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Key Point in - The Stock Replacement Covered Call Strategy

Key Point – The fact that you are creating the covered call strategy (buy-write) by doing the vertical spread is very important to note. For margin purposes, the vertical spread will be margined at a much more favorable rate than the traditional buy-write because you do not own the actual stock and therefore do not have as much to lose. This is especially important to investors/traders who trade on margin.

This scenario includes another significant value added benefit that you receive. When you purchase a spread, the most you can lose is the amount you paid for the spread which in this case is $10.15.

As you already know, the biggest risk in a covered call/buy-write strategy is a large downward move in the stock. If you had done this trade with the actual stock and the stock traded all the way down to $20.00 from $60.00 (although unlikely) we would stand to lose almost $40,000.

However, if you did the trade with the 47.5 calls in place of the stock via the vertical call spread above, the maximum loss is what you spent on the trade. Remember, you purchased the vertical call spread for $10.15. If you traded the spread an equivalent amount of times to equal 1000 shares, you would have bought a total of 10 spreads.

The total dollar amount of your investment would be $10,150.00, as opposed to $58,900 had you bought 1000 shares of Amgen outright. Your loss will be maximized at $10,150 if the stock traded down to $20.00 as opposed to a $38,900.00 loss in the case of outright stock ownership. Even if the stock was to trade down to $0, your maximum possible loss would still be $10,150.

This is because once the stock gets below $47.50, the December 47.5 calls become worthless thus the calls can not lose any more money no matter how much more the stock trades down.

In order to continue or "roll" this position, you will have to roll two options into the next month instead of one. In a traditionally structured covered call strategy (long stock, short call), you are dealing with only one option series.

However, in the stock replacement strategy, you have a second option series (the call you purchased to replace the stock) to roll into the next

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month.
This may incur an additional commission but the trade is obviously well worth it when you look at the previously stated risk/reward scenario and the size of the capital outlay needed to initiate the position.

Conclusion: As we detailed here, the stock replacement version of the covered call/buy-write strategy is an example of the proper use of option leverage. It offers the investor a bigger percentage return, less risk and less capital requirement than the traditional covered call/buy-write strategy.

Anytime you are interested in a high dollar stock, first look to see if there are any deep in-the-money calls that fit this replacement scenario and evaluate if this might be a better option.

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