to use is the one at the time you sold your call. More precise formulas, which account for commissions and other costs are given in section 2.6.3, but these illustrate the concept.

2.4.2 Up to the Minute Summary

Here's what we have covered so far:

- You won't go to jail for shorting call options.
- Naked calls are short calls without a corresponding stock position in your portfolio.
- Selling naked calls is asking for trouble.
- Covered calls are short calls sold against stock you own. You must have enough shares to cover each option sold (typically 100 shares of stock should be owned per contract sold).
- Selling covered calls is a low risk way to make money and lower your risk of holding stock.
- You may lose your shares when you sell covered calls against them.
- Rule number one of covered call selling: Never sell calls against shares you want to keep.
- Covered calls will outperform simply owning shares if the stock falls, stays the same, or rises slightly.
- Covered calls can limit your profits from a sudden large increase in stock price.
- Your broker records short call sales with a negative quantity and cost.

- As the option goes up in price, your short call position will show a loss. You won't realize this loss unless you buy back the calls.
- As the option goes down in price, your short call position will show a gain. This is how much you would keep if you bought the call back.
- You should subtract the amount you receive from shorting a call from the cost basis of your stock.
- The maximum profit you will make from a covered call is when the stock is at the strike price.
- The maximum profit is calculated by subtracting the stock price at the time you purchased the call from the strike price of the call, and then adding in the premium received.
- Another point of significance is the break-even point. Below this point you lose money, above it you make money.
- You calculate the break-even point by subtracting the call premium from the stock price at the time you bought the call.

Time for a break, perhaps? Go watch T.V., then come back here when you are rested and refreshed.

2.5 Choosing Stocks as Candidates for Covered Call Writing

Avoid selling calls against stocks that will make large moves either up or down. This means you should be neutral or somewhat bullish on the stock. Many investors purchase undervalued shares which, after a period of time, reach their fair value. Once at their fair value, these stocks tend to trade within a fairly narrow range and make excellent candidates for covered call writing. If you are extremely bullish on a stock, expecting it to make a large rise, writing calls against it is too risky, because you may lose the stock and the gains that go with it, or be forced to buy back your calls at a loss. If you are bearish on a stock you should sell it, short it, or use another options strategy to profit from its decline. You should not write covered calls against it. The chances of its declining well below the break-even point of your position are too great.

2.6 Choosing Calls for Covered Call Writing

Choosing the proper call is equally important — not all calls are created equal. Here are the main considerations:

1. The strike price.

2. The time to expiration.

3. The return and the amount of downside protection offered by the call.

These interact to a degree, but let's take them one at a time.

2.6.1 The Strike Price

You can choose to sell either an out-of-the-money call or an in-the-money call.[2] If you are more interested in keeping your shares, you may be drawn to out-of-the-money calls, particularly if the stock you are considering is highly volatile or you are bullish on it. In-the-money calls usually carry higher premiums than out-of-the-money calls, and therefore provide more downside protection. Out-of-the-money calls have the highest maximum profit potential, but the stock must rise to actually get it.

Example

Dan's Landmine Company shares are selling for $20 a share. An April $15 call is selling for 8-points and an April $25 call is selling for 2-points. The April $15 has a break-even point of $12 — this means the stock must drop more than 40% before you start losing money. The April $25's break-even point is $18 which delivers much less protection. On the other hand, thanks to the out-of-the-money strike price of the April $20, you can make much more money if the stock cooperates. Here's a table of the potential return at expiration for each call using, a variety of stock prices:

In-The-Money Call		Out-Of-The-Money Call	
Stock at Expiration	Net Profit	Stock at Expiration	Net Profit
10	($200)	10	($800)
12	0	15	(300)
15	300	18	0
20	300	20	200
25	300	**25**	700
30	300	30	700

Incidentally, you might find it good practice for your future options trading to check my math in this table. Remember if you do this that since the calls are held to expiration in this example, when the calls are in-the-money, you sell the stock to your counterparty at the strike price of the option.

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[2]Note that selling in-the-money calls may affect your stocks holding period for tax purposes. For details, please see http://www.optionseducation.org/resources/literature/files/taxes_and_investing.pdf

2.6.2 The Time to Expiration

Option buyers want as much time as they can get to let the stock move in their favor before the option expires. As an option seller, your goals are the opposite — you want the stock to trade in as narrow a range as possible and have the call expire worthless, so you can keep the premium. The shorter the time period before expiration, the more pressure is placed on the call buyer and the less on you, the call seller. On the other hand, calls which are only a few days or weeks away from expiration may not have enough time value left to make them worth selling. So you must balance the amount of time left in the call (less is more) against the premium you will receive for selling the call (more is more).

2.6.3 The Return and the Amount of Downside Protection

To decide how much return you want, you must first know how to calculate the return from a covered call position. You want to know both the *return if exercised* and *the return if unchanged*. The first is the amount you would make if the stock were called away. The second is the amount you would make if the stock remained unchanged by expiration. If you sold an in-the-money call, the return if exercised will be the same as the return if unchanged. Fortunately, the computations are not complex.

Calculation of the Return If Exercised and Return If Unchanged.

You calculate your net profit if exercised and unexercised, and then divide that by your net investment. Let's start with net investment — just add all the cash outflows and subtract all the cash inflows to get the total expense:

	Stock Cost
+	Stock Purchase Commissions
–	Option Premiums Received
+	Option Sale Commissions
	Net Investment

Now we find the net profit if exercised Add everything you get, subtract everything you spend to get your net profit:

	Stock Sale Proceeds
–	Stock Sale Commissions
+	Dividends Earned
–	Net Investment
	Net Profit if Exercised

Ditto with net profit if unchanged:

	Unchanged Stock Value
+	Dividends Earned
–	Net Investment
	Net Profit if Unchanged

Notice that we don't subtract sale commissions when we calculate net profit if unchanged. This is because you usually do not sell the stock if the option expires, but continue to write new calls against it. For in-the-money calls, the profit if unchanged is the same as the profit if exercised.

Now we can compute the returns:

Return if Exercised = Net Profit If Exercised/Net Investment

Return if Unchanged = Net Profit If Unchanged/Net Investment

As with profit if unchanged, if you sold an in-the-money call, the return if unchanged should be the same as the return if exercised.

Calculating the Percentage of Downside Protection

Now we must calculate the percentage of downside protection we receive from the calls. You just divide the break-even point by the points of protection you got from the call. We first adjust our net investment for any dividends we will receive:

	Net Investment
–	Dividends received
	Total Stock Cost at Expiration

The break-even point is then:

Break-even Point = Total Stock Cost at Expiration / Number of Shares

We ignore stock sale commissions in this calculation because if the stock has dropped to this point, it will be out-of-the-money. This means it will expire worthless and our shares will not be called. The purchase commissions are already included in the calculation of net investment (see section 2.6.3).

