COVERED CALL OPTION WRITING

FOCUS ON INVESTMENTS

For over twenty years, Vantage has incorporated covered call option writing as a strategy to promote additional cash flow within an account. A covered call option combines the sale of the right to buy stock already held in the account with the benefits of stock ownership such as receipt of dividends and voting. The effective use of this strategy will provide the investor with additional income over merely owning the underlying stock while still participating in a pre-set limit of upside growth. One risk is that the upside potential of the stock is capped which creates a risk of losing the opportunity for growth of the position beyond the strike price of the option contract.

WHAT IS A COVERED CALL OPTION?

An option is a contractual right to either buy or sell a specific amount of a position at a fixed price within a set amount of time. Although there are many different ways to utilize options, Vantage typically focuses on covered call option writing or writing options for positions existing within the account. Each option is contracted for 100 shares. When an option is sold, the buyer purchases the right to either buy (call) or sell (put) the underlying position at the strike price for a period of time up until the expiration date. Options generally expire on the third Friday of the month specified in the contract.

HOW DO THEY WORK?

Assume YZX Trading Co. stock is selling for $30 per share. On the options exchange a call option on YZX Trading Co. might be offered for $1 per share for the right to buy YZX at $35 (strike price) with an expiration date of Nov 19th. The seller would receive $1 per share in option premium for selling this call option in exchange for the obligation to deliver YZX at $35 on or before Nov. 19th. If the stock goes to $37 during the contract term, it will be assigned (exercised). If the stock's value does not exceed $35 per share during the contract term, it will expire and the obligation to sell ends. The seller keeps the option premium and a new option can then be written.

Continuing with the example, long-term prospects appear promising, but the short term indicates the position will remain relatively flat. Selling a call option on YZX with a strike price of $35 will produce premium, but will cap the upside potential of this position. Typically one of three outcomes will result:

- YZX trades below the strike price until the expiration date. The option expires as worthless, the premium is retained, and the strategy outperformed the position.
- YZX shares fall in value. The option expires as worthless, the premium is retained, and again the strategy outperformed the position.
- YZX shares rise in price above $35. The option is exercised and the position value is capped at $35. The position is sold at the strike price. The sale of the stock is realized and the premium retained. In this outcome the strategy may have underperformed the position if the total proceeds, including the option premium, total less than the current market value.

WHEN SHOULD COVERED CALL OPTIONS BE USED?

- When certain portfolio holdings are considered to be neutral or moderately bullish.
- When a concentrated stock position provides an orderly method of divesture of shares.
- When a position has reached a preferred exit value.
- When the desire to increase cash flow and willingness to limit the upside profit potential in exchange for limited downside protection on a position exists.

HOW DO WE USE THIS STRATEGY?

Our investment team utilizes this strategy in a variety of ways depending upon on market conditions. If we feel the equity market is likely to stay neutral or go down, then we sell covered calls at a strike price closer to the actual price in order to receive a higher premium. On the other hand, if we feel the market is bullish, then we focus on retaining more potential for upside by selling covered calls with a strike price much higher than the current price. Typically the premium is less when the gap between current price and strike price is increased.

When divesting a concentrated position, such as company stock, covered calls may also be utilized. Rather than selling the stock outright, the Investment Manager may write covered calls at staggered intervals with increasingly higher strike prices. This can reduce the risk of opportunity cost – a possible result of selling the position all at once. If the calls are not exercised, additional premium can be generated while awaiting a higher market value.

When interest rates are low, covered calls can be used to assist the overall cash yield on a portfolio with an allocation toward bonds. Low interest rates can hamper the income stream within an account and thus have an adverse affect on a retiree trying to maintain an established lifestyle. Covered calls can be sold at a strike price closer to the current position value in order to receive a higher premium.

EXPECTED TAX TREATMENT

Covered calls are generally written for a period shorter than one year, so any option premium received for a contract that expires unexercised is short term capital gain. For those clients with capital losses from prior years, this can allow an offset against the current gains which could mean the call premium is effectively tax free. When calls are exercised and the underlying position is sold, the income from the call takes on the same character as the underlying stock and becomes a taxable event. Thus, if the underlying position has been held for at least one year, even a six-month call, when exercised, will generate long term capital gains. Tax rules are subject to change and individual situations will vary so it is important to review your situation with your tax advisor.

BENEFITS:

- Portfolio income increases while maintaining limited ownership.
- Creates downside protection if the underlying position decreases in value, up to the extent of the premium received.
- Option contracts can be written again and again on the same position if they continue to expire worthless.

RISKS:

- The upside potential for gain is limited on the underlying position (known as opportunity cost).
- The downside risk on the underlying position still remains.

Disclosures: Option contracts include opportunity risk and may require the sale of the underlying position prior to the expiration date of the contract. Positions subject to option contract terms will require re-purchasing of the contract prior to sale resulting in additional cost. Premium values for option contracts fluctuate and are subject to market volatility and demand. Option contracts sold in client's accounts are subject to the discretion of the Investment Manager at Vantage Financial and will be utilized when appropriate within the specific account strategy. Use and positioning of option contracts within an account will vary based on market conditions and the portfolio's overall composition. Additional information regarding options is contained in the Characteristics and Risks of Standardized Options disclosure, which will provided upon request. All investments carry a certain degree of risk including the possible loss of principal and there is no assurance that an investment will provide positive performance over any period of time. Past performance is no guarantee of future results. This information is not intended to be a substitute for specific individual investment or tax advice.