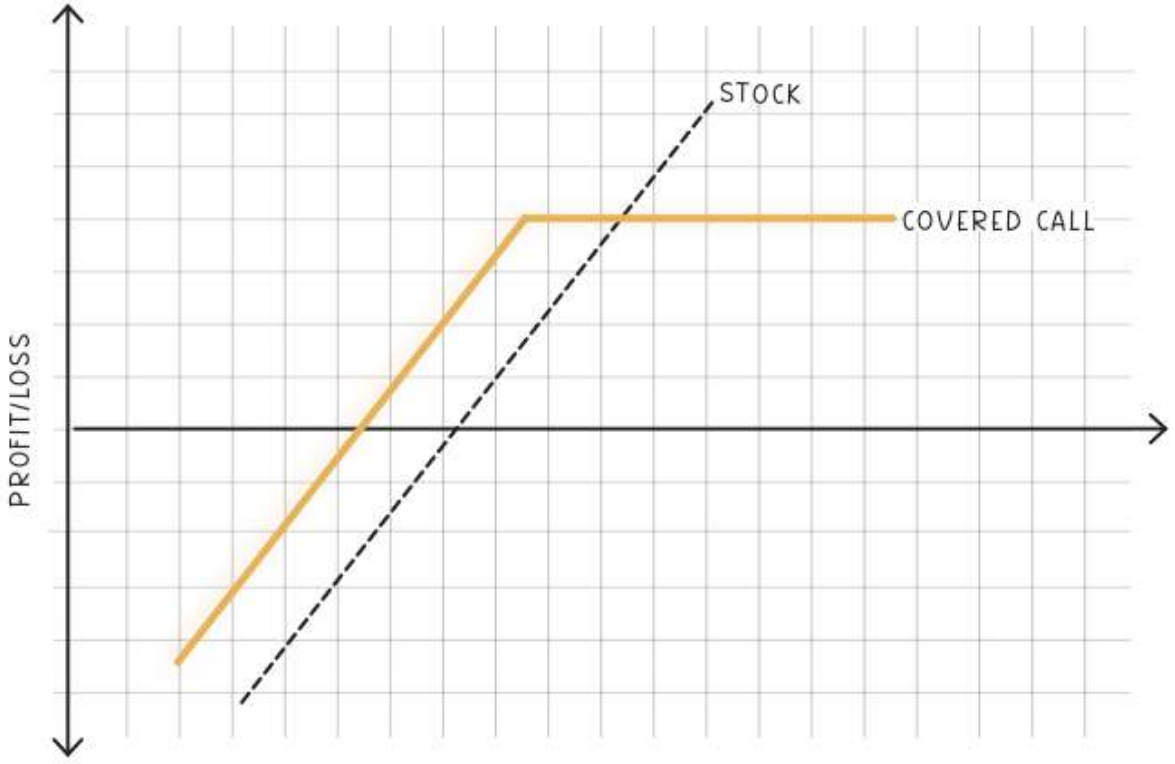
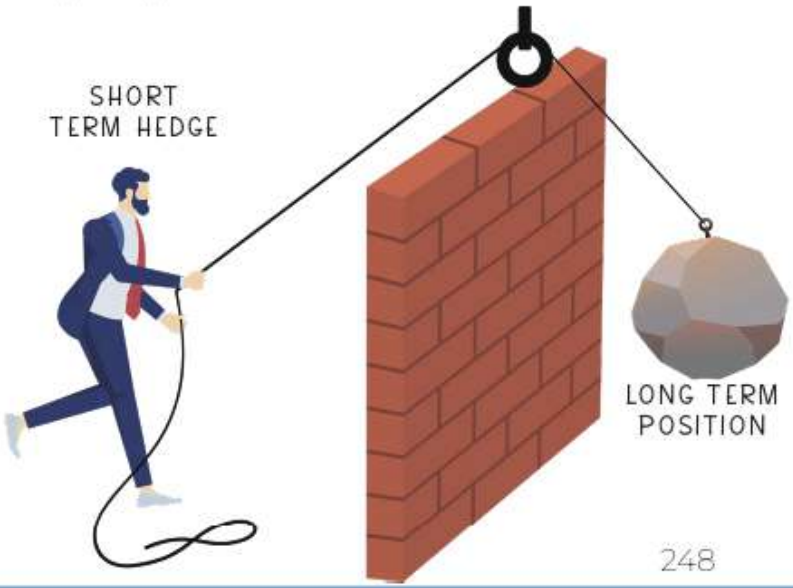
10.4 COVERED CALL STRATEGY

Explainer Video

> A COVERED CALL IS A TRADING STRATEGY WHERE A LONG POSITION IS TAKEN IN CASH OR FUTURES MARKET AND ITS UPSIDE IS LIMITED BY SELLING SAME AMOUNT OF CALL OPTIONS TO BENEFIT FROM THE PREMIUM.

