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Assembling a Covered Call Portfolio on Dividend-Paying Stocks

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Assembling a Covered Call Portfolio on Dividend-Paying Stocks

By Ben Branch

Article Highlights

- Stocks selected for covered-call writing should be profitable and have generous, secure dividends.
- Using call options with expiration dates 12 months out reduces the potential transaction and tax costs.
- Before initiating a position, compute the return if the stock rises, falls to a loss or stays flat by expiration.

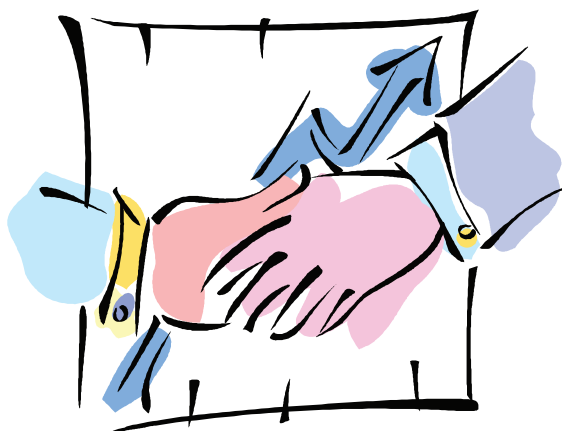
Covered call writing is one of several ways options are traded.

While often done on an ad hoc basis, one can assemble and manage a portfolio of covered call option positions as either a part of a larger portfolio or on a stand-alone basis. Such an approach does require more detailed attention than managing a stock-only portfolio. Nonetheless, systematically managing a portfolio of covered calls has much for me to recommend it.

Covered writing can generate returns in three ways:

- First, the call writer is paid up front to write the calls, thereby reducing the net cost (stock price – option sale proceeds) of the position;
 - Second, the covered writer earns any dividends paid on the call-covered stock; and
 - Third, the option writer may be able to capture some of the underlying stock's price appreciation.
- Taken together, these three income sources can generate rather attractive returns.

For example, as this article is written, stock in AT&T Inc. (T) is selling for about \$35.60. Calls with a strike price of \$37 having about nine months to run trade for about \$0.83. The stock is paying a dividend of \$0.46 per quarter, or \$1.38 over the life of the nine-month call. A covered call position on AT&T would cost \$34.77 (\$35.60 – \$0.83). If the stock trades at or above the strike price at expiration, the position would generate profits of \$1.38 in dividends and \$2.23 (\$37.00 – \$34.77) in price appreciation less a small



amount for transactions costs. That represents a total of \$3.61 (\$1.38 + \$2.23) on a net investment of \$34.77 for 10.38% over the nine-month period. That works out to an annualized return of around 14%. If the stock remained at its current price level (no price appreciation), the return would still

be about 8.5%. Even this lower-level return seems attractive compared to current rates on most fixed-income instruments.

Covered writing does incur some risks. One might, for example, write a call on a stock whose price then drops by much more than the sum of the proceeds from the call sale and dividend payments. For example if AT&T's stock price fell to \$27, the loss on the stock position (\$35.60 – \$27.00 = \$8.60) would greatly exceed the sum of the dividends and call sale proceeds (\$0.83 + \$1.38 = \$2.21). Alternatively, the price of the optioned stock could increase substantially once the position is established. In this case, although the call writer may still earn a decent return, significant money would be left on the table, giving the investor a bad case of option writer's regret. In the above illustration, if AT&T's stock price rose to \$45, one who purchased the stock at \$35.60 but did not write a call on it would earn a profit of \$9.40 (plus dividends) for a return of more than 30%. Clearly, option writing involves significant risks. But what type of investing offers attractive returns with no risk?

Covered option writers should not be expecting home run-like returns. Rather, their objective should be to earn reasonably attractive and steady returns with a limited amount

How Do Taxes Impact Call Writers?

Taxes also need to be factored into the call writer's strategy. If a call is written against an existing stock position and ends up being exercised, the gain or loss on the stock represents a capital gain or loss for the investor. If the stock has been held for more than a year, the gain or loss is classified as long-term and taxed at a relatively attractive rate (20% for most investors). If, however, the stock has been held for less than one year, any gain is short-term and taxed at the investor's marginal rate on ordinary income.

This rate largely depends upon the investor's total taxable income and is well above 20% for most investors. The marginal rate on ordinary income rises to 39.6% for those in the top tax bracket and even higher for those subject to the Affordable Care Act (ACA) 3.8% tax on

net investment income. That ACA tax applies to married couples with incomes above \$250,000 and singles above \$200,000.

