

# The Covered Call



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## 1. The Covered Call Explained

### 1.1. Introduction

The covered call is an excellent strategy for generating monthly income or for maximizing returns from the sale of shares owned.

For example, let's imagine you owned 100 shares of Apple at \$90. The share price has risen to \$108. You intend to sell the shares at \$110. Rather than wait for the share price to rise to \$110 you sell a covered call to another investor which expires 6 weeks from today at the \$110 strike price.

In the example above, you have just agreed to sell your Apple shares to another investor for \$110 any time between now and the expiry date. The investor pays you a premium for the 'right' to buy the Apple shares from you at \$110. This gives you an added premium for agreeing to sell your shares to that investor.

An important point for you to know is that the investor to whom you sold the call option has the right, but they are not obligated to buy the shares from you. If the share price doesn't rise above \$110 they will not buy the shares from you at \$110.

Welcome to the covered call.

[CLICK HERE](#) to watch a short video showing you an overview of the covered call strategy in 1 minute.

### 1.2. How to construct the Covered Call

The covered call is constructed when an investor buys at least 100 shares of stock and then sells a call option contract against the shares that he or she owns.

Note, in most scenarios the stock is usually bought first and when the share price has risen the investor will then sell the covered call. You can place both orders at the same time.

**Covered Call = Buy the stock + Sell the call option**

In our Apple example, we bought 100 shares at \$90 and sold the \$110 call option later when the share price rose substantially.

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### 1.3. Covered Call: Debit or Credit

The covered call strategy will always be established at a net debit. The major cost is buying the shares but some of this cost is reduced by selling the covered call. Overall, the trade is established as a debit.

**Covered Call = Net Debit.**

### 1.4. Covered Call: Example

Look at the call option quote for Apple:

AAPL ▾		SIMULATED TRADING			SIMULATED TRADING	
Delta	Gamma	Call Theta	Bid	Ask	Description	
0.514	0.063	-0.030	◆ 2.61	2.67 ◆	▾ JAN 20 '17 ⓘ 110	
0.224	0.049	-0.022	◆ 0.79	0.82 ◆	115	
0.074	0.022	-0.010	◆ 0.21	0.22 ◆	120	

To establish a covered call with AAPL, imagine that we bought 100 Shares of Apple at \$90 several months previous. The share price has risen substantially to \$108 and we are getting ready to sell at \$110. Instead of waiting for the share price to rise, we decide to sell 1 call option contract of the Jan 20<sup>th</sup> \$110 call option for \$2.61 (Bid) or \$261 total (because 1 contract controls 100 shares). The result is us holding 1 covered call on AAPL for the \$110 strike price.

The net debit or cost is the price paid for the shares (\$90) minus the income from the covered call (\$2.61) which equals \$87.39.

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This is one of the real benefits of the covered call. The initial cost of buying the stock is being reduced by the sale of the call. Let's start comparing the two strategies:

	<b>Apple \$110 Covered Call</b>	<b>Apply buy the stock</b>
<b>Net Cost of share purchase</b>	\$8,739	\$9,000

As you can see, by selling the call we have reduced the net purchase cost of the stock.

### 1.5. Covered Call: Outlook for the share price

The covered call is a mildly bullish or neutral strategy. By employing this strategy, we are only mildly bullish on Apple, as we expect to sell the stock at the call option's \$110 strike price. An investor with a more bullish outlook will simply own the stock.

#### **Covered Call = Neutral to Mildly Bullish**

### 1.6. Covered Call: Maximum Profit

The maximum upside profit for our Apple covered call is said to be 'limited' to the difference between the strike price (\$110) and the purchase price of the stock (\$90) plus the credit received (\$2.61) for selling the call. The max profit occurs when the share price trades at or above the \$110 short call strike price at expiry.

#### **Maximum Profit = Limited**

Maximum Profit = Short Call Strike Price minus Purchase Price Stock plus Credit received

AAPL example:

Max Profit = \$110 (Short Call Strike) minus \$90 (Purchase price Stock) plus \$2.61 (Credit from sale of \$110 Call) = \$22.61 per share or \$2,261 total.

Let's do a quick comparison of our profit potential if we simply bought 100 shares of the AAPL stock at \$90 and if the share price rose to \$110. The profit would be \$20 per share or \$2,000 total.

