

# The Covered Call Analyzer

## Here's how covered calls work

We will be giving an actual example of a covered call buy/write below, but first some definitions and rules.

### DEFINITIONS AND RULES

**Simple Definition** - Covered calls have two parts. First, someone must own some stock. Second, someone must be willing to give the holder of the stock some money for the right to buy the stock at a certain price at a later date.

**Broader Definition** - Covered calls are rights or contracts (call options) you sell to someone in exchange for some money (call premium), giving them the right to buy stock you own, at a fixed stock price (strike price) within a fixed time period (before expiration of the call option). The holder of the call can buy the stock at the strike price at any time before expiration. The call contract expires at expiration if not exercised and the seller keeps the call premium. The buying of stock and the selling of call options on that stock is called a buy/write (*buying* the stock and *writing* the option contract). The buying and selling (writing) is all done by your broker, and is generally just as easy as buying and selling stock.

**Other Things you need to know** - Thousands of companies have put and call options traded on their underlying stock, resulting in thousands of put and call options that are traded every day. There are no contract documents that are signed. Options are traded just like stock through a brokerage company.

We will be describing only covered calls in this "Short Course", which means that the owner of the stock sells the calls to someone else. The seller of the calls is "covered" with actual shares and will be able to deliver the stock to the buyer if they are called.

There are two types of Covered Calls. The first is "In-the-Money" (ITM) calls that have a strike price below the stock price. For example, the strike price is \$12.50 and the current stock price is \$13.67. The premium for this call will be large - made up of the difference between the strike price and the stock price plus some premium above the strike price. This is a defensive strategy when you think the stock price is going to go down. You lock in the current price if the stock goes down. The other Covered Call is Out-of-the-Money (OTM). This means the strike price is above the strike price. For example, the strike price is \$15.00 and the current stock price is \$13.67. The premium for this call will be small - made up of speculation that the stock price will go up and even go over the strike price. If the stock price does go up, you add to the call premium the appreciation of the stock price. This is an offensive strategy when you think the stock price will go up.

**The Analyzer Objective** - Covered calls provide the investor with some insurance. The premium received from the sale of the call is not at risk. The investor selling the calls against "owned" stock gets to keep this premium. The question is when to use "In-the-Money" calls vs. "Out-of-the-Money" calls. The Covered Call Analyzer strategy is to always use "Out-of-the-Money" calls and anticipate getting called at the strike price at the next expiration. The Analyzer uses algorithms that calculate those OTM call premiums (prices) that are exceeding the normal prices investors would pay for a stock's call contract. There seems to be more attention paid to these stock's calls. Why are these OTM call prices "out-of-line" with the normal? It usually means that something good is going to happen to the stock price. The people

who know what is going to happen are the "insiders". There can be a lot of insiders - company officials, analysts, and even government officials that might know that a company is going to get a government award, and many more. Most insiders don't buy the stock when they know something is going to be good for the company. They generally have to declare the purchase, and it is more expensive (buying at the stock price). The better way for "insiders" to make money on this anticipated good news, is to buy calls - just buy the calls (known as naked calls). Buying calls does not have to be reported by the insider. If the stock's "good news" pushes the stock price up from \$11.00 to \$12.50 a share, there is a 13.6% return. Not bad. But, if they buy the \$12.50 calls at \$0.90 and the stock goes above \$12.50 before expiration, the call price will go from \$0.90 to above \$1.50 - a 66.7+% return. Much better. See example below. Most investors can't trade "naked calls", but average investors can sell covered calls to those insiders who are anxious to take advantage of "what they know". The Analyzer finds those stocks that have really good call premiums. Covered calls are considered "conservative" and are allowed in IRA and other safe accounts. Call premiums offer insurance against a "downside" in purchased stocks. So the Analyzer has become "The Covered Call Analyzer."

**Some Rules** for options trading:

1. The expiration day for equity (stock) options is the Saturday following the third Friday of the month. Therefore, the third Friday of the month is the last trading day for all expiring equity options. However, some professional traders can go in on expiration Saturday and "clean up" expiring options that have a little value. [Options Calendar](#)
2. Options are traded with expiration dates for the next two months and then a variety of months (and years) after that. These are called option cycles.
3. Stock options are generally traded in \$5.00 increments of strike price except for low value stocks (below \$35.00) where the increment is \$2.50. In 2010, a few stocks with \$1.00 strike prices were introduced to provide more flexibility in buying and selling puts and calls. The number of stocks with \$1.00 strike prices have increased since then.
4. In-the-money (ITM) calls have a strike price less than the stock purchase price. Out-of-the-money (OTM) calls have a strike price higher than the stock purchase price. The Analyzer can analyze in-the-money and out-of-the-money buy/writes. For our portfolios, we consider only out-of-the-money buy/writes since we anticipate a double return - increase of share price to the strike price and the premium received from the sale of the call.
5. Option symbols identify the underlying stock, the expiration month, and the strike price. In 2010, a new method of identifying these parameters was introduced but can vary by exchange or broker. For this website, the Analyzer uses a symbol like this:  
  