Now we compute the percentage of downside protection. First the number of points of protection received:

	Starting Share Price
–	Break-even point
	Points of Protection

And the percentage of downside protection is:

Percentage of Downside Protection = Points of Protection / Starting Share Price

And that's all there is to it — time for an example:

EXAMPLE

You are considering buying 500 shares of Gorski Goldworks at $23 a share. This means you can sell five calls against these shares. You find an out-of-the-money Gorski Goldworks July $25 call selling for $3.

Net Investment:	
Stock Cost (500 shares @ $23)	$11,500.00
Plus Stock Purchase Commissions	8.95
Less Option Premiums (5 Contracts @ 300)	1,500.00
Plus Option Sale Commissions	11.20
Net Investment	$10,020.15
Profit if exercised and return if exercised:	
Stock Sale Proceeds (500 shares @ $25)	$12,500.00
Less Stock Sale Commissions	8.95
Plus Dividends Earned	300.00
Less Net Investment	10,020.15
Profit If Exercised	$2,770.90
Divide by Net Investment	10,020.15
Return If Exercised	27.7%
Profit if unchanged and return if unchanged:	
Unchanged Stock Value (500 shares @ $23)	$11,500.00
Plus Dividends	300.00
Less Net Investment	10,020.15
Profit if unchanged:	$1,779.85
Divide by Net Investment	10,020.15
Return If Unchanged	17.8%
Break-even point:	
Net Investment	$10,020.15
Less Dividends	300.00
Stock cost to expiration	$9,720.15
Divide by shares held	500.00
Break-even point	19.44
Percent of downside protection:	
Starting Stock Price	25.00
Less break-even price	19.44
Points of protection	5.56
Divide by Starting Stock Price	25.00
Percent Downside Protection	22.3%

Returns are sensitive to the size of the position. Larger positions will generally have greater returns and lower break-even points, because commission costs will be a smaller percentage of the initial investment.

One last note: If you are intending to use margin, you must include margin interest and some other stuff in these calculations. I don't do that here since this is a guide for beginners, and beginners shouldn't use margin. Grizzled veterans don't use it because they know better. However, if you are curious, there is a spreadsheet at

http://www.ssr.com/sdb/BAILOUT/Spreedsheets/CoveredCalls.gnumeric

which will calculate all of this for both cash and margin accounts.

2.6.4 Choosing The Proper Return

When comparing returns between various covered call possibilities and other potential investments, the best metric is the return if unchanged. By using the return if unchanged, you can compare returns without speculating on the future of the stock. To compare calls with different amounts of time to expiration, you must **annualize** the returns first. By converting the returns to a yearly rate by annualizing them, you place all the calls on an equal footing and can also compare the returns to the potential yearly yields from other investments, such as treasuries.

Fortunately, this is not a complex calculation. The general formula is:

Annualized Return = Return over period * 365/days in period

Example

Assume the call described in the previous example, which gave a return if unchanged of 17.8%, was held for 90 days before it expired:

Annualized Return = 17.8% * 365/90 = 72%

This is not your yearly rate of return. It would be very unusual to be able to get a consistent enough return every 90 days to make this annualized return your actual yearly return. The purpose of annualizing is to place all investment returns on an equal footing for comparison purposes.

Selecting a minimum acceptable return is a personal choice. You must be comfortable with the return and feel that it compensates you adequately for the risk you take on by owning the stock and selling the calls. And you should remain flexible — as economic circumstances change, you may decide to raise or lower your minimum acceptable return. A return of 1% a month (12% a year) is often suggested as the minimum standard. While 12% a year is nothing to sneeze at (Bernie Madoff became infamous by claiming to make this amount each year), the time may come when less risky investments are available (such

as bonds) that pay 12%. You should demand a higher return in this case to compensate you for taking on the additional risk involved in stock ownership and option strategies.

Market volatility comes and goes — during periods of high volatility, option premiums are often higher. During these periods you should also be encouraged to ask for more. When volatility decreases and the option premiums along with it, you will have to be happy with less, or use a longer time to expiration, or both. My own personal minimum rate, at the time this is written, is a somewhat flexible annual rate of 15%.

2.6.5 Choosing Enough Downside Protection

This is a more difficult problem. The percentage of downside protection, which was given earlier, is a popular metric because it is easy to calculate. However, there are problems with it. Highly volatile stocks, which tend to be riskier, also tend to have much higher option premiums. This means that the percentage of downside protection will always be greater the riskier the stock. This is obviously a good thing, but the problem comes when you try to use this metric to decide if 15% protection on a risky, volatile stock is as good as 6% protection on a less risky stock. There are mathematical ways to deal with this, but introducing those here would take us far beyond the category of a beginners guide to options.

Even if you know the mathematics, it may be that the best course of action remains using your knowledge of the underlying stock to choose the appropriate level of protection. My own personal downside percentages vary from stock to stock. For a very stable stock, I might be happy with 3%. More commonly, I look for 5%. If the stock is extremely volatile, I may ask for 10%. And I have been known to turn to the advanced math techniques on occasion, but this has been a minority of cases.

2.6.6 Combined Writes

As previously discussed, since you can sell an in-the-money option for more money, it will provide greater downside protection. Out-of-the-money calls, with their smaller premiums, provide less downside protection, but can give a much greater return if the stock reaches the strike price of the option. Your investment goals will usually determine which type of call you prefer.

Sometimes option premiums do not cooperate with you no matter what your goals are. The in-the-money options may provide such skimpy returns that even the investor whose primary interest is downside protection will discard them. Out-of-the-money calls may give so little downside protection that even the most aggressive investor decides they are not worth the risk. If you have a large enough stock position, (1,000 shares or more), you can sometimes find a better solution by selling in-the-money calls against half of your position, and out-of-the-money calls against the other half.

EXAMPLE

It's January, and you purchase 1,000 shares of Gorski's Silverado Mine, Inc., for $42 a share. Available calls are the July $40 call for 4-points, and the July $45 call for 2-points. You calculate the returns and downside protection for each call, and here is what you find:

	Return if Unchanged	Return if Exercised	Percent Protection
In-the-money call	5.1%	5.1%	10.5%
Out-of-the-money call	6.0%	12.2%	5.7%

It is hard to be happy with anything here. The conservative investor will be pleased at the 10.5% protection, but will not be happy with the less than 1% return a month for his investment. And even the aggressive investor would feel that a measly 6% return does not compensate for only having 5.7% downside protection. The situation can be improved by selling 5 in-the-money calls against half of your shares, and 5 out-of-the-money calls against the other half:

	Return if Unchanged	Return if Exercised	Percent Protection
Combined write	5.4%	8.4%	8.1%

This provides much nicer potential, with good downside protection and still leaving open the possibility of a more than 1% return per month if exercised. This is an especially useful strategy for low volatility stocks which are stuck between strike prices.