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	<b>Apple \$110 Covered Call</b>	<b>Apply buy the stock</b>
<b>Net Cost of share purchase</b>	\$8,739	\$9,000
<b>Max Profit (if \$110)</b>	\$2,261	\$2,000

When we compare the max profit of the covered call strategy versus simply buying the stock, we can see the power of the covered call strategy. We have made more profit for the same scenario.

However, one must bear in mind that the upside potential is capped with the covered call strategy. In our AAPL example, the max profit is \$2,261. The upside potential for just owning the stock is not capped, as the share price continues to rise so do the profits.

This is a major trade-off that you must consider for the covered call.

	<b>Apple \$110 Covered Call</b>	<b>Apply buy the stock</b>
<b>Net Cost of share purchase</b>	\$8,739	\$9,000
<b>Max Profit (if \$110)</b>	\$2,261	\$2,000
<b>Max Profit</b>	\$2,261	Unlimited

The counter argument for the covered call is that although there is more potential upside in simply owning the stock, we will not be in the stock to benefit from it. This is because we intended selling at \$110 regardless.

The lesson here is to ensure that you pick a strike price at which you are happy to sell your shares at.

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### 1.7. Covered Call: Maximum Loss

The maximum loss for the covered call strategy is said to be 'unlimited'. As the share price of Apple falls below the break-even price, losses continue to accumulate. Theoretically, share prices can fall to zero, therefore losses can be substantial. The maximum loss is limited to the cost of the stock minus the premium received for selling the covered call.

	<b>Apple \$110 Covered Call</b>	<b>Apply buy the stock</b>
<b>Net Cost of share purchase</b>	\$8,739	\$9,000
<b>Max Profit (if \$110)</b>	\$2,261	\$2,000
<b>Max Profit</b>	\$2,261	Unlimited
<b>Max Loss</b>	\$8,739 (Unlikely)	\$9,000 (Unlikely)

Again, the covered call compares favorably against buying the stock outright.

### 1.8. Covered Call: Break-Even Price

The break-even price for the covered call is equal to the purchase price of the stock minus the income received for selling the call option.

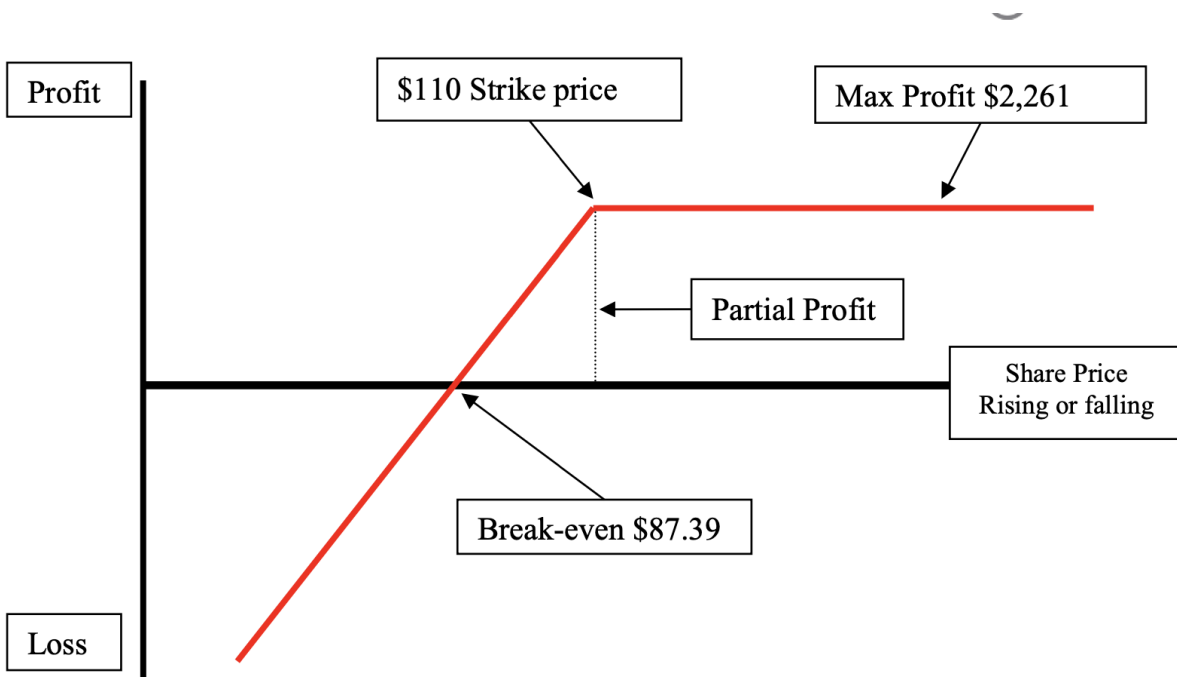
**Break-Even Price = Purchase price of stock minus income from selling calls**