If a call is written and expires worthless or is covered with an offsetting purchase, the difference between its sale price and the cost of covering (zero if the call expires without being exercised) is classified as a short-term gain or loss regardless of how long the call position was in place. IRS classifies a trade that starts out with a short sale as short-term regardless of whether the sale is said to have preceded the covering purchase. Clearly, the investor would prefer to have income in the form of long-term capital gains rather than taxed as ordinary income. This article's next installment will discuss how to limit the tax hit on covered call writing.

of risk. To pursue this objective effectively requires attention to detail both when setting up the positions and when monitoring them over time.

Why Use Dividend Stocks

Consider what types of stocks tend to be attractive option writing candidates. Since one of the main sources of return for option writers is the dividend, stocks selected for covered writing should have generous and secure dividend yields. Ideally, the yield will exceed the yields on both the S&P 500 index and 10-year Treasury notes. Not only does a high dividend yield provide a significant part of the desired return, if it is sustainable, the dividends will also tend to support the stock price even when the overall market is under pressure. Only if the company itself has a strong position within its served market and earns a profit rate that comfortably covers the dividend does a generous current dividend rate provide the kind of protection that is likely to limit losses in a declining market. Preferably, the company would not only sport an attractive and sustainable dividend yield but it would also have growth potential. The covered option writer could then seek to capture some of this price appreciation potential by

writing calls that are a bit out of the money (strike price above current stock price). A look at analysts' forecasts and the recent earnings and dividend history would provide some insight into the firm's growth prospects. In summary, stocks with generous and sustainable dividends that are expected to grow generally represent attractive candidates for a covered option portfolio. Two lists of potentially attractive stocks for covered writing are the 30 stocks making up the Dow Jones industrial average and the stocks in the S&P 500 Dividend Aristocrats index.

Stocks selected for the Dow tend to be mature industry leaders, most of whom pay relatively generous dividends that they tend to be able to maintain. The 10 with the highest yields are called the Dogs of the Dow, most of which would be classified as value stocks. AAIL tracks a Dogs of the Dow screen that lists the current Dow dogs, along with their indicated dividend yields, at www.aail.com/stock-screens/screendata/Dogs.

Dividend aristocrats are stocks that have increased their dividends annually for at least the last 25 years. Clearly such stocks are very likely to have sustainable dividends, based on their past performance. Dividend aristocrats with high yields are reasonable candidates for covered option writing.

The components of the 2014 S&P 500 Dividend Aristocrats index and their current yields can be found at: www.topyields.nl/Top-dividend-yields-of-Dividend-Aristocrats.php.

Pricing and Timing

Once attractive candidates for option writing have been identified, the next step is to examine the stock's option pricing. Options are not written in a vacuum. Some of the factors that make stocks attractive for option writers may also tend to reduce the options' prices. In particular, stocks with a modest degree of anticipated volatility and high dividend yields tend to have lower call prices than more volatile stocks with little or no dividend yield. Still, if the objective is to produce consistently attractive returns, sticking to less-volatile stocks with decent dividend yields is probably a good idea.

Options can be written at various strike prices and with various lengths to expiration. In order to capture some of the upside from the stock's potential price appreciation, the option should be written out of the money (strike price above the current stock price). The further the option is out of the money, the greater the potential upside from price appreciation, but the lower

the market price of the option. For example, nine-month AT&T calls with strikes of \$36, \$37 and \$38 were selling for \$1.33, \$0.83 and \$0.57 respectively. The more optimistic one is about the stock's potential price appreciation, the further out of the money the option can be written. Selecting a higher strike price option could result in a significantly greater upside. In the AT&T example, writing calls with a strike of \$38 rather than \$37 would mean receiving \$0.26 (\$0.83 – \$0.57) less for writing the option. The potential gain from price appreciation would, however, rise by \$1.00 (\$38 – \$37), thereby increasing the potential upside by \$0.74 (\$1.00 – \$0.26). This greater upside may seem attractive. But if the stock price falls or does not rise much, the lower strike option would have produced a better outcome.

The call writer must also decide how long an option to write. In the AT&T case, options were listed with expirations of 1, 2, 3, 6, 9 and 21 months away. As the length of the option's term increases, its price increases, but generally at a somewhat decreasing rate. For the AT&T options with a strike of \$37 and terms of 1, 2, 3, 6, 9 and 21 months, the prices were \$0.05, \$0.12, \$0.22, \$0.43, \$0.59, \$0.83 and \$1.57. While the market price increases as the term is lengthened, the rate per month usually declines as length rises. Thus the option writer might be able to earn a somewhat higher return per period

by writing shorter-term options. Such an approach has some significant disadvantages, however. Specifically, the more times one must buy and sell options and stock, the greater the transactions costs and the greater the likelihood of adverse tax results. Moreover, one can get whipsawed by short-term price fluctuations. So option writers should generally set up their initial covered call positions with relatively long-term options.

Writing one-year options is a pretty good place to start. That way if the stock reaches the strike price and is exercised, the position will give rise to long-term capital gains, which are taxed at a favorable rate. Moreover, writing one-year options gives the situation time to evolve favorably. That is, the stock has a reasonable opportunity to rise and the investor can hold the stock long enough to earn several dividend payments.