2.6.7 Up to the Minute Summary

Here's the new stuff we've covered:

- You should be neutral or mildly bullish on stocks you choose to sell calls against.
- Do not short calls against stock you are bearish on. You should sell the shares, short them, or use another options strategy to profit from their decline.
- Selling in-the-money calls provides more downside protection.
- Selling out-of-the-money calls offers higher potential profits, but the stock must increase in order to realize them.
- Sell a call with as short a time to expiration as possible, while still meeting your personal criteria for downside protection and minimum expected return.

- There are two returns of interest for covered calls: The return if exercised and the return if unchanged.
- The return if unchanged is the best metric to use for selecting between various call writing possibilities.
- Annualize the return if unchanged before using it to compare calls with different times to expiration.
- The annualized rate of return does not predict your yearly return.
- The percentage of downside protection is easily calculated, but doesn't provide a good basis for comparison between stocks with different levels of volatility.
- Position size influences the returns. Larger positions have a greater percentage return.
- Choosing a minimum acceptable return is a personal and subjective decision. Here are some guidelines:
  1. It should compensate you for the additional risk you take on by owning stock and selling calls. This means it should be higher than the highest rate paid by a safer investment (such as a bond or treasury).
  2. If option premiums increase, you should be flexible and ask for a higher minimum return.
  3. If option premiums decrease, you may need to lower your minimum return or use a longer expiration time, or both.
- Selecting the minimum downside protection is a more difficult problem.
- Your downside protection may need to be different for each stock. Understanding the company is perhaps the best guide to setting your minimum downside protection.

2.7 So You Sold a Covered Call, Now What?

Because options expire and your stock can be called, you need to pay more attention when you invest with options than you do with a stock only position. The easiest course of action is always to do nothing, and this will often result in a profit. But doing nothing will not always be the best course. And should your stock tank suddenly, doing nothing can give you substantial losses.

In this section we will discuss how to handle the situations where your shares make large movements before expiration. section 2.10 discusses what to do when the stock movements occur near expiration.

A word to option beginners: Several times in the next section we will make suggestions to buy back calls you have sold. You may wonder if this is possible — why would anyone

sell them the call at a loss? If you find yourself wondering this, remember that calls are wasting assets — they are not like stock. The person who bought your call a few months ago for 5-points will be very happy to sell it back to you for 1-point, especially if expiration is near, because at expiration they will lose their entire investment.

2.8 What do to if the Stock Goes Down

Your decision should be guided by your valuation of the underlying stock. If the share price decline is because of news which indicates a deterioration in the underlying business and you have become bearish on the stock, the best course of action may be to close the position completely: buy back the calls for a small profit, and sell the shares. But the reasons for a stocks share price decline are not always clear. If you see no substantial reason for the stocks decline, and are still at least neutral on the stock, it is probably better to sell more time value.

To sell more time value, first buy back the call you sold and then sell a new one, with a different expiration date and/or strike price. Many brokers allow you to do this in one step, which can result in better prices and lower commissions. Utilize this feature if they offer it. Since the stock has declined, the original call will be worth less now, which means you can buy it at a small profit. Replacing the current call with a new one is called **rolling**. Various terms are used to describe various types of rolls:

Roll Forward: The current call is replaced by one with a later expiration date.

Roll Up: The current call is replaced by one with a higher strike price.

Roll Down: The current call is replaced by one with a lower strike price.

Various combinations of these are possible - for example, **rolling forward and down** replaces the current call by one with a later expiration date *and* a lower strike price.

2.8.1 Rolling Down

Since the stock price has declined, you should roll down. Whether you should also roll forward to a later expiration date depends partly on how much time has passed since you sold the first call, and partly by the current option premiums.

Example

You buy shares of Arlo's Political Cartoons, Ltd. at $32, and sell a April $30 call against your ARLO shares for 6-points. Two months later, ARLO shares have declined in price, and your calls will have dropped also. Here's your situation:

	Opening Position	Current Position	Gain (loss)
Stock	32	25	(7)
April $32 Call	(6)	(1)	5
Maximum Profit	4	4	
Break-even	26	26	
		Net Gain (loss)	(2)

You have a net loss in this position of 2-points. You have lost 7-points in the stock, which is offset by by a 5-point gain in your call.[3] If you hold on to the present position, the most you can make is 1-point from further time decay in the call. And the stock may decline even more by that time, offsetting even this small improvement.

You find an April $25 call selling for 4-points. You decide to roll down. You buy back your April $30 call at a cost of 1-point, and sell the April $25 call for 4-points, for a net profit of 3-points on this transaction. This improves your downside by 3-points, moving it to $22. Here's the new position:

Stock	25
April $25 call	(3)
Maximum Profit	3
Break-even	22

Note that in this position, as long as the shares stay above $22, you stand to make an additional $300 dollars by expiration — much more than the $100 additional you could make by sticking with your original position.

To get a better picture of your total profits at expiration, here is a table comparing the profits from the original position with the rolled position at expiration:

ARLO shares at expiration	Profit from April $30	Profit from April $25
20	(600)	(200)
22	(400)	0
25	(100)	300
26	0	300
28	200	300
30	400	300
40	400	300

Obviously the rolled down position has a smaller maximum profit potential than the original. By rolling down, you have obligated yourself to sell shares at a lower price. *Rolling down generally reduces the maximum profit potential of a covered call.* However, when your