**CIE1221A12.5** - where CIE is the stock symbol, A is the month (A is Jan, B is Feb, etc. so A is January), 21 is the expiration date in January, 12 is the year (January 21, 2012), and 12.5 is the strike price.
6. Each option contract represents 100 shares of the underlying stock, so you must purchase the stock (or have the stock) in blocks of 100 shares.
7. Five options exchanges create markets in options, including the Chicago Board Options Exchange (CBOE), the AMEX and NYSE Options Exchanges.

It has been found over time that covered calls provide one of the safer option strategies. Covered calls can be traded in IRA accounts. Call contracts are traded just like equities (stocks) in large volumes every trading day. There is a commission on the option transaction.



## **EXAMPLE Cobalt International Energy, Inc.**

Before running the **Covered Call Analyzer** we input \$2,000 in the money available field along with the default parameters. We were looking for stocks to publish in our \$10,000 Aggressive Portfolio.

On December 17, 2011 (expiration weekend), the **Analyzer** found this buy/write, which is presented in a way that allows you to know what to do and how to execute the transaction with your broker:

Buy **100** shares of **COBALT INTERNATIONAL (CIE)** at **\$11.00** (closing last trade price) and sell **1** call **Out-of-the-Money** contracts of **CIE1221A12.5 (Jan\$12.50)** at **\$0.90** (closing bid price) expiring on **1/21/2012**. Cost is **\$1,110**, and income from sale of the calls is **\$79** and includes your commissions. Actual return if called at expiration is **19.7%**.

The **Analyzer** suggested buying 100 shares of Cobalt International at \$11.00 per share for a total cost of \$1,110, assuming \$9.95 in commission charges (The **Analyzer** calculates the number of shares, in blocks of 100, and total cost after commission insuring that you do not go over the money available of \$2,000. You can put any value into the money available field before running the **Analyzer**, but remember that you have to have enough money to buy at least 100 shares).

You could leave these shares in your account and hope that the stock moves up. Actually, the price will probably fluctuate - go up, go down, or stay the same - over the next few months. The **Analyzer** has identified Cobalt International as a good covered call candidate. What this means is that you will be giving someone the right to purchase your stock (100 shares of Cobalt International) at a predetermined price (\$12.50) within a predetermined time (before 1/21/2012) and that person will give you some money (\$0.90 per share) for the right to do this. The predetermined stock price at which you will sell the stock is called the strike price; the time period is set by an expiration date; and the money given is the premium. The right to do this is called a covered call option contract.

The reason it is called a covered call is because you own the stock and can deliver the shares if the strike price is reached or exceeded and the buyer of the contract calls your stock away (you have the contract covered). In most cases, this is what we want for out-of-the-money (OTM) calls. Options are traded daily on thousands of stocks and the **Analyzer** helps you find good stock/call combinations (or buy/writes - you buy the stock and write the call) like Cobalt International. We have the **Analyzer** select stock/call combinations that have a strike price above the stock purchase price. This is an out-of-the-money call. This means that the price will have to appreciate to the strike price before it will get called away. Thus you will make more money in addition to the premium, in stock appreciation.

Let's get back to our example. The **Analyzer** found Cobalt International out of all the stock/call combinations because it met all our input parameters (default in this case), had a high premium price (\$0.90) and a large spread between the stock purchase price and the out-of-the-money strike price. The call contract that was found had a strike price of \$12.50 (out-of-the-money) with expiration on the Saturday after the third Friday of the next month (January 21, 2012) and selling for \$0.90 per share (the call bid price or premium). What this means, is that there are investors who are willing to give you money (\$0.90 per share) for the right to buy your Cobalt International Inc. stock at \$12.50 a share (the strike price) within the next 30-35 days (actually any time before January 21, 2012). Because you paid \$11.00 per share, which is lower than the strike price (\$12.50), this is an out-of-the-money covered call transaction, meaning the stock price has to rise to \$12.50 before it will be called away. You get the call price (\$0.90 premium) for selling the call contracts as well as possible appreciation of the stock share price to \$12.50 before the shares of Cobalt International would be called away.

