An Introduction to Covered Call Writing
The Potential To Generate Income On Your Equity Portfolio

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February 26, 2014

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Covered Call Writing

What Is a Covered Write?

- A covered write is an agreement to cap upside stock appreciation in exchange for current income.
  – One type of covered call, known as a **buy-write,** involves the simultaneous purchase of stock and writing of a call.
  – Another strategy, known as an **overwrite**, involves writing call options (wholly or partially) against shares you already hold.

- Covered Call Writing Strategy:
  – Buy or own underlying stock and sell calls
  – Generally, each option contract represents 100 shares of stock
  – Call premium received

Examples:

_ Long (own) 100 shares of XYZ and sell 1 XYZ Apr 45 call

_ Long 1,500 shares of XYZ and sell 15 XYZ Apr 45 calls

_ Long 2,000 shares of XYZ and sell 10 XYZ Apr 45 calls

Why Consider a Covered Call Strategy?

- Potential to Generate Income
  - When the option is sold, a premium (option price) is received.
  - Any gain or loss will be realized when the option is exercised, expires or is closed.
  - The premium supplements any dividends received.

- To Partially Reduce the Risk of Stock Ownership
  - Since the option is sold for a premium, that premium can partially offset any potential loss on the stock.
  - However, it is important to note that premiums are typically a small part of the total capital requirements of the strategy.
  - This strategy has less 'downside risk' than an outright 'buy' of the stock.

- To Establish an Upside Selling Price Target (Only True if Assigned)
  - In return for the premium received, the call writer agrees to sell the stock at the strike price if assigned – caps upside potential.

Risks and Considerations

- **Opportunity Cost / Stock Ownership** – The writer of a covered call forgoes the opportunity to benefit from an increase in the value of the underlying security above the option strike price, but bears the risk of a decline in the value of the underlying security. At some point in time, long stock will outperform a covered write.

- **Equity/Market Risk** – Option prices are driven by several factors, one of which is the price of the underlying security. If the price of the stock underlying an option increases or decreases, the value of the option contract may change. An increase or decrease in market and/or stock volatility is also likely to affect the price of an option contract.

- **Assignment** may occur at any time during the life of the option. If the call is assigned, the writer must deliver the underlying security.

- **Rolling**, or buying back a call and writing another with a different strike price and/or maturity, could result in added commissions, which could reduce roll returns.

- **Taxable Event** – The sale of the stock through an option assignment or the closing of an option position may produce a tax consequence. Please consult with your Tax Advisor prior to entering into any transactions.[1]

- **Qualified Covered Calls** – Certain in-the-money covered call writes are deemed ‘unqualified’ and carry certain tax consequences. You should consult your Financial Advisor or Tax Advisor.

- The outlook for the broader market or the underlying security may change.

There is no guarantee that these strategies will succeed. This information is intended to illustrate products and services available. The strategies do not necessarily represent the experience of other clients, nor do they indicate future performance. Investment results may vary. The investment strategies presented are not appropriate for every investor. Individual clients should review with their Financial Advisors the terms, conditions and risks involved with specific products or services. Past performance is no guarantee of future results. Supporting documentation relating to this material will be supplied upon request.

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Who Should Consider a Covered Call Strategy?

Investors who want to cap their upside for income

- The covered call strategy works best on stocks whose price might increase toward the strike price but not significantly higher.
- You must be willing to sell the stock at the strike price if the call is exercised.
  - Remember, if the stock price appreciates above the call option strike price you will forfeit any further stock price appreciation.
  - If the stock price decreases below the breakeven point you will have a point for point unrealized loss.

Covered Call Risk vs. Reward

Limited Reward with Partial Protection

- Profit potential is limited

  = (strike price - stock purchase price) + (call premium received + any dividends)

- Partial downside protection (limited only by the amount of the call premium) to the breakeven point

  = stock purchase price – (option premium + any dividends)

- Breakeven point

  = stock purchase price – (option premium + any dividends)
  - Below the breakeven point there is point for point stock risk
  - Maximum loss is the total value of the stock

Three Possible Scenarios at Expiry

Stock price climbs to or above strike price

- Do nothing - position is assigned, stock is sold at strike price
- Buy back the call to close and continue holding the stock
- Roll the position - simultaneously buy original call to close and sell a new call
- Close the position - buy call back to close and sell the long stock

Stock price unchanged; Call expires worthless, creating a gain

- Write another call
- Continue to own long stock

Stock price falls below breakeven point

- Close the position - sell stock & buy call to close
- Roll the position – simultaneously buy original call to close and sell a new call
- Call expires worthless - Continue to hold stock without partial downside protection

Remember to consider transaction and commission costs when rolling or closing options. Closing or rolling options could result in a loss.

