COVERED CALL WRITING

Covered call writing is the process of buying stock and selling a call option against it. When a call option is written against stock, the writer is granting a call buyer the right to buy the stock at the *striking price* of the written call. Alternatively stated, the call writer is obligated to sell his stock at the striking price, should the stock rise above that striking price. Therefore, it must be understood that these stocks may be sold in accordance with the fulfillment of such obligations as a call option writer. Should that happen, it is envisioned that the proceeds would then be invested in a new high-quality stock, upon which calls would also be written.

Call Premiums As Income

The income generated by the writing of calls can be made available to the client. Based upon historical patterns, it is likely that the total return of operating a covered call writing strategy will be in the neighborhood of 15% to 20% per year, based on the initial net asset value of the account. However, there is no guarantee that option premiums will, in the future, remain at levels high enough to generate that much income. It is conceivable that income could be *less* than that estimate, should premium levels drop dramatically in a stagnant market.

Risk Factors and Management

It should be understood that the covered call premium will *not* compensate for a significant decrease in the price of the stock. Hence, *this strategy has downside risk,* but that risk is less than the risk of owning the stock outright. If the stock falls, it may be possible to adjust the striking price of the written calls in order to provide additional income, and a modicum of downside protection should the stocks decline. That is, if the stock should drop in price, the original call will be bought back and, in their place, other calls will be sold at a lower striking price (and probably with a longer maturity date as well).

Conversely, if the stock should *rise* to or above the striking price of the written call, it may also be possible to make adjustments rather than let the stock be called away. Again, the previously written call would be repurchased, and a new call sold in its place. Alternatively, it may often be the case that the covered writing will merely let the stock be called away at expiration of the written call options.

One other possibility arises, although it is not anticipated to be an everyday part of the strategy. In particular bearish market periods, it may be wise to buy some puts as protection for the stocks in the account. Any such transaction could be paid for with the proceeds from written calls. This strategy would only be enacted if, in the covered writer's opinion, the overall market risk were large and therefore the protection provided by the call premiums seemed inadequate to shield against that risk. There is no guarantee that the market will indeed decline if such puts *are* bought for protection.

In any case, there is substantial risk if the stocks in the account should drop in value. The premium from the written calls will most likely not be able to compensate for that risk.

Summary

This is a strategy that does best if the market is neutral or rising. Since it has less risk than simple stock ownership, it is considered suitable for most investors, although it must be understood that there is considerable downside risk and also that any stock in the portfolio could be sold via call assignment if the underlying stock rises far enough in price.