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Who Should Consider Using Covered Calls?

- An investor who is neutral to moderately bullish on some of the equities in his portfolio.
- An investor who is willing to limit upside potential in exchange for some downside protection.
- An investor who would like to be paid for assuming the obligation of selling a particular stock at a specified price.

This strategy would work equally well for a cash, margin, Keogh account or IRA. Although this strategy may not be suitable for everyone, any of the investors above may benefit from using the covered call.

Definition

Covered call writing is either the simultaneous purchase of stock and the sale of a call option or the sale of a call option against a stock currently held by an investor. Generally, one call option is sold for every 100 shares of stock. The writer receives cash for selling the call but will be obligated to sell the stock at the strike price of the call if the call is assigned to the account. In other words, an investor is "paid" to agree to sell the holdings at a certain level (the strike price). In exchange for being paid, the investor gives up any increase in the stock above the strike price.

How to Use Covered Calls

If an investor is neutral to moderately bullish on a stock currently owned, the covered call might be a strategy to consider. Let's say that 100 shares are currently held in the account. If the investor was to sell one slightly out-of-the-money call, the investor would be paid a premium to be obligated to sell the stock at a predetermined price, the strike price. In addition to receiving the premium, the investor would also continue to receive the dividends (if any) as long as the stock is still owned.

The covered call can also be used if the investor is considering buying a stock on which he is moderately bullish for the near term. A call could be sold at the same time the stock is purchased. The premium collected reduces the effective cost of the stock and the investor will continue to collect dividends (if any) for as long as the stock is held.

In either case the investor is at risk of losing the stock if it rises above the strike price. Remember, in exchange for receiving the premium for having sold the calls, the investor is obligated to sell the stock. However, as you will see in the following example, even though the investor has given up some upside potential there can still be a good return on the investment.

Stock ZYX currently is priced at \$41.75, and the investor thinks this might be a good purchase. The three-month 45 calls can be sold for \$1.25. Historically, ZYX has paid a quarterly dividend of \$0.25. By selling the three-month 45 call the investor is agreeing to sell ZYX at \$45 should the owner of the call decide to exercise the right to buy the stock. Keep in mind that the call owner may exercise the option if the stock is above \$45, because he will be able to buy the stock for less than it is currently trading for in the open market. But, as you will see, the investor's return will be greater than if he had held the stock until it reached \$45 and then sold it at that price.

Let's take a look at what happens to a covered call position as the underlying stock moves up or down. Commissions have not been taken into consideration in these examples; however, they can have a significant effect on your returns.

Buying 100 ZYX at \$41.75 and Selling 1 Three-Month 45 Call at \$1.25

1. ZYX remains below \$45 between now and expiration-call not assigned.

The call option will expire worthless. The premium of \$1.25 and the stock position will be retained. In effect you have paid \$40.50 (which is also the breakeven price) for ZYX (\$41.75 purchase cost - \$1.25 premium received for sale of call). This would be offset by any dividends that were received, which in this example would be \$0.25.

When the ZYX call expires worthless, the covered call writer can sell another call going further out in time taking in additional premium. Once again, this produces an even lower purchase cost or breakeven.

If ZYX remains below \$45 for an entire year, the investor can sell these calls four times. For this example we will make the hypothetical assumption that the price of the stock and option premiums remain constant throughout the year.

$$\$1.25 \text{ (Call Premium Received)} \times 4 = \$5 \text{ in Premium} + \text{Any Dividends Paid} = \text{Total Income.}$$

II. ZYX rises above 45 between now and expiration-call assigned.

The call buyer can exercise the right to buy the stock and the call seller will have to sell ZYX at \$45, even though ZYX has risen above \$45. But remember the call seller has taken in the premium of the call and has been earning dividends (if any) on the stock.

If ZYX stock is called away at expiration:

| | | |
|-----------------|--|------------------|
| Receive: | \$45 for Stock | \$4,500 |
| Less: | Net Investment (Stock Cost - Premium Received) | |
| | [\$4,175 - \$125] | <u>(\$4,050)</u> |
| Return: | 11.11% | \$450* |

*In three months plus dividends (if any) received.

III. ZYX is right at \$45 at expiration.

The seller of a call may be in situation I or II. The stock may be called away and the call writer will be obligated to sell ZYX at \$45. Alternatively, the stock may not be called away. A call could then be sold going further out in time, bringing in additional premium and further reducing the breakeven point.

Summary

The covered call write is a strategy that has the ability to meet the needs of a wide range of investors. It can be used in your Keogh, margin, cash account or IRA against stock you already own or are planning on buying. Currently, there are short-term options listed on more than 2,000 stocks and more than 400 of those stocks also have LEAPS[®], Long-term Equity Anticipation Securities[™], which are simply long-term stock and index options. Today's investor has a choice of short-term and long-term expirations, as well as multiple strike prices. This strategy is actually more conservative than just buying stock, due to the fact that you have taken in premium and lowered your breakeven price on the stock position. The covered write allows you to be paid for assuming the obligation of selling a particular stock at a specified price.

Covered Call Worksheet

| | |
|------------------------|--------------------------|
| Date _____ | |
| Stock _____ | Stock Price _____ |
| Strike Price _____ | Option Price _____ |
| Expiration Month _____ | Days to Expiration _____ |
| Annual Dividend _____ | Dividend Date(s) _____ |

Initial Funds Required

Cash Account

- | | |
|---|----------------|
| 1. Purchase _____ Shares @ _____ | _____ |
| 2. Plus Stock Commission | + _____ |
| 3. Total Stock Cost | = _____ |
| 4. Option Premium (# of Calls x Price x 100) | _____ |
| 5. Less Option Commission | - _____ |
| 6. Net Option Premium (Line 4 - Line 5) | = _____ |
| 7. Total Investment (Line 3 - Line 6) | = _____ |

Call Assigned, Stock Called Away (Stock At Or Above Strike)

- | | |
|--|----------------|
| 8. Sell _____ Shares @ Strike _____ | _____ |
| 9. Less Commission On Stock Sale (Assignment) | - _____ |
| 10. Plus Net Option Premium (Line 6) | + _____ |
| 11. Less Total Stock Cost (Line 3) | - _____ |
| 12. Profit On Net Stock Position | = _____ |
| 13. Plus Projected Dividend(s) on _____ Shares | + _____ |
| 14. Net Profit | = _____ |
| 15. Percentage Return For Period (Line 14 divided by Line 7) | = _____ |
| 16. Annualized Return* (Line 15 x 365 divided by # of Days) | = _____ |

*Call Not Assigned, Stock Not Called Away
(Stock At Or Below Strike)*

Cash Account

| | |
|--|---------|
| 17. Total Investment (Line 7) | _____ |
| 18. Less Projected Dividend(s) on _____ Shares (Line 13) | - _____ |
| 19. Net Cost at Expiration | = _____ |
| 20. Breakeven Price at Expiration (Line 19 divided by # of Shares) | = _____ |

*Please Note: The profit or loss and annualized rate of return calculated will be achieved only if the parameters described can be duplicated and there is no certainty of this occurring.



FREE interactive strategies are available at www.cboe.com

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