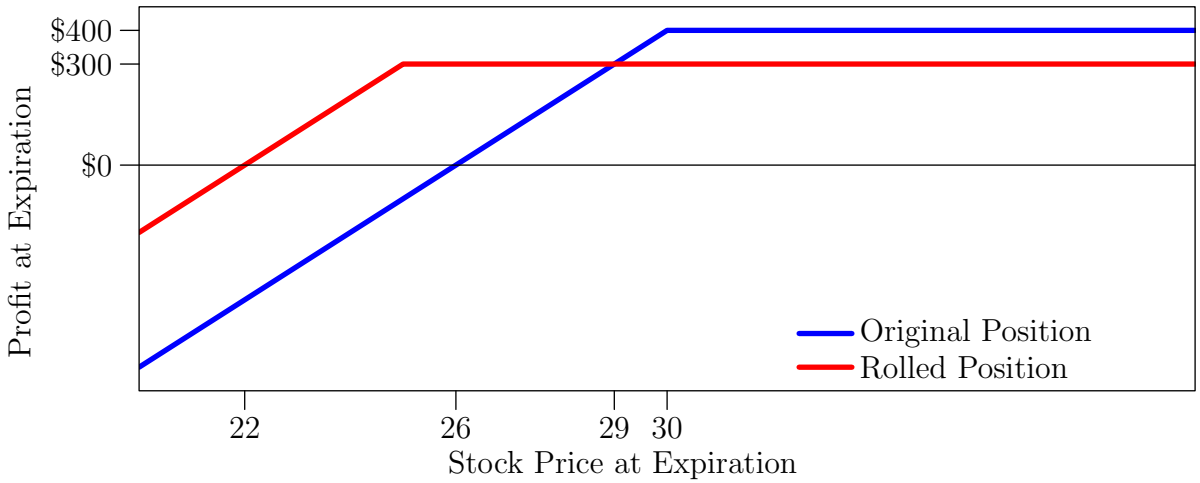

Figure 2.3: Profit graph of original and rolled positions.

stock is declining, you will usually be more interested in protecting your downside than in additional profits.

Figure 2.3 shows the profit graphs of both positions. Notice that the lines cross at the share price of $29 — this is where the profits from the two positions are equal. Everywhere to the left of that point, the rolled position outperforms the original position. Everywhere to the right, the original position outperforms the rolled position. If the shares rally above $29 by expiration, you would have been better off not to have rolled.

If the price decline in the stock is both sudden and steep, you may not be able to find an option to rescue you. This results in a **locked-in loss**. This is especially likely to occur in lower priced stocks, where the strikes are spaced farther apart. Out-of-the-money calls tend to have this problem more often than in-the-money calls. Even though you may not be happy at losing money, you may lose less by rolling down:

Example

You buy ARLO at $20, and sell the March $20 call for 2-points. ARLO shares suddenly plunge to 16, with the March $20 call now selling for 0.5-points. Here is your situation at present:

	Opening Position	Current Position	Gain (loss)
Stock	20	16	(4)
April $32 Call	(2)	(0.50)	1.5
Maximum Profit	2	2	
Break-even	18	18	
		Net Gain (loss)	(2.5)

[3]Why a 2-point loss, when the stock is only 1-point below break-even? Because the break-even point is calculated assuming expiration, when the time-value is zero. In the present situation, there is still 1-point of time value left in the call.

This gives a 4-point loss on the stock, offset by a 1.5-point gain on the call, for a net loss of 2.5 points.

The next lower strike price is $15, where the March $15 is selling for 2.5-points. You could roll down for a credit of 2 points (2.5 - 0.5 = 2), but then you must sell your stock at $15 if it is called. This is not a very happy solution, because if you roll, the very best you can do is to lose 1-point.

Such is the pain of a locked in loss. Even though rolling is painful, not rolling may be worse. Here's a table comparing the two possible outcomes at expiration:

ARLO shares at expiration	Profit from March $20	Profit from March $15
10	(800)	(600)
15	(300)	(100)
18	0	(100)
20	200	(100)
25	200	(100)

Unless the stock rallies above $17 by expiration, it is better to have rolled and lost, than not to have rolled at all. As you can see from Figure 2.4, the red line, which represents the

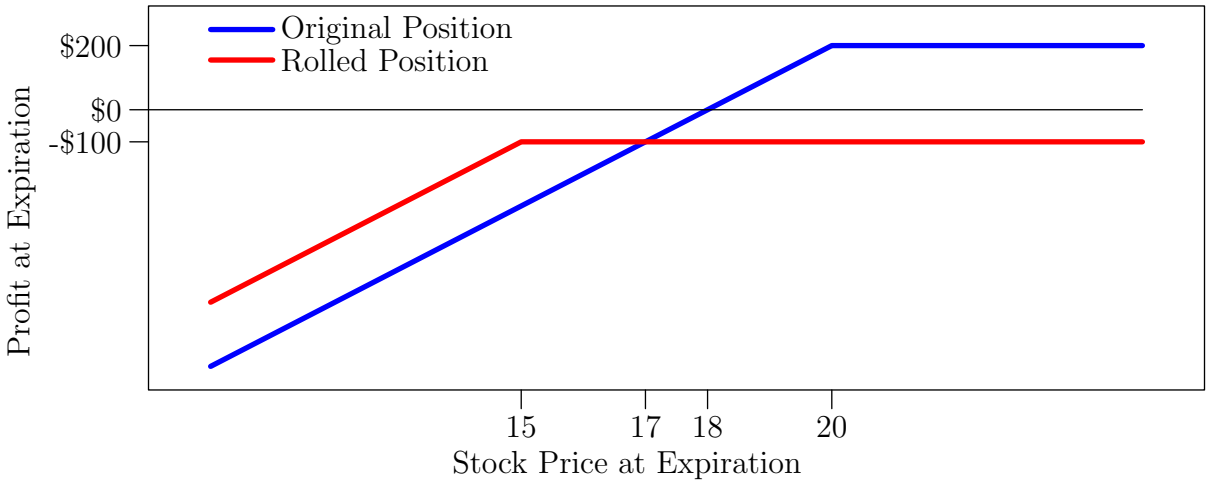

Figure 2.4: A "locked-in" loss..

rolled-position, is always below the break-even line, which graphically illustrates the locked-in loss. The two lines intersect at the stock price of $17. The rolled position does better everywhere the stock is less than $17, and the original position does better everywhere the stock is higher.

Low-priced, non-volatile stocks are the ones most likely to get you into this sort of situation. Use extra care if with these if you decide to write covered calls on them.

2.8.2 Rolling Forward and Down

In practice, it is common to roll the call both down and also forward to a later expiration date. As discussed in subsection 1.2.3, a call which is farther away from expiration will cost more because of the additional time value. This means you will be paid more when you sell it.

In spite of the extra money, rolling forward may not be a very good idea. As we saw in section 2.8, when you roll down, you also reduce your maximum profit potential. When you roll to a more distant expiration date, often all you manage to do is to slow your return to profitability. The more distant expiration dates should be only be used if you are concerned about further price reduction in the stock and need that much downside protection.

When you are faced with a locked-in loss, the higher premiums offered by the more distant call options can be especially appealing. But the distant options also lock you into a lower strike price for a longer period of time. It often works out better when you sell several short-term calls instead of one long-term call. By repeatedly harvesting the premiums from the shorter-term calls, you can return to profitability in the shortest possible time, and possibly escape the locked-in loss.

