

Module 5:

Strategy #3: Create dividends from stocks you own by selling covered calls



Module overview

- A trading strategy that can turn almost any stock into an income stock

Strategy overview

- Covered calls are calls sold on stocks that you own
 - The call is covered by the shares you hold in your account
 - The calls will have a strike price that is above the current market price of the stock
- When the call is sold you generate immediate income
- You retain the rights to any dividends that are paid
- You participate in any appreciation in the stock up to the strike price of the call

How to sell covered calls

- First, you must own the stock
- Then, find an option that offers suitable income
 - Suitable income depends on several factor including the cost of the trade, risk of exercise and return on investment
 - Cost of the trade is determined by commissions which vary greatly among brokers from about \$1 to more than \$15
 - Risk of exercise can be found with delta
 - Return on investment should be considered on an annualized basis and should meet a minimum baseline

Example 1: An income stock

- Assume you own Altria (NYSE: MO), a popular income stock with a yield of more than 3.5% that is trading at \$62
- You would like to increase the yield to at least 5%
- There is an option expiring in one month with a strike price of \$65 trading at \$0.20
 - If you could sell an option like this every month, that would increase income by \$2.40 and boost the yield to more than 7% annualized
 - Options on low volatility stocks like MO will be low-priced and demonstrate the importance of commissions

Annualizing income

- To compare options, it can be helpful to annualize returns
- This is a quick shortcut, not a mathematically precise calculation
- To find annualized returns, multiply the return by $365/X$ or $12/Y$ where X is the number of days until the option expires or Y is the number of months

$$\$0.20 / \$62 = 0.3\%; 0.3\% * 365/30 = 3.65\%$$

$$\$0.20 / \$62 = 0.3\%; 0.3\% * 12/1 = 3.6\%$$

Example 1 (cont)

- Delta on the one-month option is 0.18 indicating an 18% probability the option will be in-the-money at expiration
 - This indicates an 82% probability the option will expire worthless
 - As a seller, your ideal outcome is for the option to expire worthless
- Reducing delta reduces income; increasing income increases the probability the stock will be sold
 - If the stock is sold, you might owe capital gain taxes on the stock and that factor must be considered in your analysis

Example 1 (cont)

- Contingency planning assuming you sold a \$65 call for \$0.20 and MO rises in value
 - If the stock is trading above \$65 on expiration day you can close the trade with “buy to close” order. Expect to pay the intrinsic value
 - If MO is at \$65.15, you buy the option at \$0.15 and have a \$0.05 profit
 - If MO is at \$68, you can buy the option for \$3, losing \$2.80 but possibly avoiding a tax bill

Example 2: Creating a “dividend”

- This strategy can be applied to non-dividend paying stocks like Tesla (NASDAQ: TSLA)
 - This is a high volatility stock which means lowering the probability of being in-the-money at expiration will require a strike price relatively far away from the market price
 - You can use a price calculator (<http://goo.gl/0WThht>) to find a value of delta you're comfortable with
 - With TSLA at \$255, the first option with a delta below 0.20 expiring in one month has a strike price of \$300
 - Sell the \$300 call to minimize the chance the option will be exercised at expiration. This call is trading at \$2.75 (a one-month return on investment of 1.1%)

Conclusions from examples

- Premiums will be low on low volatility stocks (including income stocks) and high on high volatility stocks (including growth stocks)
- High premiums help offset the risks of owning high volatility stocks
- Short-term options maximize flexibility
 - You could sell a five-month option on MO for \$1 but the probability of exercise is 35%; selling one-month calls allows you to change the strike price on future calls
 - You could sell a five-month option on TSLA for about \$10.50 (a yield of 4.1% or 9.9% annualized) but the risk of a 10% decline in TSLA is 66% (delta on the put)

Bottom line

- You can generate income from many stocks
 - In April 2016, there were 7,271 actively-traded stocks on US exchanges.
 - 3,525 companies paid a dividend (49%)
 - 4,293 stocks had options available (59%)
- This strategy can result in short-term capital gains if the stock rises significantly
- This strategy can lower the effective cost basis of stocks if the stock declines

To implement Strategy #3

- Identify stocks you would like to own or identify stocks you own that you would like more income from
- Find short-term call options on those stocks
 - Generally 1-3 months provides income and flexibility
 - Consider setting a maximum delta such as 0.20
- Sell the options
- Monitor your position with a contingency plan in mind if taxes are a consideration

What's next?

- Strategy #4: The “Stock repair” Strategy: Ratio spreads