Looking at our Apple example: Break-even price = \$90 (purchase price shares) minus \$2.61 (income from calls) = \$87.39

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	<b>Apple \$110 Covered Call</b>	<b>Apply buy the stock</b>
<b>Net Cost of share purchase</b>	\$8,739	\$9,000
<b>Max Profit (if \$110)</b>	\$2,261	\$2,000
<b>Max Profit</b>	\$2,261	Unlimited
<b>Max Loss</b>	\$8,739 (Unlikely)	\$9,000 (Unlikely)
<b>Break-even price</b>	\$87.39	\$90.00

This is another advantage of the covered call over simply buying the stock. You can see from the above that the share price can fall further with the covered call before we start to make a loss.



**Figure 1: Profit and Loss Dynamics for the Apple Covered Call**

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### **1.9. Covered Call: Partial Profit**

Partial Profit occurs if the share price at expiry is between the breakeven-price and max profit. In our example with Apple, partial profit occurs at expiry if Apple trades between \$87.39 and \$110.

### **1.10. Covered Call: Profit or loss before expiry**

Before expiration, an investor can take a profit or cut a loss by buying the call option if it has market value which will be done at a net debit. The investor can also decide to then sell the stock. Profit or loss would simply be the net difference between the debit initially paid for the stock and the sale of the call option and the net credit received for selling the stock and buying back the call option.

### **1.11. Covered Call: Profit and Loss Tables**

It is important for you to get into the habit of creating profit and loss tables. [CLICK HERE](#) to watch a video showing you how to create P&L tables for the covered call.

Here is an example of a P&L table for the AAPL covered call. Remember we bought 100 shares of the stock for \$90 and we sold the \$110 call for \$2.61.

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AAPL share price at Expiration	Profit from AAPL Shares	Income from Selling \$110 Call	Value of \$110 Call at Expiry	Covered Call Profit/Loss
\$103	+\$1,300	+\$261	\$0	+\$1,561
\$104	+\$1,400	+\$261	\$0	+\$1,661
\$105	+\$1,500	+\$261	\$0	+\$1,761
\$106	+\$1,600	+\$261	\$0	+\$1,861
\$107	+\$1,700	+\$261	\$0	+\$1,961
\$108	+\$1,800	+\$261	\$0	+\$2,061
\$109	+\$1,900	+\$261	\$0	+\$2,161
\$110	+\$2,000	+\$261	\$0	+\$2,261
\$111	+\$2,100	+\$261	-\$100	+\$2,261
\$112	+\$2,200	+\$261	-\$200	+\$2,261
\$113	+\$2,300	+\$261	-\$300	+\$2,261
\$114	+\$2,400	+\$261	-\$400	+\$2,261
\$115	+\$2,500	+\$261	-\$500	+\$2,261

### 1.12. Covered Call: Effect of Volatility

An increase in volatility has a negative effect on the covered call. As volatility increases the time value of the call option increases. Therefore, if an investor changed their mind and wanted to buy back the call option, the time value element will be more expensive to repurchase.

### 1.13. Covered Call: Theta (time decay)

[CLICK HERE](#) to watch a video showing the impact of Theta on the covered call.

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Theta is the rate of decay in the time value of an option. Theta has a positive effect on the covered call. Because you sold the call option, theta is working to your advantage. As each day passes to expiry the reduction in time value of the option is working to your advantage.

Look at the option quote for Apple again:

AAPL ▾		SIMULATED TRADING		SIMULATED TRADING		Description	
Delta	Gamma	Call Theta	Bid	Ask			
0.514	0.063	-0.030	◆ 2.61	2.67 ◆	▾ JAN 20 '17 ⓘ		110
0.224	0.049	-0.022	◆ 0.79	0.82 ◆			115
0.074	0.022	-0.010	◆ 0.21	0.22 ◆			120

You can see from the quote that the \$110 call has a theta value of -0.030. What does this mean? It means that the value of the \$110 call will erode by \$0.03 per share or \$3 total per day between now and expiry. Because we sold the call option, this is working to our advantage. If all things being equal and conditions do not change, we could buy back the call that we sold at a cheaper price than what we paid for it because of time decay.