2.8.3 Partial Rolls

If you have a large position (at least 500 shares, but 1,000 shares or more is better) and find yourself facing a locked-in loss, the **partial roll down** may be useful. In this strategy, only a portion of your shares are rolled down:

Example

You buy 1,000 shares of ARLO for $20 a share (spending $20,000), and also sell 10 March $20 calls for a premium of 2-points (receiving $2,000.) This is exactly the same situation as in the previous example, but with a much larger position. The position size won't help you — if you rolled all the calls, you would still end up with a locked-in loss.

As before, with ARLO drops suddenly to $16, the March $15 calls are now selling for 0.5-points. Instead of rolling all 10 calls, you roll only 5. You buy back 5 $20 calls for 0.50 points each, and sell 5 $15 calls for 2-points each. As will be shown, this avoids the locked-in loss scenario.

If the stock moves back above $20, unlike the complete roll-down where you will be left with a locked-in loss of $100, the partial roll-down allows you a gain of $500. To see this, just add all the transactions together assuming the stock moves back above 20 by expiration:

Description	Amount
Initial Purchase:	
Buy 1,000 shares @ 20	($20,000)
20 Jan. $20's @ $2	2,000
Partial Roll Down:	
Buy back 5 Jan.$20's @ 0.50	(250)
Sell 5 Jan. $15's @ $2.50	1,250
Stock Rallies above 20:	
Sell 500 shares @ 20	10,000
Sell 500 shares @ 15	7,500
Net profit	$500

Figure 2.5 shows the graphs of all three positions. The loss is no longer locked-in, and a profit can result on a rally. Furthermore, the shares need only return to $19 to break-even. The partial roll does not have as much protection as the original position, but it gives better protection than not rolling at all.

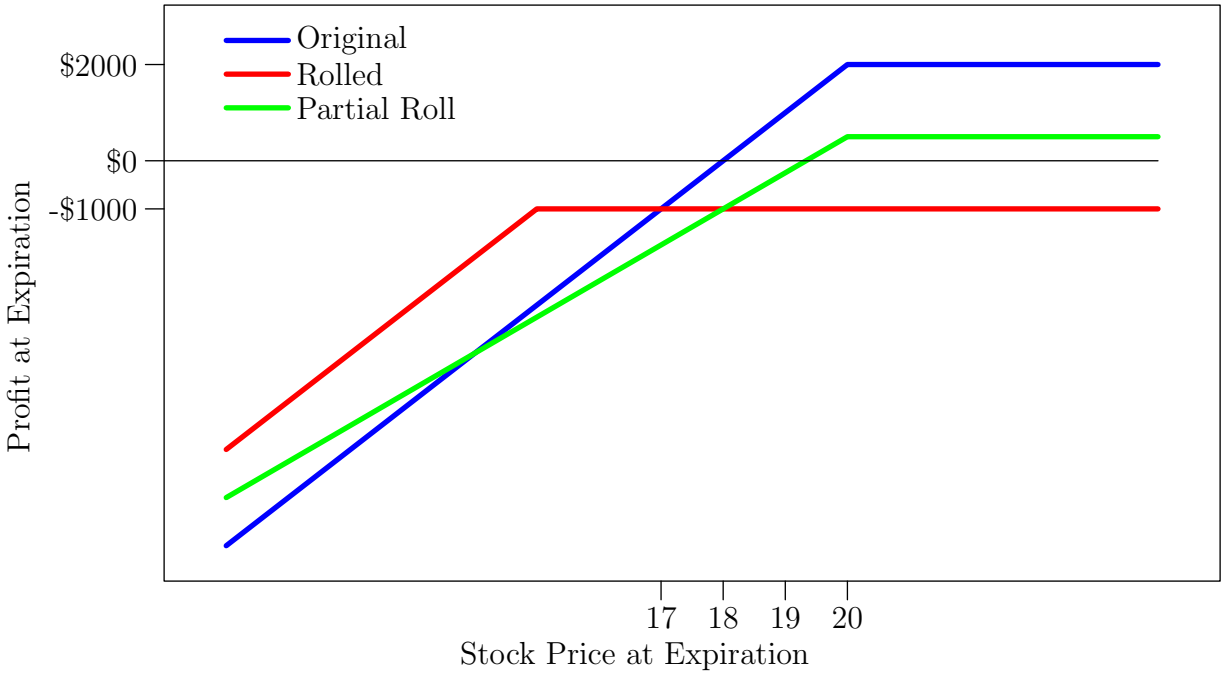

Figure 2.5: The effects of not rolling, rolling down and partially rolling down.

With partial roll-downs, it becomes an advantage to roll forward and down in order to harvest larger premiums. Since you are no longer locked into a loss, you do not need to be concerned about locking yourself into a losing position for a longer period. You are ready to make profits if the stock rebounds, and take full advantage of the additional protection offered by also rolling forward to a later expiration date.

Should the stock continues to drop and you there seems to be no hope for an immediate rally, you can always roll the rest of the position down.

2.8.4 Buying a Put

For the sake of completeness, it should be mentioned that it is also possible to protect a covered call position by purchasing a put. Since we are focusing on calls in this part of the book, this tactic will be discussed later. The interested reader is referred to section 9.4.

2.9 What to do if the Stock Goes Up

A nicer problem to have is when the stock rises in price after selling the call option. There are basically three alternatives:

1. Roll up
2. Close the position early.
3. Do nothing.

2.9.1 Rolling Up

Example

You buy ARLO shares at $30 and sell an at-the-money 6-month call for 6-points. This gives you a maximum profit at expiration of 6 points anywhere above $30, and a break-even price of $24.

ARLO is finally receiving respect from investors, and instead of dropping, the shares surge, climbing to a new high of $40 a share. Since the stock has climbed $10, you might expect your call to go up by the same amount, but that will occur only near expiration. With many months remaining before expiration, your 6-month $30 call will perhaps increase by only 5 points, and be worth around $11. Out-of-the-money calls with higher strikes will also see their premiums rise — the 6-month $40 call might be selling for around 7-points.

