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Script - Covered Call Strategies

Introduction to Equity Option

An equity option is a right, not an obligation, to buy or sell a stock (or other security) for a specified price on or before a specific date. There are two types of Equity Option: Call option is the right to buy a stock; Put option is the right to sell a stock. The person, who purchases an option, whether it is a put or a call, is the option "buyer". Conversely, the person who originally sells the put or call is the option "seller".

The specific stock on which an option is based is commonly referred to as the underlying security. Option premium is the price of an option a buyer must pay to an option seller for an option contract. In return, the option seller is obligated to deliver the underlying security to the option buyer if the option is exercised.

Covered Call Strategies

Covered call strategies pair a long position with a short-call option on the same stock for an upfront premium paid by the buyer. Investors can get an additional source of income by selling covered call. It means that you already own shares of the underlying stock and you are selling someone the right, but not the obligation, to buy that stock at a strike price until the option expires—the price won't change no matter which way the market goes. In return, the buyer pays you, the seller cash, also known as the option premium.

The strike price of a call option determines whether that contract is "in-the-money", "at-the-money" or "out-of-the-money". "In-the-money" means the strike price is less than the stock price. The buyer will most likely exercise his right to buy the stock, as the strike price is less than the market price of the stock. You will mostly likely have to deliver the stock and receive the premium.

When the strike price is the same as the stock price, that is "At-the-money". The buyer is indifferent to exercise his right to buy the stock. You may not need to deliver the stock if the buyer does not exercise the right and receive the premium.

If the strike price is greater than the stock price, which is "out-of-the-money", the buyer will most likely not exercise his right to buy the stock, as the strike price is greater than the market price of the stock. You will mostly likely not have to deliver the stock and receive the premium.

Illustration of a covered call strategy*

You have 100 shares of ABC Co, purchased at USD 30 a share. You decide to sell a covered call option on ABC stock, with strike price at USD 35, option premium is USD 4 per share.

If the market price of ABC co. rises up to USD 37 a share, this is "in-the-money" with strike price less than stock price. There will be 400 USD gain from the premium plus the 500 USD realized gain in common stock. You benefit from the additional cash flow and stock appreciation, but do not participate in additional profits. If it is "At-the-money", the market price of ABC co. being the same as the strike price, there will still be 400 USD gain from the premium as well as the 500 USD realized gain in common stock. You benefit from the additional cash flow and stock appreciation.

When the share price remains at USD 30 per share, which is less than the strike price, that will be "out-of-the-money". The net gain will only be the USD 400 from the premium. You benefit from the additional cash flow only. If the share price goes down further to USD 27 per share, the 400 USD gain from the premium can help offset the downside of the unrealized depreciation of the stock. You benefit from the additional cash flow while offsetting the stock depreciation.

*These hypothetical examples are for illustration only and do not represent any actual return likely to be achieved.

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