Buy-Write Strategies for a Flat Market

Up one month, down the next. The stock market this year has offered lots of excitement. As of this writing, broad market indexes have provided little sustenance for bulls or bears, with results not far from early 2018.

One strategy that may be appealing in a relatively flat stock market is to use covered calls. Even if the actual stock you own goes nowhere, trading in options may deliver meaningful investment income. The downside of this approach is that any gains in a strong upturn may be limited.

Selling the Upside

A covered call strategy can begin with the purchase of a stock that seems appealing.

Example: In October, Carl Wagner buys 200 shares of XYZ Corp., trading at $50, for $10,000. He instructs his adviser to sell (or "write," in option lingo) two call options on XYZ stock at a $55 exercise price, expiring in January, which is three months away. Each call gives the option owner the right to buy 100 shares of XYZ for $55 apiece until a given date in January.

In this hypothetical example, Carl receives 90 cents per share from his sale of the call option. For his 200 shares, that's $180. From that point on, several things can happen.

Flat Market

Say that XYZ shares bounce around $50 for three months. They never top $55, so it never pays for the owner of the option to buy Carl's shares. The call option expires unexercised.

Here, Carl's $180 income from selling the call would be 1.8% of his $10,000 investment in XYZ. He'd also collect the quarterly dividend, which might be, say, 0.5%, if XYZ pays a 2% annualized dividend. That's a 2.3% total return in a quarter of a year, or 9.2% annualized, while XYZ shares went nowhere. Going forward, with the option not exercised, Carl can write another call on the shares of XYZ he still owns.

This is a simplified, hypothetical example. Trading costs aren't included, for one thing. Nevertheless, a "buy-write" strategy might produce desirable results if stocks are in a trading range.

Up Market

In another scenario, XYZ shares break above the $55 exercise price, and the call options are exercised. As this is a "covered" call, Carl can fulfill his obligation under the option contract by delivering the 200 shares of XYZ that he owns.

Here, Carl gets a 10% return ($5 profit after buying at $50 per share), plus the 1.8% return from selling the call, and perhaps the quarterly dividend, as well. Not a bad profit for holding this stock for three months.

Of course, XYZ might zoom past $55 to $60 or $65, and Carl would miss out on a greater profit after relinquishing his shares. That's a key disadvantage to this strategy.

Down Market

Carl's shares of XYZ might plummet because of company news or a broad stock retreat. The $180 in cash from selling the call would be scant consolation if his $10,000 outlay drops to $9,500 or $9,000 or lower. Carl could sell another call, after the option expiration, pocketing more income but still bearing most of the stock's exposure to loss.

Go with the Pros

The market for listed call options can be complex. Should you sell an "out-of-the-money" call, as Carl did? An at-the-money-call (exercise price equals current trading price)? An in-the-money call (lower exercise price)? Take a close or distant expiration date? Buy back the call you've sold because you decide to keep your shares?

Investors may like the concept of using covered calls but might be reluctant to make all the necessary decisions. This has led to the creation of buy-write funds. With these vehicles, financial professionals decide which assets to purchase and which options to sell, covered by holdings in the fund.

There are many forms of covered call and buy-write funds, with different methods of squeezing income from selling options. Tax treatment also can vary because some of these funds make distributions that are part long-term capital gain, part short-term capital gain, and part untaxed return of principal. If you're interested in such a fund, determine how your money will be invested.