At Share Navigator, we love selling time premium when implied volatility is high.

#### 1.14. Delta and the Covered Call

[CLICK HERE](#) to view.

#### 1.15. Covered Call: Picking the strike prices

Some covered call strategies can be considered more bullish than others. The degree of bullishness depends primarily on the strike price of the short call, which determines how high the underlying stock (or index) needs to increase for maximum profit to be realized at expiration.

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- **Most bullish:** a covered call when the short call is out-of-the-money. The income received from the sale of the call will be lower but the profit potential will be higher from the sale of the stock. Profit potential is only achieved when the share price goes over the strike price.
- **Neutral:** a covered call when the strike price of the short call is at-the- money. More income from the sale of the call but less profitability from the sale of the stock if the share price rises substantially.
- **Least bullish:** a covered call when the short call strike price is in-the- money. This will give you the highest income from the sale of the call but the lowest profit potential from the sale of the stock.

#### 1.16. Covered Call: Assignment Risk

Assignment on any Equity option or *American*-style index option can, by contract terms, occur at any time before expiration, although this generally occurs when the option is in-the-money.

#### 1.17. Covered Call: Actions to take at expiry

The action you take at expiry will depend on where the share price is trading at:

- **If the share price is above the short call strike price:** Do nothing and enjoy the profits. The shares will be sold at the strike price and the position will disappear from the trading account the following trading day.
- **If the share price is below the short call strike price:** Do nothing. The calls will expire worthless and disappear from your account on the following trading day. You will keep the shares. And then you can sell another covered call for the following month.

#### 1.18. 10 minute video overview of the Covered Call

[CLICK HERE](#) to view.

#### 1.19. Covered Call: Our view

For those who want to own shares and generate additional monthly income or maximise the potential sale of stock, it is excellent. For the novice option trader, covered calls are

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a great start to learning about options.

However, as you become more experienced you will find less risky ways of achieving the same profit potential using other option strategies.

### **1.20. Test your Knowledge**

Time for you to apply your knowledge.

1. Pick any stock or index that you are mildly bullish on.
2. Login to your personal simulated trading account. Please [contact us](#) if you don't have a personal simulated trading account.
3. Buy 100 shares of any optionable stock.
4. Sell 1 contract of a covered call for an expiry 1-2 months out.
5. Monitor the trade and write down as many questions that spring to mind
6. [Contact us](#) with your questions.

### **1.21. Please leave a Review on Google**

[CLICK HERE](#) to leave a review of this course on Google. We would love to get your feedback. Thank you.

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## 2. How to place and manage Covered Call Trades

### 2.1. How to place a Covered Call on TWS

[CLICK HERE](#) to view.

### 2.2. How to place a Covered Call on IBKR Mobile APP

[CLICK HERE](#) to view.

### 2.3. How to manage a Covered Call

[CLICK HERE](#) to view.

### 2.4. How to Close a Covered Call on TWS

[CLICK HERE](#) to view.

### 2.5. How to Close a Covered Call on IBKR Mobile APP

[CLICK HERE](#) to view.

### 2.6. How to Roll Out a Covered Call on TWS

[CLICK HERE](#) to view.

### 2.7. How to Roll out a Covered Call on the IBKR Mobile APP

**Note:** There is no rollout function on the TWS mobile APP. So the process is quite simply this:

1. Close down the original Covered Call option placed (follow the steps in the previous lesson - closing down a Covered Call)
2. Open the new Covered Call trade for the new expiry (As per opening a Covered Call).

There is no additional cost in terms of trading commissions - it is just a two step process. We would recommend using the desktop version for rolling out.

### 2.8. How to manage the position size with the Covered Call

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### 3. Mentoring Service

Embark on a streamlined journey to financial proficiency with our Stock and Options Mentoring Service. Elevate your learning curve by enlisting a **personal** mentor who will guide you through the intricacies of stock and options trading. Our comprehensive program offers:

- Weekly one-on-one mentoring sessions, ensuring personalized attention and targeted skill development.
- Gain a competitive edge with daily live market updates
- Exclusive access to curated stock watchlists
- Insights into our meticulously crafted options and futures trades.
- Save valuable time, effort, and money as you fast-track your education with our dedicated support system.

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