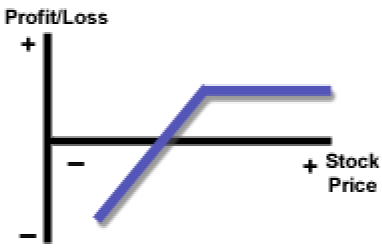
Introduction: The Covered Call Challenge

This is the first of four articles on some of the concerns and solutions with the use of Covered Calls as an investment strategy. The use of Covered Calls has increased greatly in recent years. It is a simple strategy in which a stock is purchased and then a call option is written against that position to generate income. In writing the call, the investor has created an obligation to deliver the stock at the strike price. Purchasing the stock acts as collateral for the call option. The call option obligation remains until the time of expiration of the option. Delivering the stock previously purchased can fulfill this obligation; therefore, the name **covered** call. In return for making the stock available for delivery, the investor receives an option premium or the price of the call option. This premium can provide a several percent return per month to the investor. Writing covered calls is a fairly conservative investment strategy. In general a covered call strategy is more conservative than just holding the stock alone. And it has the potential to greatly increase the income compared to collecting dividends, however this strategy has certain drawbacks.

Figure 1. Covered Call Profit / Loss Profile



As Figure 1 indicates, writing covered calls is a bullish to neutral strategy. It works best when the stock rises or remains at the same price. The weakness is when the stock falls, since the losses follow the stock as the price decreases. The covered call premium provides some protection, but it is limited by the amount of premium that is earned. Typical covered call premiums average about 2-3% per month of the stock price. If the underlying stock drops 20%, the loss can wipe out many months of collected premiums. Option premiums can be increased by writing options deeper in the money (ITM), but this is done at the sacrifice of return (time premium). Dividends on the stock also help to cushion a fall in prices, but again this has a limited effect. Deep ITM covered calls offer a higher downside protection, but a lower potential return if you are assigned. Also note that the profits are limited on the upside once the stock price moves above the strike price of the call option.

Recently, several advisory services and seminar providers have advocated a form of covered calls using LEAPS. LEAPS are Long term Equity Anticipation Securities or basically options with expiration dates that go out more than one year in time. This is a more leveraged form of trading a covered call where the LEAP option is used in lieu of the underlying stock. Once the LEAP is purchased short-term calls are written to earn income and pay for the LEAP. This strategy is referred to as a Diagonal Calendar Call Spread. Strategies like this are great if the stock goes up. But if the stock declines it is even more devastating than owning the stock. The leap is often purchased for 1/3 the cost of the underlying stock. This provides great leverage if the stock goes up, but the leverage works in reverse if the stock goes down. If the stock falls 30% your LEAP position will be virtually wiped out. There are many scenarios that can create a decline in stock prices:

1. Weakness in the economy
2. Catastrophic events like 9/11
3. Market sells off because of an extended bubble
4. Sector news like a change in farm subsidies or sub-prime problems
5. Company specific problems with earnings
6. Various other unforeseen events

Probably the most popular means of protecting the down side in the stock market is the use of the stop order. A stop order is an order that is executed when the stock hits a specified price level. For example, if you have a stock that you want to sell if the price goes under $50 per share, you could enter an order to sell if the price hits $50. However, when the market suddenly goes down because of an event like #2 or #3 listed above, the decline could be so rapid the $50 sell order is not executed until it is several points lower than the stop loss point. Worse yet, it is not unusual to have a sudden negative spike in the stock price cause the stop to be executed, only to have the stock price rebound and return to its previous price before the short term scare occurred. Exiting positions with stop orders can have unpredictable and undesired results.

Negative company and sector issues can be resolved through diversification. Additionally, diversification can be accomplished through Mutual Funds, Exchange Traded Funds (ETF's), or holding more than 10 stocks. However, the first 3 events in the list above could negatively effect all stocks and diversification would be virtually ineffective in providing protection. A lot of assets invested in 401K's and IRA's are invested in Mutual Funds, which are at the mercy of the market and are not insured against a decline. Just think about it, would a wise person consider **not** insuring their house or car? But most of us think nothing of having thousands of dollars at risk in a 401K or Mutual Fund without any insurance for a decline. Even diversified investors were devastated with losses in 2001 and 2002 and it did not matter if they were diversified. In a general decline, most stocks fall, even the high quality ones, and poor quality stocks fall even more. A person about to retire within a few years after 2000 would have had little time to make up for the losses sustained in 2001 and 2002.

So now you can see the pitfalls with covered calls and long stocks as investment strategies. In our next article, part 2 of 4, a method will be examined to aid in ameliorating the down side concerns with covered calls and stocks in general.