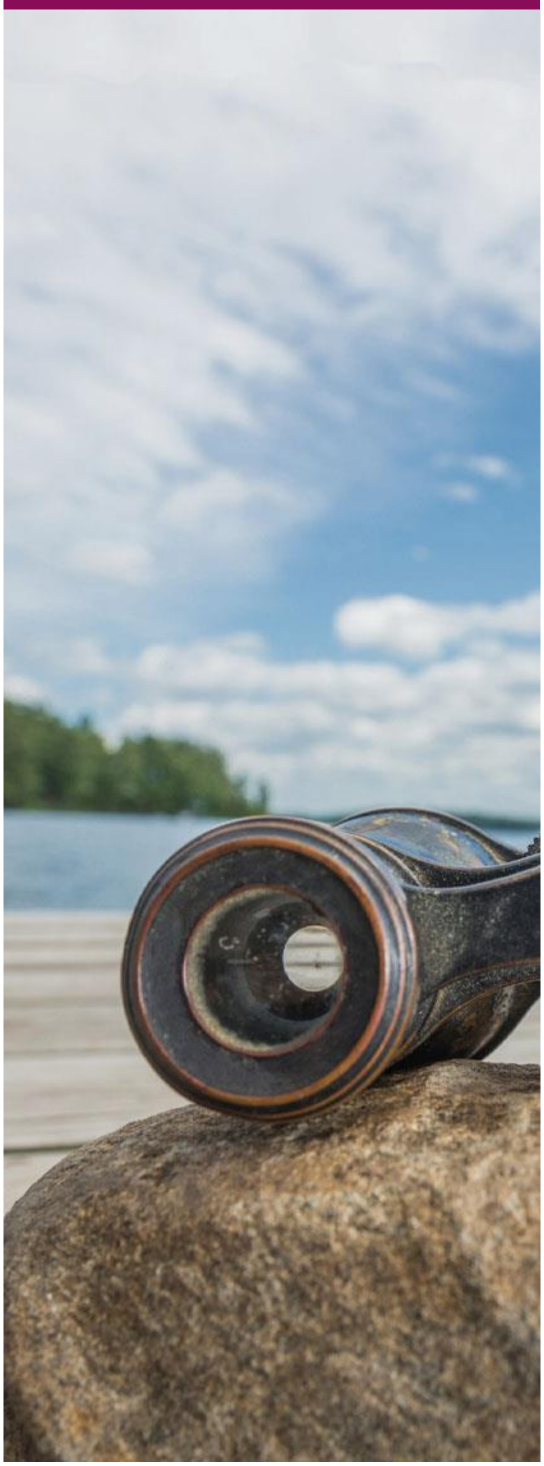
RICHARDSONGMP
VINCENT
YU

News update



Generating income and selling stocks by writing call options

An option contract is a financial instrument that allows the option buyer the “option” to either buy (Call option) or sell (Put option) an underlying stock position at a pre-determined price (exercise price) for a certain period of time until expiration.

For example, if I bought a call option on Microsoft Corp shares with a strike price of US$25 that expires in two months, I have the option of buying Microsoft shares at US$25 anytime up to the expiration. If Microsoft shares were currently trading at US$22 on the market, I would NOT exercise my option to buy at US$25. It is better to just buy the shares on the market at the lower price. If the market price remained around US$22 at expiration, my option would simply expire worthless.

It is important to understand that statistically, approximately 80% of option contracts tend to expire worthless.

When I buy any option contract, I must pay a cost or premium. For example, the premium for a put option contract on 100 shares of Microsoft might be around US$1.00 per share, or US$100. Like any other publicly traded financial instrument, this premium is partly determined by the collective forces of buyers and sellers on the market. But, option premiums are mostly determined by the market value of the underlying stock, the option’s exercise price and time to expiration.

