



[The Covered Call / Buy-Write Strategy](#)

For better or worse, most investors purchase stocks with the intent of holding their shares for an extended period of time.

We do this mainly because the media and industry professionals have drilled into our heads, year after year, time after time, that it's best to buy and hold. The recent bull market phenomenon also fueled this mindset because the 'buy and hold' strategy worked extremely well - for a while.

Whether or not the 'buy and hold' strategy is still the most efficient way of investing remains a topic for discussion. However, it is still the strategy that most investors are comfortable with and tend to follow.

The first strategy we will discuss is a hybrid of the buy and hold strategy, one that provides for better and more consistent returns a large majority of the time when compared to naked stock ownership alone.

When we buy a stock, there are three possible outcomes. As we discussed previously, two of these scenarios are generally negative and only one outcome is generally positive. If the stock goes up, that is good. If the stock goes down, that is bad. And if the stock stays still, that is also a bad outcome.

To briefly recap, not only do you have a loss in opportunity cost (the money invested in your stagnant stock could be making you money if somewhere else) but also, you have incurred commission costs on both the way in and way out. So, in this case, only one of the three scenarios provides a positive return.

For the sake of description, we will identify the three potential scenarios as the "up" scenario, the "down" scenario and the "stagnant" scenario. By employing the covered call or "buy-write" strategy, you can change the outcome of the scenario profile so you have two positive potential results instead of only one.

Employing the covered call or "buy-write," we still have the "up" scenario as a positive result, but now the "stagnant" scenario will also produce a positive result since we collect a premium and the third scenario, the "down" scenario will not be as negative.

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Thanks to the covered call strategy, now two of three scenarios end in a positive result and the third has a result that is less negative.

Let's take a closer look at the covered call strategy and its construction. There are two components of the covered call strategy, the stock component and the option component.

The stock component consists of a long stock position (you own stock). The option component consists of selling one call per every one-hundred shares of stock owned.

Remember, one option contract is worth one hundred shares of stock. So for example, 1000 shares of stock equals 10 call contracts or 200 shares equals 2 call contracts.

The chart below shows more examples of the proper construction of buy-writes.

Please take special note that the ratio of stock to calls must be exactly 100 shares to 1 option contract.

<u>Number of Shares Owned</u>	<u>Call Contracts to Sell</u>
100	1
300	3
1700	17
9200	92
14500	145
267000	2670

The philosophy behind the covered call strategy is not complicated. It entails using a long stock position along with a short call option to create a positive stream of additional income, much in the same way a person would purchase a house and then lease it out to collect rent in order to pay for the mortgage.

Another analogy is that of the insurance company. An insurance company receives premiums month in and month out. Over a period of time, this constant stream of income easily builds to a point where it outweighs any pay out the insurance company may face, even for catastrophic events.

The constant and reoccurring collection of option premiums works better if done over longer periods of time (for example, one year.) That time frame allows the odds to play into your favor.



Now let's talk about the odds. There have been several studies done on the topic of premium buying versus premium selling. The goal of the studies was to determine whether it is better to buy options or sell options.

Recent studies have found that selling the premium was the correct trade 78% to 83% of the time. That is a very high percentage and is worth taking advantage of when a good opportunity presents itself.

The covered call strategy takes advantage of the fact that an option is a depreciating asset because its extrinsic value goes to zero at expiration. The process by which an option's extrinsic value dissipates is called time decay.

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