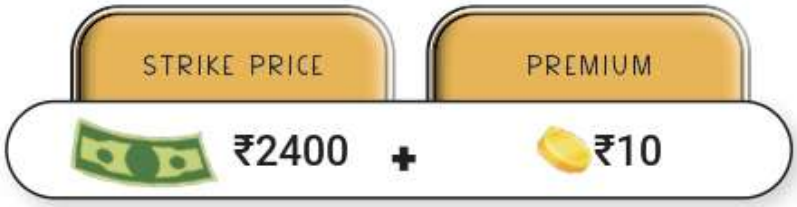


When one expects the markets in general to fall and they have a large chunk of shares, they can sell call options to collect the premium and compensate for the losses that they would incur if the stock falls down. However, here the losses are not limited. The profit potential is limited.



WE EARN INCOME BY RECEIVING A PREMIUM FOR THE CALL WE SELL, IRRESPECTIVE OF THE PRICE AT EXPIRY.

Suppose we have a stock at ₹2000 and we expect the market to go down temporarily. What we can do is, we can sell a call at :



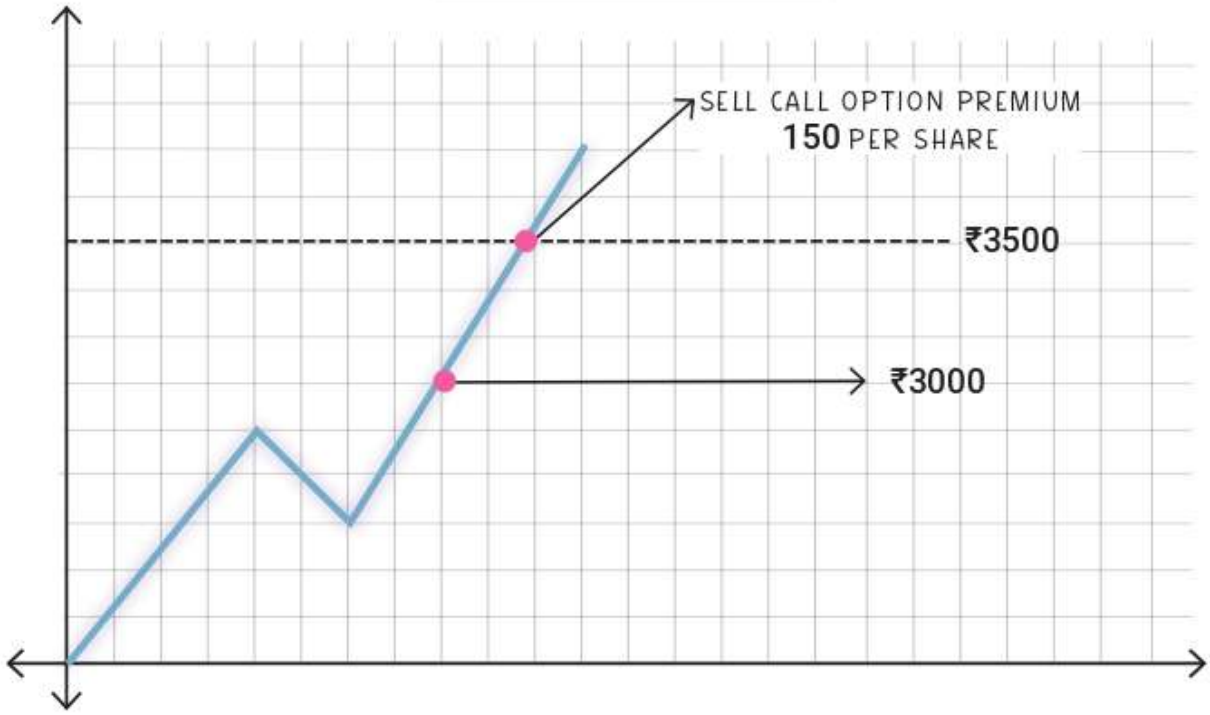
Now, as the share price goes down our losses will be reduced by this ₹10.

Let's say

MARKET PRICE ON EXPIRY	NET PROFIT/ LOSS	EXPLANATION
₹2300	**Profit/Loss** = Profit/Loss on CashPosition + Profit/Loss on Selling Call Options = (₹2300 - ₹2000) + (₹10) = ₹300 + ₹10 **= ₹310**	We would make a profit of ₹300 from each unit of share due to capital appreciation. Also, we have received additional ₹10 for each option sold. So, our total Profits would be ₹310 as there is no payoff required for call option.
₹2500	**Profit/Loss** = Profit/Loss on CashPosition + Profit/Loss on Selling Call Options = (₹2500 - ₹2000) + (₹2400 - ₹2500 + ₹10) = ₹500 - ₹90 = **₹410** MAXIMUM PROFIT ₹410 is the maximum profit. If the stock price continues to increase, the loss from the options position would increase by the same amount.	We made a profit of ₹500 from share price increase but it was partly offset by ₹100 loss in the options. We also received ₹10 as premium. Going ahead any additional profit from cash would be offset by same exact value loss in options. So, the maximum profit that we can earn is ₹410.
₹1600	**Profit/Loss** = (₹1600-₹2000) + (₹10) = -₹400 + ₹10 **= -₹390**	We have a loss of ₹400. This loss is reduced by ₹10, which was the premium received from call sold.