Three Possible Scenarios at Expiry: Example

Consider a Covered Write strategy on the following stock and option:

Stock Information

Symbol: XYZ   Price: $68.26

Shares: 500   Ann Div: $0.84

52 Week Range: 48.13 – 73.99

Capital Required

500 Shares at $68.26 =	$34,130.00
Stock Commission =	$512.88
Stock Cost =	$34,642.88
Option Proceeds =	$1,825.97
Capital Required =	$32,816.91

Option Information

Selling: 5 1021H70 (10 Aug 70.00) Calls @ $3.80

There are 121 days to expiration

Dividend to Expiration: $0.42

5 CALLS at $3.80 =	$1,900.00
Call Commission =	$74.03
Option Proceeds =	$1,825.97

This example is for hypothetical purposes only. Commission fee is for illustrative purposes only. Actual commission charge may vary. Tax implications have not been included as they vary for each investor. Please consult your tax advisor before executing any options strategy.

Scenario 1

Stock price climbs to or above strike price

If Exercised - Return (if option is assigned):

- Actual Return = Net Profit/Capital Required
- Net Profit =Stock Gain + Option Premium Commissions (using 30% discount) + any Dividends
- Annualized Return =(365/Days to Expiration) x Actual Return

Calculation

Sell 500 Shares at $70 Strike Price	=	$	35,000.00
Less Stock Commission	-	$	527.23
Plus Expected Dividends	+	$	210.00
Total Proceeds	=	$	34,682.77
Less Capital Required	-	$	32,816.91
Net Profit	=	$	1,865.86
Percentage Returned for Period	=		5.69%
Annualized Return	=		17.15%

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Scenario 2

Price unchanged; Call expires worthless, creating a gain

Price is unchanged - Price Return or Yield if the call expires worthless

(calculated for out-of-the-money calls only):

- Actual Return = Net Profit / Capital Required
- Net Profit = Option Premium – Commissions + any Dividends
- Annualized Return = (365 / Days to Expiration) x Actual Return

Calculation

500 Shares at $68.26	=	$ 34,130.00
Plus Expected Dividends	+	$ 210.00
Less Capital Required	-	$ 32,816.91
Net Profit	=	$ 1,523.09
Percentage Returned for Period	=	4.64%
Annualized Return	=	14.00%

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Scenario 3

Stock price falls below the breakeven point

Your breakeven price:

(Capital Required – Expected Dividends) / # of Shares

Calculation

Capital Required	=	$	32,816.91
Less Expected Dividends	-	$	210.00
Net Amount	=	$	32,606.91
Shares	=		500
Breakeven Price	=	$	65.21

Maximum Loss = $65.21 per share
Investor looses point for point below breakeven point

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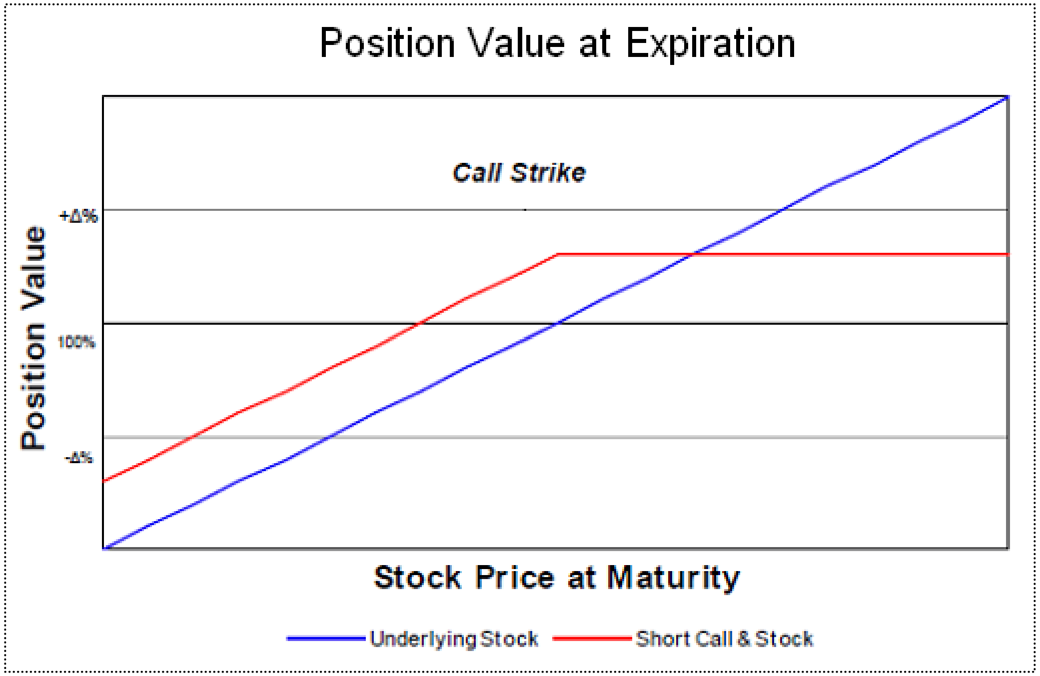
Covered Call Profit and Loss Chart

- Profit potential is limited; Forgo upside stock price appreciation if assigned
- Yield created if price is unchanged and option expires worthless
- Partial downside protection