You can roll up to the $40 by buying back the $30 call and selling the $40 call. Unlike roll downs when you receive additional credits, roll ups cost you. This one costs 4 points:

Sell the $30 call for 6-points:	6
Buy the $30 call back for 11 points:	–11
Sell the $40 call for $7 points:	7
Net Points remaining after roll:	2

Since you started with 6 points, and now have 2, you gave up four points for the roll. What you gained in exchange is increased potential profits. Here's a comparison of the two positions if ARLO is above $40 at expiration:

	$30 Call	$40 call
Option Profits	$600	$200
Stock Profits	0	1,000
Net Profits	$600	$1,200

The profit graph in Figure 2.6 compares the original position with the rolled up position. As you can see from the graph, rolling can dramatically increase the potential profit, but at

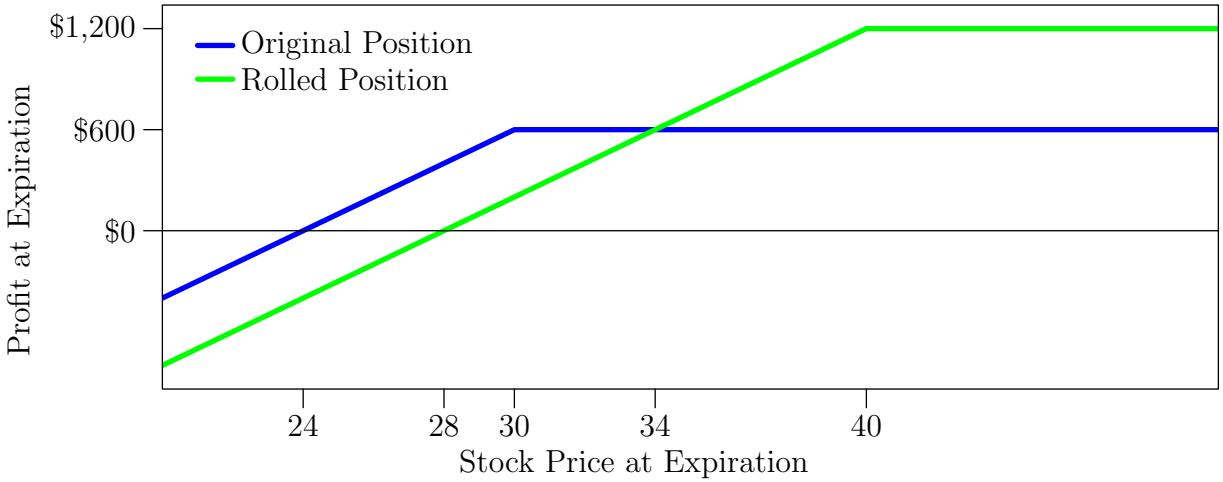

Figure 2.6: Comparison of rolling up with holding the original position.

increased risk. *When you roll up, your break-even point will always be increased by the net debit you pay to roll.* It cost us 4-points to roll up to the new position, and as you can see, the new break-even point is 28 — 4 points higher than the original position. Essentially, by taking a 5 point loss on the original call (selling it for 6 points, then buying it back for 11 points), you have added 5 points to the price of your stock. So the rolled up position is the same as if you bought the shares at $35, then sold the $40 call for $7. So the new break-even point must be $35 - $7 = $28, and the new maximum profit must be $40 - $35 + $7 = $12. If, in addition to rolling up you also roll forward, you will get a bigger premium. This reduces the cost of the roll and increases your downside protection. It also gives more time for the stock to move in your favor.

The intersection of the two lines, which is where the two positions are equally profitable, is particularly important for roll ups. While the profit potential is appealing, you need to consider how likely it is that the stock may move back down from $40 to $34. This would be a 15% drop, which may or may not be likely to occur before expiration. If you think it is very likely that the stock could fall this much before expiration, it is best to stay with

the original position. As a rule of thumb, 10% movements are quite common, but a move of 20%, while rare, is not unheard of, even in healthy companies.

Remember that rolling up incurs additional risk. When you entered the position, you chose it based on your minimum requirements for an acceptable return. If the stock moves up and your minimum return requirements are being met, think carefully before risking them. On the other hand, many investors have a negative emotional reaction to spending more money on a position they have already established. Strive to evaluate the situation as rationally as possible. While you shouldn't chase illusory profits, do not let your emotions scare you away from investing more if you conclude that the stock is likely to reach higher levels.

2.9.2 A Word of Warning

Investors often roll irrationally because they are overly attached to a stock and can't stand the thought of losing it. Such investors may roll up the second the stock reaches the strike price of their short call. Rolling up costs money, and if the stock is moving powerfully upwards, these repeated debits can weigh heavily on such an investors emotions. When they can't stand it any longer, after spending so much to get to where they are, they will just buy back all the calls at a large debit. Of course, as any investor knows, after a strong rise by a stock, a fall is likely and it is usually sharp and painful. So after buying back all their calls and leaving themselves exposed to downside risk, they will often see their overly loved stock fall back to much lower levels. The best way to avoid this situation is to always follow rule number 1:

Rule Number One: Never sell a call against shares that you really want to keep.

But should you break rule number 1, and probably we all have at one time or another, the way out of this situation it is to allow your stock to be called away for a nice profit. Bid it a tearful farewell and use the money to go to Cancun. You'll always have your memories of each other.

2.9.3 Closing Early

As the stock rises, the intrinsic value of the call will rise. If the rise is dramatic, the call may lose its time value and begin to trade near parity.[4] In this situation, it is often best to close the position early.

Example

ARLO shares were purchased at $25 and a six month $25 call was sold for 3-points, for a maximum potential profit of $300. Within a month or two, much sooner than expected,

[4]Recall from Chapter 1 that an option is at **parity** when the call premium is equal to the intrinsic value of the option.

ARLO rises to $33 and the call is trading at 8-points (parity). If you now decide to close the position, you will spend $8 to buy back the calls, and sell the stock for $33, giving you an effective sale price of $25. You keep the option premium of $300, which is your maximum profit.

The advantage of closing early is that you realize your maximum return in a much shorter time than expected. This will push your annualized return well over your minimum requirement. The cash received can then be redeployed in other investments. While rolling up is a possibility that can also be considered in this situation, closing early is clearly better than hanging on to the position for another 4 months with no additional profit possible.

You will be paying some additional costs for this. There will be extra commission costs and if there is a dividend due, you may not receive it. In most cases this will not be significant, but should always be taken into account when making your decision.

Most brokers will accept orders to sell the stock and buy back the call as one order. This is usually to the investors advantage, as it can save in commissions and result in better prices.

2.9.4 Doing Nothing

For some investors, doing nothing is the most difficult thing of all. However, if there is no compelling reason for rolling or closing early, leaving well enough alone is the best course.

2.9.5 Up to the Minute Summary

- If the stock declines in price before expiration, you can:
  1. Roll down and/or forward.
     - Rolling down reduces your profits but increases your downside protection.
     - Rolling down can lock-in your losses. This may still be better than leaving the position alone, due to the increased protection you receive.
     - Rolling down and forward may be considered. It can further increase your downside protection, but will lock you into lower potential profits for a longer period.
     - By not rolling forward, you can sometimes recover more quickly from a locked-in loss by selling more short-term calls to lower your cost basis.
  2. If you have a large position (1,000 shares or more), you can do a partial roll.
     - Partial rolls avoid a locked-in loss, but have reduced downside protection when compared to rolling down the entire position.
     - When you do a partial roll, rolling forward becomes more reasonable, since you have left open the possibility for upside profits.

