

# Fiscal Fitness

## Taking Cover

### *A Refresher on Options*

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Once upon a time, in the land of reality, stocks didn't double or triple in a year and our expectations of investment return were more realistic. After all, the historical return earned by equity investments from the period 1929-1999 averaged around 12% annually according to the research firm Ibbotson Associates. Today many investors are disappointed if they don't realize that level of return in a month. The reality is, stocks cannot continue to realize 25% or greater annual returns because their *growth rates* cannot sustain this level indefinitely. As the technology industry starts to mature, it's plausible that we may be entering a period where equity returns revert to their historical averages. If that occurs, how can an investor turbo-charge their portfolio in a slowing or stagnant market? **Covered call options** are one possibility.

#### *Technically speaking....*

A covered call **writer** (investor) owns the underlying stock (Microsoft, for example). The writer then decides the terms of the option contract he/she would like to write. (One contract equals 100 shares of stock) First, there is the **expiration** of the contract: when does the contract expire? Most companies have option contracts that expire anywhere from 30 days to two years on the third Friday of each month. Secondly, the option writer must determine the **strike price** of the contract. This is just a fancy word for determining the price that the option writer would be potentially content to sell the stock. If your eyes are not completely glossed over, you will be rewarded for your endurance.

#### *Cutting through the techno-babble....*

Using Microsoft (currently \$70/share) as our example, let's say Jimmy has decided to sell 3 contracts of the September (expiration date) 75's (strike price) when the stock is trading at \$70 and nets a 2 ½ point **premium**. What does this mean? Jimmy, being the savvy investor, will receive \$750 (\$250/contract) for writing these contracts. The cash is deposited into his account to reinvest, earn interest, buy golf gloves etc. It's his regardless of the future movement of Microsoft. What are the advantages? The writer forces a dividend off the stock and gives some downside protection to his stock position. The option premium also increases his return on investment. Determining the strike price can be a bit tricky (depends on an investor's future expectations of the stock) but can also serve as a potential exit price for the stock to be sold at. This can take the emotion out of the selling process.

What about the *disadvantages*? There is the risk of the stock being **called away**. This means that someone else exercised his or her right to buy your stock at the strike price if the market price of the stock exceeds your strike price on the expiration date of September 15 (third Friday). Selling the stock can trigger a taxable event in taxable accounts. However, you can avoid this by buying back the option, presumably at a loss. Lastly, there is the opportunity cost of lost upside profits. If Microsoft surged to \$85/share at expiration and you were forced to sell at \$75, a 2 ½ point premium on the contract is less than you could have made had you held onto the stock. That is an opportunity cost. Obviously, you try to sell options at strike prices that you don't feel the stock will achieve within the contract's time frame.

I realize I have shared a brief and simplified example but the premise remains the same for all covered call option writers: deriving income from the portfolio's stocks. Options can be used for the most simple portfolio strategies to very complex hedging techniques. While covered call writing may not be appropriate for every investor, it is an overlooked investment strategy can substantially enhance portfolio returns without the risk you may associate with options.