Option Trading Series – eBook 5 of 8

SELLING A COVERED CALL TO OPEN

Swissquote

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About the author

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Emmanuel has over twenty-five years experience in financial markets, including equities, CFDs, options and futures. Emmanuel started his career with Société Générale in Paris, then with Citibank, Jefferies, Brown Brothers Harriman in London in equities, options and fixed-income trading before joining Internaxx Bank (now Swissquote Bank Europe) in Luxembourg.

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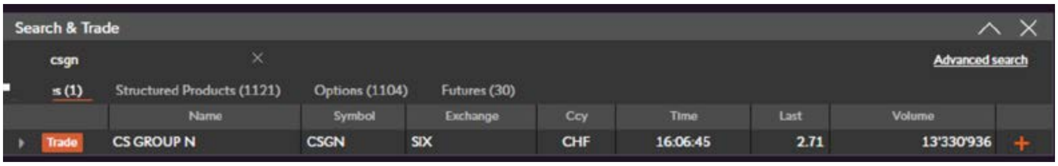
We saw in our last chapter that selling calls to open, or "writing calls" in options lingo, can be very risky, and will also block some of your cash as margin. Our next strategy will need no margin calculation. It is one of the most utilised and successful options strategies, and will involve writing calls after buying the underlying stock.

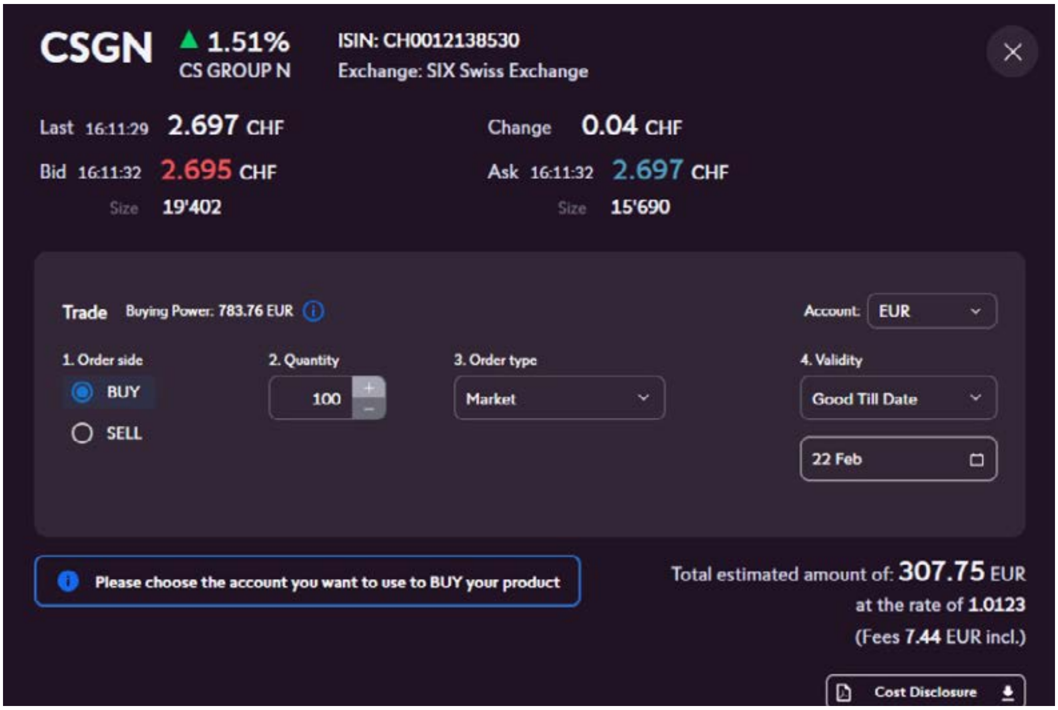
For the first time since we started discussing options, we will see a combination of trades. Short calls are said to be "covered" if you buy the underlying security first, then sell the call.

We are also going to see what this looks like on the Swissquote platform. The stock we'll use for this example is Credit Suisse (symbol: CSGN) on the Swiss Exchange SIX. I have no specific insight into this company, but just chose it because the price per share is low, so I won't need to use much capital to illustrate our lesson.

Let's start with the purchase of the shares. On the Trading space within the eTrading platform of my Swissquote account, I'm typing "CSGN" in the widget called "Search & Trade". For the record, I am doing this on Wednesday, 22 February 2023.