- If the stock increases in price before expiration, you can:
  1. Roll up and/or forward.
     - It will cost you some money to roll up.
     - Rolling up raises your downside break-even point by the amount of the debit you pay.
     - Rolling forward and up is often a good thing to do in this situation. It can reduce the net debit you pay which will also give you more downside protection.
     - You should only roll if you feel the movement of the stock can be sustained. If a 10% move seems likely and will bring you back to the point where the original position and rolled position have the same returns, stay with the original position.
     - Do not roll up in a desperate attempt to hold on to a stock you do not wish to sell. You probably shouldn't have sold calls against this stock to begin with.
  2. Close Early
     - Closing early should be considered when the call is trading at or near parity.
     - The advantage of closing early is that it increases your annualized returns well over your personal minimum.
     - Consider what you may lose when you close early in making your decision. Consider total commission costs as well as any dividends you may miss by closing the position.
     - If you do close early, having your broker close the complete position can save commissions and get you better prices.
  3. Do nothing.
     - This can be the most difficult choice for some investors.
     - Absent a compelling reason to take another action, doing nothing is the smartest thing to do.

2.10 Actions to take at Expiration

Congratulations, you and your option have made it nearly to expiration. The time value premium is disappearing more and more rapidly from your short call. Now what?

2.10.1 Rolling Forward

You may wish to roll forward, to a later expiration date. If your call is in-the-money, the perfect time to roll forward is when the time value has completely disappeared from the call. As long as there is time value left in the call, even though the option is in-the-money, there is little risk of assignment. And you are still earning money as the time value decreases. But if the option begins to trade at parity or below parity, early exercise becomes likely. This is due to arbitragers, who can make a profit on calls which sell at a discount to parity.

Example

ARLO shares are trading at $26, and your $25 call is selling for 1-point (it is at parity). You should definitely roll this call.

If your call is out-of-the-money, the situation is not so clear. One way to approach this situation is to calculate the return per day you will receive by continuing to hold the call with the return per day from the later-term call. If the later-term call has a higher return, then rolling forward is probably a good idea.

Example

You are one month from expiration, and have an out-of-the-money call which is selling for 0.5-point. There is a call with the same strike that expires in four months which is selling for 2.5-points. Should you roll forward?

By remaining with the current call, you will make $50 in the next month (assuming it stays out-of-the-money and expires worthless). This is $1.67 per day. Since the time premium in the new call is $2.50, you will potentially make $250 in four months. To properly compare the roll forward with just holding the original call, you need to include commissions. Let's say that the commission for rolling forward is $10.50. (250–10.50)/120 comes to $2.00 a day, so you should probably roll forward to the new call.

When doing these calculations, you should use the amounts from your total position, and not just single calls. This is because returns increase with greater position size, so a position that might not be worth rolling forward if you only own one call might be worth rolling forward if you own several.

Example

As in the previous example, you are one month from expiration, but you own 10 out-of-the-money calls with each selling for 0.5-points. Should you roll to the later dated call which is selling for 2.5-points?

The current calls will make you $500 in the next month, which is $16.67 per day. The longer term call will make you $2,500 in four months. Commissions for trading more calls are typically higher, so the commission cost for this example will be $16.50. (2500-16.50)/120 is $20.70 per day.

Rolling forward, being a net credit transaction, will always increase your maximum profit and give you more protection by lowering the break-even point.

2.10.2 Rolling Forward and Up

At expiration, you have little choice but to roll forward. It may also be an advantage to roll up as well. Note that if your calls are out-of-the-money, the approach used in subsection 2.10.1, where we compared the returns from each call, can't be used as the only basis for your decision if you are also rolling up to a higher strike price.

If you are near expiration and your call is in-the-money, you *must* roll forward and up if you want to keep your shares. Near expiration, especially with a volatile stock, you may be able to roll up for a credit, (recall that rolling up usually involves a debit). If you find yourself in this situation, make sure you take advantage of it.

EXAMPLE

You own $25 calls on Peter's Lengthy Endpins which are in-the-money and selling for 5-points. PETER's stock is at $28, and there is a three-month call with a strike of $30 which is selling for 7-points. This means you can roll your calls up and earn an additional 2 points. It would be extremely foolish not to take advantage of this. You improve your maximum profit potential by 7 points and reduce your downside risk by two points.

2.10.3 Rolling Down

This situation often occurs just after expiration when a call has just expired worthless. If the stock has not moved much below the strike, the decision is not so difficult. However, the stock may have dropped substantially below where it was when you sold your previous call. If that is the case, you need to decide whether to wait for the stock to recover before selling more calls, or sell new calls with lower strike prices immediately. Your decision, as always, should be based on the companies performance. If there is a good reason for the decline, exiting the position may be best.

EXAMPLE

Peter's Elite Endpins (ticker symbol: PEE), has dropped to $22. Your $25 call has just expired worthless for a 100% cash gain. You have a choice of two 3-month calls, an

in-the-money $20 call with a premium of 3.5-points, and an out-of-the-money $25 call with a premium of 0.75-points.

If you think PEE's price decline is temporary, you should consider the $25 call. Even though the premium is small, the maximum profit would be large if PEE returned to $25 by the new expiration date. On the other hand, if you are concerned about further price decline, the $20 call provides a lot of downside protection, and its time-value premium (1.5) is twice what you get from the out-of-the-money $25. You'll undoubtedly wish to consider the price you spent for PEE as well. Waiting until the stock recovers is also a possibility. Other considerations involve tax issues surrounding selling in-the-money calls.

It's impossible to give one rule that applies to all situations. As always, when selling covered calls, try your rational best to strike a balance between protection and profit.

2.10.4 Letting Your Stock be Called

In general, your best course of action when your covered calls approach expiration is to harvest more premiums by rolling forward or forward and up. If you are able to do this, your total return over time will be higher.

However, if the stock has reached the point where you regard it as over valued and due for a correction, you may be better off allowing it to be called. Some people sell calls in the hopes that they will have their stock called at a higher price and get paid a few more points above market for shares they would want to sell anyway. I have tried this a few times with dubious results. It is not clear to me that this strategy for selling a stock results in superior returns.

You sometimes find yourself in a situation where rolling forward provides a minimal return. In such cases, you may be tempted to roll-up as well. If rolling up decreases your protection to a point where you are uncomfortable with it, then the best course of action is to let the shares be called, and find another investment. This second point is also related to your valuation of the stock and its future potential.