Key Calculations to Make

Before actually assembling a covered position, the investor should make several calculations.

First, compute the return if the stock is at the same price at option expiration as it was when purchased. In this case the gain would be equal to the sum of the dividends to be received plus the proceeds from the option sale. The return would be this gain divided by the net cost of the position (cost of the stock less the proceeds from the

option sale). For example, if the stock had a 3.5% dividend yield and the call was sold for a price equal to 6% of the stock's price, the position would produce a total return of about 9.5%. An attractive covered position should generate a decent return in this circumstance. In the AT&T example, this was 8.5%.

Second, calculate how far the stock's price would have to fall before the position would show a loss. This is the same percentage number as the gain on the transaction if the stock price did not change. That is, the sum of the dividends and proceeds from the option sale. Note that if the stock falls further, the position will show a loss. In the AT&T example, the stock would have to fall by \$2.23 to \$33.37 (a decline of about 6.5%) before the position would show a loss (assuming the expected dividends are in fact paid). The price of \$33.37 represents the breakeven point. As long as the stock's price stays above this level, the position will show a profit.

Third, compute the maximum gain on the position: the sum of the dividends and option proceeds plus the difference between the option's strike price and the cost of the stock. For a nine-month call, the annual return is this sum divided by the cost of the position, which has already been calculated above. In the AT&T example, the maximum gain on the position would be 12.77% (17% annualized). In more aggressive call writing using options with a strike of \$38.00, the

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Who Gets the Dividend?

When a company declares a dividend, it establishes the day that determines who receives that dividend, referred to as the record date. Those who are on record as owning the stock on that date will be paid the dividend even if they sell their shares before the checks are sent out. Because settlement of trades takes three business days, you must have purchased the stock three or more days prior to the record date in order to receive the dividend. The first day after the last day for owning the stock and being paid the dividend is called the ex-dividend date.

The stock's price will typically fall on its ex-dividend date by about the amount of the dividend. In the case of AT&T, with a dividend of \$0.46 per quarter, the stock price will tend to open about \$0.46 lower on the ex-dividend date than the price at which it closed the day before.

Those who trade options need to keep an eye on ex-dividend dates of stocks on which they have written options. If the call owner chooses to exercise the option just before the ex-dividend date, they will capture the dividend. If they let it pass, the covered writer will receive it.

was very small when compared to the current assets, which made the margin of safety look very healthy.

The company had also been in business for a number of years and was profitable. Less attractive was the fact that it operated in a cyclical industry and suffered from client concentration, but that would explain the low valuation of this stock to a certain extent.

This is how I find and analyze a potential net-net. I do not intend to recommend you buy this Gencor Industries, or for this to act as investment advice; it is simply an example of a stock trading at net-net working capital levels and one that seems to fit the bill of the kind of stock I look for.

Why Net-Net Isn't Used by Every Investor

If the results are so clearly in the favor of net-net stocks, why isn't every equity investor following this approach?

One reason may be that in order to trade at these extreme valuations, this particular category of value stocks are typically small caps—their share prices (and market capitalization) have shrunk, in many cases by 80% or more. This makes them unattractive for large portfolio managers and unprofitable for brokerage firms to research.

Another argument is that such extreme valuations—especially net-nets—are difficult to find in today's

equity markets. But in my experience there are usually over 200 individual stocks worldwide trading as net-nets at any one time. Besides, the studies that Tweedy, Browne have collected over the years show that the approach works equally well around the world, in all the main equity markets.

In other words, there are always plenty of places to look.

They are out there and with a little bit of effort can be quite easily identified. The strategy continues to work as well as when it was first articulated by Benjamin Graham in the 1930s, whose wonderful book "The Intelligent Investor" features timeless material on what he called "bargain issues." ▲

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Trading Strategies

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potential gain would be 14.0% (18.7% annualized). The covered option position should only be established if the investor finds each of these calculated numbers attractive.

Outcomes

In a portfolio approach to covered writing, the objective would be a set of outcomes that were not only generally

positive, but provided a relatively steady and attractive return.

In periods when the market rises rapidly, returns from the strategy, while attractive, might lag the market and leave a significant amount of the long stock positions' upside on the table.

On the other hand, in a declining market, the income generated by option writing coupled with the type of solid dividend-paying stocks selected for the

portfolio would generally cushion the impact of the weak market such that the overall portfolio return would be significantly above the market averages.

Finally, in a directionless market, the strategy should generally outperform the market averages, as the proceeds from option writing would add to the returns on the long stock positions without leaving much money on the table from those few stocks that did well. ▲

Ben Branch is a professor of finance at the Isenberg School of Management at the University of Massachusetts Amherst and is an expert in bankruptcy investing, bankruptcy management, and valuing distressed assets. Find out more about the author at www.aaii.com/authors/ben-branch.
