What is a covered call?

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6 MIN READPublished February 17, 2023

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A covered call is a kind of options strategy that offers limited return for limited risk. A covered call involves selling a call option on a stock that you already own. By owning the stock, you’re “covered” (i.e. protected) if the stock rises and the call option expires in the money. A covered call is one of the lower-risk option strategies, and it’s even suitable for [beginning options](https://www.bankrate.com/investing/options-trading-strategies-how-to-beginners/)traders.

Here’s how a covered call works, the pros and cons and when to use this option strategy.

**How a covered call works**

A covered call is a basic options strategy that involves selling a [call option](https://www.bankrate.com/investing/what-are-call-options-learn-basics-buying-selling/) (or “going short” as the pros call it) for every 100 shares of the underlying stock that you own. It’s a relatively simple options trade to set up, and it generates some income from a stock position.

A covered call is a kind of hedged strategy, in which the trader sells some of the stock’s upside for a period of time in exchange for the option premium. Normally, selling a call option is a risky thing to do, because it exposes the seller to unlimited losses if the stock soars. However, by owning the underlying stock, you limit those potential losses and can generate income.

At the expiration of the [call option](https://www.bankrate.com/investing/what-are-call-options-learn-basics-buying-selling/), one of two things will happen:

* **If the stock finishes above the call’s strike price,** the price at which the call goes in the money, then the call buyer buys the stock from you at the strike price. The call seller keeps the option premium.
* **If the stock finishes below the call’s strike price,** then the call seller keeps the stock as well as the option premium. The call buyer’s option expires worthless.

Let’s run through an example to see how it all works.

Stock ABC is trading at $20 per share, and a call with a strike price of $20 expiring in three months costs $1. The contract costs a premium of $100, or $1 \* 1 contract \* 100 shares per contract. To execute a covered call, the investor buys 100 shares of ABC for $2,000 and then sells one call to receive $100.

Here are the profit and loss on the various elements of the covered call:

In this example, the trader who set up the covered call breaks even on the whole trade at $19 per share. That’s the stock price of $20 minus the $1 premium received. At stock prices below that, the trader loses money, more than offsetting the $1 premium received. At a stock price below $20 at expiration, the trader keeps the stock and keeps the full premium.

At a stock price of $20 at expiration, the trader would keep the full $1 premium and the stock usually will not be called by the call buyer. So, the trader makes $100 at this stock price.

At stock prices above $20 at expiration, the trader’s gain is capped at $100. While the short call loses $100 for every $1 increase in the stock price above $20, that loss is fully offset by the stock’s gain. As a result, the trader ends up with a maximum of $100 in profit, the original premium received. In this situation, the trader loses all potential stock profits above $20 per share.

In a real sense, if the stock rises too high above the strike price, the trader has lost money – money that otherwise would have been made. But by holding 100 shares of the stock for each contract that’s been sold, the trader hedges the risk and still can enjoy some upside.

In all covered calls, the maximum upside is the option premium, regardless of where the stock goes. While you can’t make any more than that, you can definitely lose more. The stock can fall – all the way to $0 potentially – and the premium will be the only upside. In this example, you’d make $100 on the option premium but lose $2,000 on the stock, leading to a net loss of $1,900.

Of course, if the stock fell a lot, you could repurchase the call option for less than you paid and then sell the stock position, if you prefer.

**What are the pros and cons of a covered call?**

A covered call can be an attractive options strategy for a variety of reasons, but like all options strategies, it has its downsides, too.

**Advantages of a covered call**

* **Generates income from a position.** A covered call can generate income from a stock position that may or may not pay a dividend, increasing its overall profitability.
* **Relatively low risk.** A covered call is a relatively low-risk way to trade options since you protect the short call with your stock position.
* **Easy to set up.** A covered call is also a relatively easy position to establish. It’s important to first buy the stock and only then sell the call.
* **Hedges your risk.** A covered call hedges your risk in a position by providing some compensation.
* **Can be re-established over and over.** If the call expires worthless and you retain your shares, you can set up the covered call again and again. Even if your shares are called from you, you can repurchase the stock and set up a covered call again.

**Disadvantages of a covered call**

* **Small, limited upside in exchange for downside.** With a covered call you can earn a relatively small amount of income but must bear any downside from the stock, leading to a potentially lopsided risk-return setup.
* **Trading away all the stock’s upside.** One of the reasons you likely own the stock is for its potential to rise over time. By setting up a covered call, you’re trading this upside until the option’s expiration. If the stock rises, you lose a gain that you could have earned.
* **May “lock up” your stock until option expiration.** By selling a call option, you may feel disinclined to sell your stock until the option expires, though you could repurchase the call option and then sell the stock.
* **Requires more capital to set up.** With a covered call you’ll need money to buy stock and that requires substantially more cash than you’d need in a pure options strategy.
* **May create taxable income.** Selling a successful covered call will generate taxable income in a taxable account. In addition, if the underlying stock is called from you, it may create a further tax liability if you had a capital gain on the stock.

**When to use a covered call**

A covered call can make sense in a few scenarios, including the following:

* **You don’t expect the stock to move much.** With a covered call, a trader doesn’t want the stock price to rise above the option’s strike price, at least until after the option expires. And it’s good if the stock doesn’t fall much either. If the stock stays broadly flat, you can still collect your premium and not lose much, if any, gains.
* **You want to generate income from a position.** If you’re looking to take advantage of the relatively high price on options premiums, you can set up a covered call and generate income. In effect, it’s as if you’re creating a dividend from a stock.
* **You’re trading in a tax-advantaged account.** If you’re using covered calls, you’re generating income and potentially may have the stock called away, both of which can create tax liabilities. So, setting up covered calls inside a tax-advantaged account such as an [IRA](https://www.bankrate.com/investing/what-is-an-ira/) may be attractive, helping you avoid or defer taxes on these gains.

**When to avoid a covered call**

A covered call should probably be avoided in the following situations:

* **You expect the stock to rise in the near future.** It makes little sense to sell away a stock’s potential upside in exchange for a relatively small amount of money. If you think a stock is poised to move higher, you probably should hold on and let it rise. Then after it’s climbed a lot, you might consider setting up the covered call.
* **The stock has serious downside.** If you’re holding a stock, you generally expect it to rise. But don’t use a covered call to try to get extra cash from a stock that looks like it’s going to drop significantly in the near or long term. It’s probably best to sell the stock and move on, or [you could try to short sell the stock and profit on its decline](https://www.bankrate.com/investing/short-selling-how-to-short-a-stock/).

**Bottom line**

A covered call can be a relatively low-risk way to use options to generate income, and it’s often popular with older investors who don’t want to sell their positions but would like some income. With a covered call you’ll earn a limited return in exchange for running an often-limited risk.