2.10.5 Up To The Minute Summary

- In-the-money calls trading at or below parity should be rolled forward (and possibly up), to avoid early exercise.
- Out-of-the-money calls should be rolled forward if the return per day of the new call (including commissions) is greater than the return per day left in the existing call.
- If you have the chance to roll forward and up for a credit near expiration, do so.
- If the stock has dropped in price, you might consider a new call with a lower strike price. Balance your decision rationally considering downside protection, returns, and the health of the company as well as the valuation of the stock.

- In some cases, especially when rolling produces returns which are below your standard, and protection is also reduced, it may be best to allow your stock to be called.

2.11 Philosophies of Covered Call Writing

Now that you have the basics of covered call writing under your belt (and a lot of the subtleties too!), it's time to turn to the bigger picture.

You can identify four broad philosophies of covered call writing (five, if you count the people who are opposed to it). These are:

1. The shareholder who also writes calls philosophy.
2. The total return philosophy.
3. The option only philosophy.
4. The incremental return philosophy.

It's certainly possible to adopt one of these philosophies as your own, and view the others as mistaken — many investors I know place themselves in one of these three groups. Speaking only for myself, I think all these schools of thought have merit, and I use all of them in my own investing.

2.11.1 The Shareholder Philosophy

Those who have spent a lot of time and energy building a portfolio of good stocks are naturally going to wish to protect them, and often do not wish to be in a position where they must surrender them at options expiration. At the same time, they are also drawn to the additional income that covered call writing can provide. People who hold to this line of thought will be drawn to writing out-of-the-money options for the premiums, since these are less likely to cause the stocks to be called.

While other philosophies may thumb their noses at the lower premiums such investors accept, there is actually some mathematical basis to believe that moderately out-of-the-money short calls can provide the highest returns. And since such investors are comfortable owning their stocks at the shares current price levels, they do not concern themselves as much with downside protection. They may also buy back short options early for quick profits if such profits show up during the life of the call.

You may have shares in your portfolio of companies you know well, have researched carefully, and held for a long time (or hope to hold for a long time). Especially when these companies reach their fair value price, or become somewhat over valued, you might consider selling calls against them to make more money.

In the traditional value-investor approach, (and I consider myself one), a fairly valued stock is either sold, or held because it pays a dividend. In my opinion, covered calls

represent a viable alternative strategy to simply selling the shares when the reach fair value. After all, a good company (like a good man or woman) is hard to find. When you sell your shares, you need to look around to find some place else to put your money. Why not make a little with it while you look?

2.11.2 The Total Return Philosophy

Others feel that you need to view the call options plus shares as a total position. These investors tend to favor in-the-money short calls due to their higher premiums and greater downside protection. They are unconcerned if the stock is called as long as their objectives have been met.

Traditionally oriented investors tend to think that the total return guys are not concerned enough with fundamentals. I'm not sure that's true, but a concern with the underlying stock is not inconsistent with this view. They are also troubled by total return investors tendencies to buy stock for the purpose of profiting from writing calls against them.

Absent a better investment, I don't see the problem with, for example, buying shares of a strong company which are trading at the low end of their value range, and making money on it by selling calls against it. I've done this many times with excellent success. While I wouldn't buy these shares as a long-term investment, they represent solid value and if you can recognize the value and turn it into a cash stream, why should anyone have a problem with that?

If you do try buying shares just to write calls against them, see if your broker has a "buy-write" option, where they buy the stock and sell the calls at one time. Like rolling, doing both through the broker in one order can reduce commissions and provide better prices.

2.11.3 The Options Only Philosophy

There are those who only use options. These people feel that they can make the most money by using more complex option strategies, such as spreads, rather than buying shares of stock. There is a lot to be said for this point of view as well, even though that may horrify readers who are long-term buy and holders only. Options can leverage your return and reduce your risk, and many of the ways they can do this do not involve any stock ownership at all.

In my view, combining this with the traditional value investors discipline of understanding the underlying companies only makes it a more viable approach. It is also quite a bit of fun. But they miss out on good opportunities because they never want to own stock, and so can't write covered calls.

2.11.4 The Incremental Return Philosophy

This is part philosophy and part strategy, and is used by well heeled investors. To do it, you need at least 500 shares of stock, with 1,000 or more preferred. You decide on a price

which represents your sale price for the stock. It's best if this sale price is based on an understanding of the fundamentals of the company, rather then being plucked from the air.

You begin by selling calls against only part of your position. You sell long term calls at the strike closest to the current price of your shares. If the stock moves above this, to the next strike above, you roll these calls up, and then sell additional calls at this new strike price until you have a net credit from the total transaction. Generating a positive cash flow at each roll is the key to this strategy. Eventually, your entire position will have calls written for it at your target price, and will be called away, giving you capital gains from the stock as well as the accumulated option premiums.

Example

Gorski's Silverado Mining Corp. is selling for $30, and you own 1,000 shares. You think a fair price for this stock is $50. You begin by selling 3 of the longest term calls you can find for $7 each. You make $2,100 from this transaction.

One month later, Gorski's Silverado Mining has risen to $40. Your original $30 calls are now selling for $10, and the long term $40 calls are selling for $6. You buy back the three $70 calls for a net debit of $3,000. Now you must sell enough new calls to turn this into a new credit, so you sell 6 long-term $40 calls for $3,600. You make $600 from this transaction.

A new month, a new share price. Gorski's Silverado Mining is now selling for $50, your target price. The $40 calls are now selling for $10, and the long-term $50 calls are selling for $7. You buy back all 6 of the previous calls for $6,000, and since your target price has been reached, you sell 10 $50 calls against your entire position, for $7,000. You make $1,000 from this transaction.

At this point, you have made $2,100 + $600 + $1,000 = $3,700 in option profits, and when your stock is called, you will make an additional $20,000 in stock profits.

This strategy tends to work better than longer it is drawn out, as the option premiums are allowed to accumulate. As such, it is well suited to a low volatility, flat market. Should one of the interim calls lose its time value premium and therefore become a candidate for early exercise, you simply roll that fall forward to an even later date. This will increase the option premiums also.

2.12 Chapter Glossary

Buy to Open Open a long option position.

Covered Call A short call position combined with a long position in the underlying stock.

Short Position Selling stocks or options that you do not own.

Shorting The act of selling stocks or options that you do not own.

Rolling Trading a call with a current strike and expiration date for another one with a different strike and/or expiration date.

Rolling Down Trading a call you own for a call with a lower strike price.

Rolling Forward Trading a call you own for a call with a later expiration date.

Rolling Up Trading a call you own for a call with a higher strike price.