New York Securities Pty Ltd

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# Options Strategy – The Covered Call

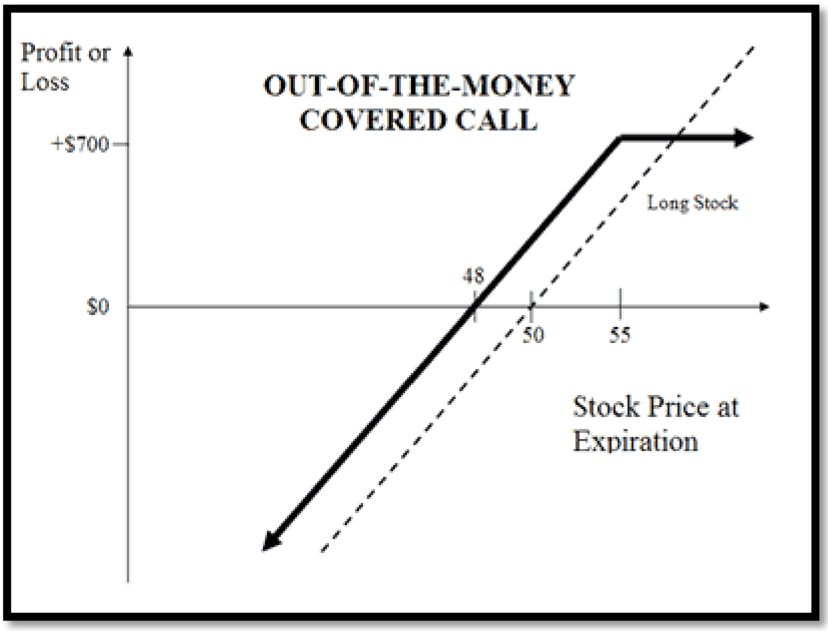
The covered call is a strategy used to generate income from holding a long position in a stock. Additionally it offers limited protection on a decline in the underlying share price. It is a strategy that is normally executed when an investor who is long on the underlying share has a short term neutral view on its share price.  It is also commonly referred to as a ‘buy-write’

In order to execute the covered call you must ensure you hold sufficient quantities of the underlying, that is if each call option represents 1,000 shares and you are looking at selling 1 call option you must be holding 1,000 shares of the underlying to ensure the call is fully covered. No margins are required to be paid on a covered call.

**The covered call is executed as follows**;

The investor holds 1,000 shares in XYZ as at 1st January 2010; the share is trading at $54. The investor has a short term neutral view on its share price for the month of January 2010.  As such the investor sells (writes) 1 x (out-of- the- money) XYZ JAN $55.00 Call option for $0.70 premium.

The income the investor derives from writing the call option is 1 x 0.70 x 1000 (1,000 shares per contract) =$700 (excluding brokerage).




Three possible Scenarios will occur;

1) XYZ will trade sideways for the month of January and at expiry closes lower than the $55 strike price. The result is the call option expires worthless, the investor keeps the premium and the investor retains a long position in the XYZ shares.
2) XYZ falls in value far below the strike price of the call option at $55. The result is the option expires worthless; the investor keeps the premium and retains a long position in XYZ shares.
3) The XYZ share price increases above the strike price of $55. The result is the call option is exercised (The investor sells 1,000 share at $55) and the upside on the share is capped at $55, plus the call options premium.

**Alternative action prior to expiry**

If the investors view on the share price changes significantly prior to the call option expiring, the investor can close out (buy) the call position on the ETO market. The closing transaction thus relieves the investor of the obligation to sell their shares at the strike price of the call option (in this example $55). Prior to taking this action the investor should weigh up the profit and loss that could be realized from the option transaction against the unrealized profit or loss from holding the underlying share.

**Overall,** while this strategy can offer limited protection from a decline in price of the underlying share and limited profit with an increase in stock price, it generates income because the investor keeps the premium received from writing the call. At the same time, the investor can appreciate all benefits of underlying stock ownership, such as dividends and voting rights, unless he is assigned a on the written call and is obligated to sell his shares. The covered call is generally regarded as a conservative strategy because it decreases the risk of stock ownership.

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**For more information on this strategy please call New York Securities Pty Ltd on (08) 9363 1700 to speak to an Accredited Derivatives Advisor.**

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