

The “stagnant” scenario vs. The “down” scenario

The “stagnant” scenario

When we apply the covered call strategy to the stagnant stock scenario, we take a negative return scenario and turn it into a positive scenario. Remember, when we sell an option, we receive a premium for doing so.

When the stock does not move during the option’s life, the extrinsic value of the option goes to zero. The amount of money paid for the option goes to the seller. We’ll take a look at how this sets up.

Let’s go back to our previous example with the stock trading at exactly \$9.50. We sell the front month, at-the-money call, which would be the 10 strike call. We sell the front month 10 strike calls at \$.50.

As time goes by, there is less chance for the option to become “in-the-money”. As this happens, the extrinsic value lessens and finally, after Friday expiration, the option is worthless.

The stock finishes at \$10.00 and you have received no capital appreciation but you have received the full \$.50 of extrinsic value from the option sale. If the studies are correct and selling the premium works 80% of the time, then you will collect approximately \$4.00 per contract sold over the course of the year.

As the examples demonstrate, writing covered calls against a stagnant stock can provide you with an acceptable return instead of frustration, wasted time and capital.

The “down” scenario

In the final scenario, where your stock purchase is headed down into negative territory, the covered call strategy can help minimize your losses. Although picking losers and incurring losses is inescapable, it can be minimized and controlled. Let’s take a look at how the buy-write can help us do that.

For example, let’s say you bought a stock for \$9.50 and at the end of the month the stock had traded down to \$8.50, you would have a \$1.00 loss on our investment.

However, if you had sold the 10 strike calls for \$.50, you would only have a \$.50 loss. You would have a \$1.00 capital loss in the stock, but a \$.50 option gain from selling the option, which would expire worthless.



If you were going to buy the stock anyway and incur a possible loss, it is better to take a \$.50 loss than a \$1.00 loss. In this down scenario, the option premium received helped to offset the capital loss.

If the stock is down more than the amount you received for selling the call, then the option premium serves as an offset to the loss of the stock.

However, you can still make money in the "down scenario" using the covered strategy if the stock is only down a small amount. There is a scenario in the buy-write strategy where you can profit from owning a stock that is lower than where you bought it.

Going back to the previous example, you bought a stock for \$9.50 and you sold the front month 10 strike calls for \$.50. At expiration, the stock finishes down \$.20 at \$9.30. You would have incurred a \$.20 loss on your stock.

However, with the stock at \$9.30, the 10 strike call that you sold for \$.50 is now worthless. So, you have a \$.20 loss on the stock and a \$.50 gain from the option premium sold. This leaves you with a gain of \$.30 on a stock that is down \$.20 since the time you purchased it.

To recap: in our third scenario, the "down scenario," your loss will be offset by the option premium you received so your loss will not be as severe. You still may incur a loss, but it will be minimized, and minimizing losses is a key to successful investing.

For a complete breakdown of these three scenarios, please refer to the table below.

Covered Call Example Return Table			
Stock Price	Stock P & L	Option P & L	Total P & L
12.00	+2.50	-1.50	+1.00
11.50	+2.00	-1.00	+1.00
11.00	+1.50	-.50	+1.00
10.50	+1.00	0	+1.00
10.00	+.50	+.50	+1.00
9.75	+.25	+.50	+.75
9.50	0	+.50	+.50
9.25	-.25	+.50	+.25
9.00	-.50	+.50	0
8.50	-1.00	+.50	-.50
8.00	-1.50	+.50	-1.00



Now that we have discussed how to construct a buy-write strategy, and how it will provide returns in the three different scenarios, I would like to talk about

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