You call your broker on the Monday morning after expiration weekend (December 17) and buy 100 shares of Cobalt International and sell 1 Jan12.5 (January \$12.50) covered calls against the 100 shares of stock you just purchased. Calls are traded in 100 share contracts, and the call contract symbol is **CIE1221A12.5** (the **Analyzer** determines this symbol for you). The markets are dynamic, so you will probably not get the same prices as the **Analyzer** found at the close on Friday before expiration weekend. But they should be close and stock prices and option prices tend to move in tandem so your return should be close to what the **Analyzer** calculated. We will use the Friday close prices to continue this example. You receive \$79 for the sale of the calls (this is after the default commission of \$9.95 plus \$1.50 per contract on the sale of the 1 call contract). This money is like income, it goes right into your account or into your pocket and you don't have to give it back - it's yours, risk free. This money represents a real instant return of 7.1% ( $\$79/\$1,110$ ). If you bought the stock on margin, the return is even greater (but margin purchases are not allowed in IRA accounts).

Now you wait for the 34 days until the option exercise date, January 21, 2012. One of four things can be true on this date - the stock price went down; the stock price stayed the same; the stock price went up, but not above \$12.50; or the stock price went above \$12.50.

Let's look at each of these four scenarios:

1. The stock price went down. Your portfolio value went down, but you still have the \$79, and the person that bought the 1 call (which are contracts between you, the seller, and the buyer) is not going to take the stock away from you at \$12.50 because the stock price is less than \$11.00 (the original stock purchase price). If the stock went down to \$9.35 (-15%), your loss would be \$175 ( $\$1,110$  [cost] -  $[100 \times \$9.35]$ ), but the sale of the calls offsets that loss by \$79, resulting in an actual loss of \$96 (-8.6%). So you are better off having sold the covered calls even though the stock price went down and didn't get called. You keep the stock, you keep the \$79 premium and the call contract you sold ceases to exist after January 21, 2012.

2. The stock price stayed the same. Your portfolio value stayed the same and you still have your stock and the \$79. The person who bought the 1 call is not going to exercise, because the stock price is still \$11.00 and he/she is not going to give you \$12.50 for each of your 100 shares. You realize a 7.1% ( $\$79/\$1,110$ ) real return on this 34 day investment and keep the stock. That's an annualized return of 85.2%

3. The stock price went up, but not above \$12.50. Your portfolio value went up, you still have the \$79, and you get to keep your stock, because the person that bought the 1 call isn't going to pay you \$12.50 for shares selling for less than that price. You realize more than 7.1% real return because the stock price has appreciated from the stock purchase price but not enough to lose the stock and you get to keep the \$79 premium. The call contracts you sold ceases to exist after January 21, 2012. In case 1, 2, and 3, you may decide to sell 1 more out-of-the-money covered call for the next month (February 2011) and get some more premium, since you still own the stock.

4. The stock price went above \$12.50. This is what we want! The person who holds the 1 call exercises. That means he/she takes your 100 shares of Cobalt International Inc. at \$12.50 each. You had a gain of \$1.50 on each share that you owned ( $\$12.50$  minus your cost of \$11.00), or \$150 for the 100 shares. But you must pay a commission on the sale (call) of your stock, assumed to be another \$9.95, yielding a gain of \$140. This, added to the \$79 that you received for selling the 1 call initially, yields a total return of \$219 (a real return of 19.7%, or an annualized return of 205.4%). Your money was invested for 34 days. Your \$1,110 investment became \$1,329 (+19.7%) in that short period. Note the calculated return in the **Analyzer's** "Buy...." statement above.

The **Analyzer** is able to find stock/call combinations that the market makers are paying a high premium for and have a good spread between the stock purchase price and the strike price. Cobalt International was an opportunity that the **Covered Call Analyzer** found among all the possible covered call buy/writes. The **Analyzer** does not rely on trends, formulas or charts. It assumes that the professionals have done all that and are investing their money in call contracts, thus driving up the premium values. The **Analyzer** finds these high paying buy/write opportunities. Our objective is to get the stock called away at the next expiration date and then use the **Analyzer** to find other opportunities to sell calls on.

This example demonstrates the following key points:

1. The \$79 is never at risk.
2. Portfolio value will fluctuate with the rise and fall of stock prices whether you sell the options or not.
3. Commission effects are rather large, but the returns are also large. The larger the blocks of stock you buy and the more covered call options you sell, the less influence commissions will have on your returns.
4. One call represents 100 shares, so you must sell calls on blocks of 100 underlying shares.
5. If the Cobalt International Inc. stock went to \$16.00 (which it did) you may be upset because you missed the ride. Don't look back. Take your 19.7% return, realized in 34 days, and move on to another opportunity using the **Analyzer**. This does demonstrate that the **Analyzer** can find good stocks that the insiders know about.
6. If the stock didn't get called away, you may want to repeat the process of selling more covered calls for next month. If the stock did get called away, use the **Analyzer** to find another opportunity to re-invest the proceeds.

See where [Cobalt International](#) is today

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