Leveraging Covered Calls with LEAPS

Writing Covered Calls is an effective method of boosting income on common stocks in your portfolio. One trade-off with this conservative options strategy is the forfeiture of some of the upside price appreciation of the underlying stock when the stock closes above the strike price at the expiration date of the option. In this case, the expiration event will trigger the writer's obligation to sell the stock at the strike price, forgoing the gain between the current market price and the exercise price. If the short call was out-of-the-money when the position was put on, the writer will still realize a gain on the stock sale up to the strike price as well as retain the proceeds of the initial option sale. The nice thing about covered calls is that once the position is opened, very little monitoring or further action is required and one can just let the trade play out on auto pilot.

One way to amp up this conservative buy/write strategy with a little leverage tossed in is to use LEAPS (Long Term Equity AnticiPation Securities) instead of the underlying stock as the long side of the trade. This tactic effectively creates a debit calendar spread, and you will generally need to be approved for level 2 options trading in your brokerage account. The trade-off here, compared to going long the stock to secure the short call position, is that a much higher level of maintenance and monitoring is required. Be sure you are up to the task.

First, consider the following example of a typical covered call trade. On January 6, 2012, Abbott Labs, (ABT) closed at $55.86. The midrange quote on a May 2012 $57.50 Call option contract was $1.05 (One contract controls 100 shares of the underlying stock). In a standard Buy/Write trade, the trader would purchase 100 shares of ABT at $55.86 and sell 1 May $57.50 contract at $1.05. The net cost of the transaction before commissions is $5481 (5586 – 105 = 5481). If ABT stock closes below $57.50 at expiration, the call option would expire and the static gain on the trade would be $105, or 1.9%. If the stock closes above $57.50, triggering an exercise, the investor would receive $5750 from the sale of the stock. With a net debit of $5481, the gain on the trade is $269, a return of 4.9%. Not bad for a four month investment.

Now lets look at the same trade using a January 2013 $50.00 Call option with a midrange cost of $7.00. The intrinsic value of the option is $5.86 giving it a Delta of .84. Delta is a measurement of the sensitivity of the theoretical value of the option price compared to a one point movement in the underlying stock. Theoretically speaking, then, a one point move in the stock would result in a change of 84 cents in the option price.

To complete the spread, we sell the same May 2012 $57.50 Call and receive proceeds of $105. The net debit for this position is $595 (700 – 105 = 595) before commissions. Like the covered call described above, we are effectively putting on a position involving 100 shares of ABT, but with one-tenth the outlay. When entering this type of spread, it is advisable to make sure that the long side's days-to-expiration exceeds that of the short side.

There are a number of ways that this leveraged trade can play out. If ABT closes below $57.50 at the May 2012 expiration, that option expires worthless and you keep the $105 in profit just like the covered call. The static return on the trade is 15% compared to the 1.9% return on the covered call trade. However, if ABT stock closes above the $57.50 strike price at any time during the life of the May Call contract, there is a chance of being assigned, ie., required to fulfill your obligation to deliver 100 shares of ABT at $57.50.

If you are assigned, and you do not own the stock, you will find yourself "short" 100 shares of ABT. Now there is a decision to be made; either cover your short by buying 100 shares on the open market, or exercise your option to buy 100 shares at the $50.00 strike price of your January 2013 option. Almost always, the latter alternative is not advisable for reasons to be explained next.

Say that at or before expiration of the May $57.50 Call, ABT closed at $59.00 and you receive a notice of assignment. First, you keep the $105 credit received when you sold the Call. Further, it's reasonable to assume that the January 2013 $50 Call would now have a total value somewhere in the neighborhood of $9.75, with $9.00 of "intrinsic" value and $.75 of theoretical "time" value. You will recall that the time value of the January 2013 Call was $1.14 when the position was opened. If you exercise your option to purchase 100 shares of ABT at $50 you would effectively forfeit the remaining "time" value of $.75. You would be better off just buying the shares on the open market to cover your short position and just sell your January Call at $9.75 if it is your wish to fully exit the position.

So this is how the trade shakes out after being assigned assuming ABT trading at $59.00 per share and you choose to fully exit the position. You cover your short stock position by purchasing 100 shares at $59.00 on the open market for a loss of $150. You sell your January 2013 Call at $9.75 for a profit of $275.00. Your proceeds and profit on the short May Call is $105. Total gain before transaction costs is $230 (275 + 105 – 150 = 230). The ROI before commissions after fully exiting the position is 32.8% (230 ÷ 700). Or you could just stay long the January 2013 Call and repeat the process by selling a July 2012 Call.

Clearly there is a lot to keep track of using this leveraged approach as opposed to simple covered calls, but the extra rewards may be worth it provided that you are in a position to monitor your positions on a daily basis. And yes, transaction costs will impact the results. The other extremely important point to remember is to avoid options spreads on thinly traded issues. Wide spreads in the bid/ask price can easily eat away at any potential profits.