Now, I can also *sell* a call option contract (which is called option “writing”). I would then collect the premium, rather than pay it. However, in this case, the obligation is much higher as I am now obligated to sell the underlying security IF the call option buyer decides to exercise her option. But, if statistically approximately 80% of option contracts tend to expire worthless, put another way there is roughly an 80% probability that I would simply collect the option premium without fulfilling my obligation as the option writer/seller. That said, there are going to be some individual differences depending on the volatility of the underlying stock.

Therefore, option writing or selling is another strategy to generate income in a portfolio, in theory similar to collecting dividends from an investment. Of course, there is a significant difference when one sells a call option which is the obligation to deliver the stock. There isn’t a risk to accept a dividend.

Let me provide an example again using Microsoft Corp. shares. If I owned Microsoft shares and wrote or sold one call option contract (100 shares) on Microsoft shares with a strike price of US$25 with a premium of US$1.00 per share, I will be paid the premium of US$1.00 per share, or US$100 total (“Covered Called”). If Microsoft shares rose on the market from the current price of US$22 to US$26, the call option buyer would likely exercise (because they can buy it from me at a lower price than the market price) and I would be obligated to sell my shares at US$25. Please note that if I am indeed “called”, my actual sell price is US$26 (that is, the US$25 exercise cost plus the US$1 premium I received).

If the market price never rose to US$25 before expiry, then the option buyer would not exercise and I simply keep the premium of US$1.00 per share or US$100 total. Note that although the decision to exercise an option is the choice of the buyer, if an option contract is in the money (in the case of a call option, the market price is above the exercise price), there is a risk of an automatic exercise based on option exchange rules. In any case, employing a strategy of writing covered call options over the course of a year and on a basket of stocks could generate hundreds or even thousands of extra dollars of income within a portfolio.

It is important to understand that I only want to sell a call option on stocks that I don’t mind selling from my portfolio. The one key disadvantage of a covered calls strategy is that I am giving up on further gains above the exercise price. In other words, if I am called at US$25 and the Microsoft shares rise further to $30, I am not participating in the extra upside profits. Selling call options is a way to sell a portfolio of stocks at higher pre-determined prices (exercise prices) while generating income (collecting premiums) along the way.

There is a very basic rule that must be followed when writing covered call options. When I write the call option, I must be willing to deliver or lose the underlying stock if I am called. If I don’t want to sell the stock or believe it has much more upside potential, I will not write a call option on that stock position.

Most option contracts can be sold on the market prior to expiry. So, even when I sell a call option, I can remove that obligation by buying back that option contract (called “offsetting”) on the market.

Advantages of writing/selling call options

- A way to sell stock positions while pre-determining your sell price and final profit.
- It generates premium income in the portfolio.
- Knowing the maximum return that you are accepting.
- A profit can be made in up markets, neutral markets and even slightly down markets.
- Selling a stock, when it is at a higher price than the current market price when you sold the option contract.
- Most option contracts are liquid and can be traded on the market.

Disadvantages of writing/selling call options

- The main disadvantage is that you give up future upside potential if the stock continues to rise beyond the exercise price. Using the above example, if Microsoft shares actually moves up significantly beyond US$25, you do not participate in the further gain. Your maximum profit is limited to the total premium received (US$100) and the proceeds from selling at US$25.
- You are taking on the risk of potentially underperforming the overall market if many of your stocks are called away.
- Not all stocks have options associated with them. Only stocks with a minimum market capitalization and average trading volume, as set by the Options Exchanges, will have options available.

Contact us

Vincent Yu B.Com, CIM®, FCSI®
Vice President & Portfolio Manager
Tel.: 604.640.0208
Vincent.Yu@RichardsonGMP.com

Daniel Quon B.A. (Hons), QGJM, QDJM
Associate
Tel.: 604.640.0542
Daniel.Quon@RichardsonGMP.com

Richardson GMP Limited
500 – 550 Burrard Street
Vancouver, BC V6C 2B5

www.RichardsonGMP.com/Vincent.Yu