If the Stock Price Declines

- Below the breakeven point of $65.21, the position has point-for-point stock risk.
- Covered call writing can partially reduce the risk of owning the underlying stock.
  - If the investor owned the stock and had not written the call, the investor would have been exposed to a total risk of $68.26/share.
- The position should be monitored if it approaches the breakeven price. If so, the investor should look for fundamental and/or technical changes that might cause the stock price to drop below the breakeven price.
  - If there is a material change to the stock price the investor may:
    - Close out the position, that is, buy the call to close and sell the stock
    - Buy the call to close and continue to hold the stock
    - Roll the position

Summary

- Covered call writing may be an appropriate strategy if the investor:
  - Believes the stock can appreciate to the strike price but not significantly higher.
  - Is looking to potentially increase income.
- Remember, upside profits are limited.
  - Be willing to sell the stock at the strike price.
- Losses occur when the stock price drops below the breakeven price.
  - Downside risk is offset by the amount of option premium.
  - Re-evaluate the position if it approaches or trades below the breakeven price.
    - Take a disciplined approach.
    - Know your tolerance for risk.

Additional Information

Every investor is unique. If you are looking to generate income, establish an upside selling price target or to partially reduce the risk of stock ownership you may want to consider writing covered calls.

Call your Financial Advisor for more information on covered call writing or to learn how this strategy may suit your investment needs.

Available for your review:

– **Real-Time Options Pricing** for the different months and strike prices
– **Customized Options Search** based on your objectives and stock holdings
– **Rates of Return Worksheets** that illustrate how returns are calculated

Glossary

Call Buyer (Owner)

- obtains the right to buy the underlying shares…
- at a fixed (strike) price…
- for a specified period of time (until expiration)

Call Seller (Writer)

- assumes an obligation to sell the underlying shares…
- at a fixed (strike) price…
- if assigned (when the option is exercised by its owner)

Strike Price

- The price at which the owner of an option can purchase (call) or sell (put) the underlying stock.

Premium

- The total price of an option =

  intrinsic value + time value

Intrinsic Value

- The in-the-money portion of an option's price.

Time Value

- The part of an option's total price that exceeds its intrinsic value.
- The price of an out-of-the-money option consists entirely of time value.

Call Exercise

- Generally, the option buyer obtains the right to buy 100 shares of the underlying stock per call at the strike price.
- Stock is bought from the call seller (writer).

Glossary (continued)

Call Assignment

- Generally, the option seller is called upon to fulfill the obligation to sell 100 shares of stock per call at the strike price.
- Stock is sold to a buyer who exercises.
- Sellers are assigned on a random basis.

Expiration Month

- The month in which the option expires.
- The life expectancy of an option contract is the number of days until expiration.
- All equity option contracts expire on the Saturday following the third Friday of the designated month.
- Some stocks have long term options (called LEAPS®) that may have expirations of up to three years in the future.

Equity Calls are American-style

- They can be exercised and assigned at any time before expiration.

In-the-money calls

- A term used to describe an option with intrinsic value. A call option is in-the-money if the stock price is above the strike price.

At-the-money calls

- A call option with a strike price that is equal to the current market price of the underlying stock.

Out-of-the-money calls

- A term used to describe an option that has no intrinsic value, i.e., all of its value consists of time value.
- A call option is out-of-the-money if the stock price is below its strike price.
  Selling calls closer to at-the-money typically generates more premium than selling calls that are further out-of-the-money.

Rolling

- A transaction in which an open option position is closed and a new option position is created simultaneously at a different strike price, different expiration, or both.

Covered Write Disclosure and Risks

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Option prices may move rapidly and unpredictably in a direction unanticipated by market participants resulting in potentially severe losses. All options contracts involve inherent leverage, which will magnify any loss as well as any gain. Any number of factors may contribute to illiquidity/restricted trading including, but not limited to, disruptions in trading of the underlying asset, insufficient number of market participants, or actions of courts or regulatory agencies, all of which may effectively restrict contract disposition resulting in potential loss. Option writers may incur opportunity costs by foregoing the opportunity to benefit from favorable movements in the underlying asset.

Covered Call Risks

Options are not suitable for all investors; therefore the covered call strategy may not be suitable for all investors. Some of the risks of covered call writing are the following:

1. An option writer may be assigned at any time during the life of the option, including the day written, regardless of the in- or out-of-the-money status of the position.
2. If the short call is assigned, the writer must deliver the underlying security.
3. The writer of a covered call forgoes the opportunity to benefit from an increase in the value of the underlying security above the option strike price, but continues to bear the risk of a decline in the value of the underlying security.
4. Buying back a call to close an existing position and writing another call with a different strike price and/or expiration, also known as rolling, can have an adverse impact on the profitability of the account. Rolling will result in added, transaction costs which will reduce returns or add to any losses. Note: It may not be prudent to continually roll positions at a loss.
5. If a secondary market in options becomes unavailable and prevents a closing transaction, the options writer's obligation would remain until expiration or assignment.
6. The sale of the stock through an option assignment or the closing/expiration of an option position may produce a tax consequence. Please consult with your Tax Advisor prior into entering any transactions.

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