Option strategies— selling covered calls

Wealth Management

Bullish / Neutral strategies

The covered call strategy involves the selling of call options against a long stock position. The short call position is considered “covered,” in the event of an assignment, by the long stock position. Investors may view covered call selling (writing) as leasing out their underlying stock with an option to buy.

As a call writer, you obligate yourself to sell, at the strike price, the underlying shares of stock upon being given an assignment notice. For assuming this obligation, you are paid a premium at the time you sell the call.

Investors write covered calls primarily for the following two reasons:

- The potential to realize additional return on their underlying stock by earning premium
- To gain some protection (limited to the amount of the premium) from a decline in the underlying stock price

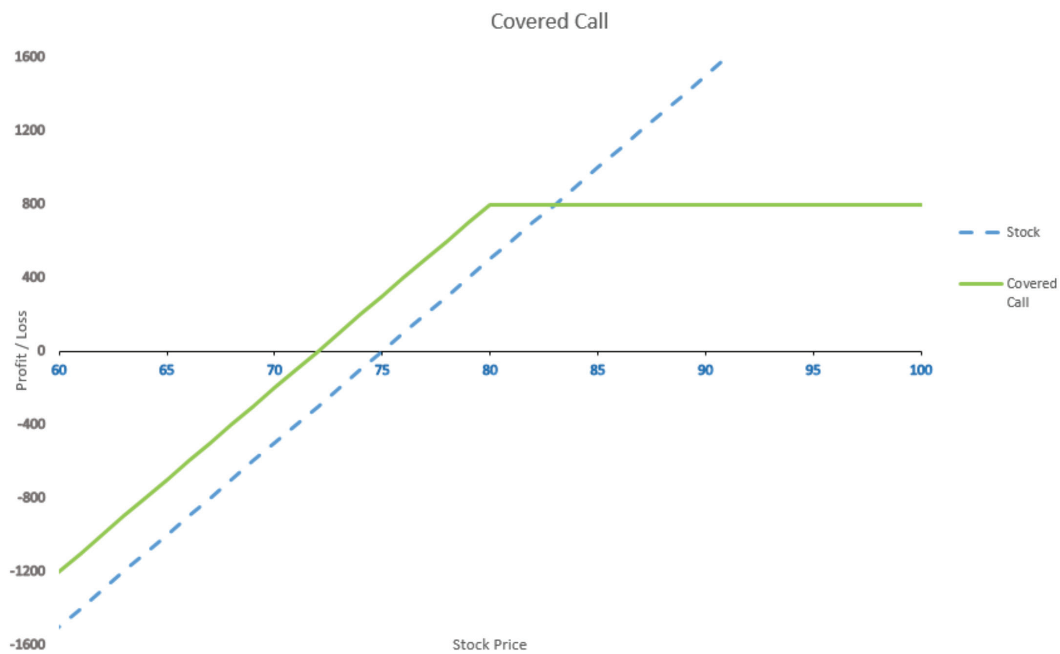
If a writer is assigned, the profit or loss is determined by the amount of premium plus the difference, if any, between the strike price and the original stock price. If the stock price rises above the strike price of the option, the writer may have the stock called away (i.e., is assigned), and forgoes the opportunity to profit from the further increases in the stock price.

If, however, the stock price decreases, the potential for loss on the stock position may be substantial; the hedging benefit is limited only to the amount of the premium income received.

Investors who use the covered call strategy should have a neutral to slightly bullish view of the underlying stock. Things to consider when choosing a covered write strategy:

- **Time frame** — The options expiration date will have an influence on its premium. While call sellers will want to focus on shorter-term options, they will have to balance this with the amount of premium they are looking to receive.
- **Strike price** — Typically, investors sell calls with strike prices that are greater than the stock’s current price (out-of-the money). This allows for some appreciation of the underlying stock price before the stock may be called away. While an out-of-the money strike price allows for potential price appreciation on the stock, it will garner a smaller premium for the seller. The investor must balance their desire to receive a greater upfront premium from the sale of the call with the potential for additional price appreciation in the stock.
- **The underlying stock** — Understanding the fundamentals for the underlying stock and being comfortable owning the shares is the most important consideration in the covered write strategy. The rate of return generated from the strategy is secondary.

Example of a covered call



Purchase 100 shares of XYX stock: $75.00

Cost of shares: $7,500.00

Sell 1 XYZ three month $80.00 strike call: $3.00

Total premium received from short call: $300.00*

Max profit of covered call strategy: $800.00*

Stock price at max profit: $80.00 or greater

Max loss of covered call strategy: $7,200.00

Stock price at max loss: $0

Breakeven price of stock: $72.00

*Commissions not included

This strategy sheet discusses exchange-traded options. It is not to be construed as a recommendation to purchase or sell a security. Before engaging in the purchasing or writing of exchange-traded options, investors should understand the nature and extent of their rights and obligations and be aware of the risks involved, including the risks pertaining to the business and financial condition of the issuer of the underlying stock. Listed options are not suitable for all investors. Prior to buying or selling an exchange traded option, a person must be provided with, and review, a copy of CHARACTERISTICS AND RISKS OF STANDARDIZED OPTIONS. A copy of this document may be obtained from the RBC Wealth Management Business Supervision Group, 250 Nicollet Mall, Mpls., MN 55401 Phone: (612) 313-1449. Additional supporting documentation including statistics and other technical data are available upon request.