This is how a covered call reduces the loss exposure. Note that the loses here are still unlimited. We can also have the opposite of this strategy to create a covered put position for reduced losses.

Let us discuss another example to better understand this.
A man buys 100 shares of Asian Paints at ₹3000. He expects the price will decrease. Further, he sells a call option at a Strike price of ₹3500 for a premium of ₹150.

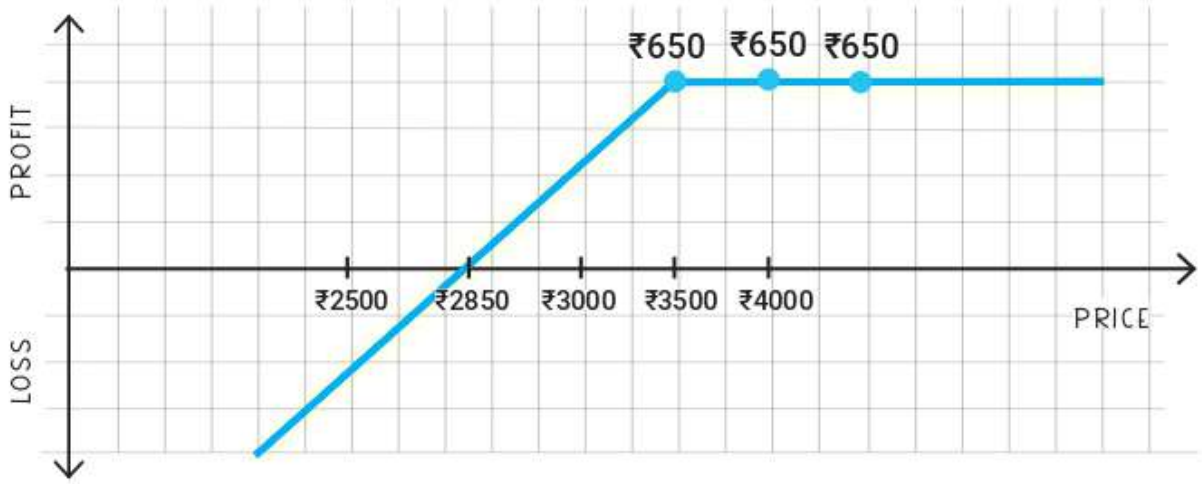


Let's say

MARKET PRICE ON EXPIRY	PROFIT/ LOSS	EXPLANATION
₹2600	**Profit/Loss** = Profit/Loss on Cash Position + Profit/Loss on Selling Call Options = (₹2600-₹3000) + (₹150) = -₹400 + ₹150 **= -₹250**	The man will incur a loss of ₹400 from his stock position. However, he has also receive ₹150 as call option premium which requires no payoff. We can see how option selling was used to reduce losses.

₹3500	**Profit/Loss** = Profit/Loss on Cash Position + Profit/Loss on Selling Call Options = (₹3500 - ₹3000) + (₹150) = ₹500 + ₹150 = **₹650** MAXIMUM PROFIT ₹650 is also the maximum profit that the man can make.	We see that the man has made a profit of ₹500 on each share that he owned. Also, he received ₹150 as premium on each call option sold. We can see that the man made a profit of ₹650 on each share.
₹4000	**Profit/Loss** = Profit/Loss on Cash Position + Profit/Loss on Selling Call Options = (₹4000 - ₹3000) + (₹3500 - ₹4000 + ₹150) = ₹1000 - ₹350 = **₹650**	The man has a profit of Rs. 1000 on each share. However, he also has a payoff to make of Rs. 500 on each option sold. Besides, he received Rs. 150 as premium. The total profit is Rs. 650 per unit of share. We can see that despite increase in share value, the total profit is same. We can say that the profits in this strategy gets limited.
₹3000	**Profit/Loss** = Profit/Loss on Cash Position + Profit/Loss on Selling Call Options = (₹3000 - ₹3000) + (₹150) = ₹0 + ₹150 = ₹150	We can see that even when there is no change in share value, because the man has received upfront premium, he will make a profit of ₹150.

The payoff chart of the same can be drawn as under. We have Price on the X-axis and Profit or Loss on the Y-axis. The straight line indicates the maximum profit. The sloping line shows how the losses are reduced by ₹150 but, can go down to unlimited.



SUMMING UP

THE STARTEGIES

PROTECTIVE PUT STRATEGY		
To hedge long position.	Here we buy put options to hedge our stock portfolio.	Limited loss and unlimited profit potential.
SYNTHETIC PUT STRATEGY		
To hedge short position.	Here we buy call options to hedge our stock portfolio.	Limited loss and unlimited profit potential.
COVERED CALL STRATEGY		
Short Term Hedge on Long Portfolio to reduce losses.	Here we sell call options to collect premium and reduce losses if the market goes down.	Unlimited loss and limited profit potential.