Clicking the [Trade] button on the left brings up the trade window.



Full disclosure: your commission is likely to be slightly more expensive than the 7.44 € you see at the bottom of this screen. For more details about trading commissions, please check our public website **swissquote.lu.**

As you can see from the screen, I have selected the order type “Market”, which means I will buy 100 shares at whatever price the stock is trading now. I have also selected my settlement currency to be EUR, since I own Euros on my account, and not Swiss Francs.

I clicked [Prepare Order], then [Place order], and voilà, I own 100 shares of Credit Suisse at a unit cost of CHF 2.708. You see below the order I just placed, and the resulting position.

Orders

Symbol	B/S	Quantity	Type	Price	Ccy	Validity	Date	Status	Last	Order
CSGN	BUY	100	Market		CHF	DAY	16:14:36	Executed	2.709	129461283

Positions

	Symbol	Qty	Unit Cost	Total Value	P&L EUR	BID	ASK	Last	Chg %	Ccy
Shares										
Trade	CSGN	100	2.708	270.70	-0.24 (-0.09%)	2.707	2.709	2.709	1.96%	CHF
			Shares subtotal	273.89	-0.24 (-0.09%)					

Now let’s look after the second “leg” of our trade, which is the call writing. I type CSGN on the “My Optionchain” widget, and see this table – for simplicity I am only showing the calls on the left, we don’t need the puts (in case you are wondering, we will discuss puts in the next two chapters).

My Optionchain

Symbol	Exchange	Ccy	Last	Chg %	Bid size
CSGN	SIX Swiss Exchange	CHF	2.713	2.11%	13'509

Strike: 2.55..2.84

Maturity: 17 Mar 2023, 21 Apr 2023, 19 May 2023

Reset filters

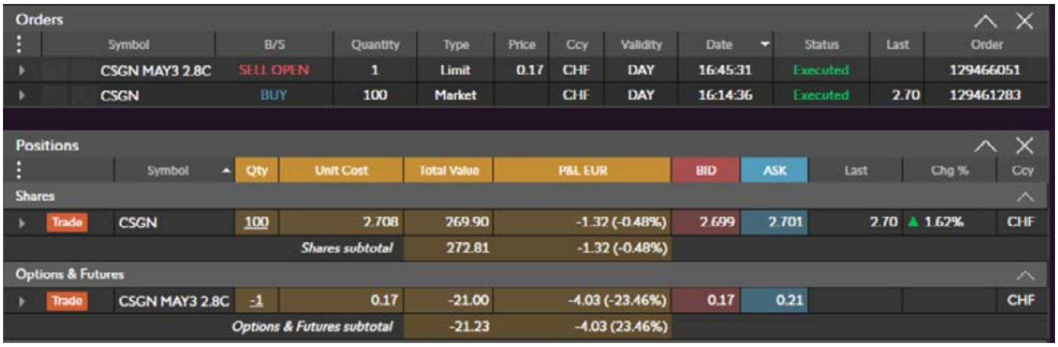
CALL

Last	Bid size	BID	ASK	Ask size	Name	strike	dist
						17 Mar 2023	
	8'985	0.21	0.24	10'324	CSGN MAR/23-C 2.55 100	2.55	-6.4%
0.10	6'973	0.18	0.20	2'701	CSGN MAR/23-C 2.6 100	2.6	-4.5%
	6'614	0.15	0.17	8'485	CSGN MAR/23-C 2.65 100	2.65	-2.7%
0.11	8'224	0.12	0.14	3'688	CSGN MAR/23-C 2.7 100	2.7	-0.8%
0.17	10'519	0.09	0.12	9'435	CSGN MAR/23-C 2.75 100	2.75	+1.0%
0.11	10'604	0.07	0.10	10'084	CSGN MAR/23-C 2.8 100	2.8	+2.8%
0.18	9'375	0.06	0.09	9'978	CSGN MAR/23-C 2.84 105.65	2.84	+4.3%
						21 Apr 2023	
	8'394	0.26	0.29	8'478	CSGN APR/23-C 2.55 100	2.55	-6.4%
	7'435	0.23	0.26	8'646	CSGN APR/23-C 2.6 100	2.6	-4.5%
0.25	8'328	0.20	0.23	8'610	CSGN APR/23-C 2.65 100	2.65	-2.7%
0.15	6'377	0.18	0.20	7'847	CSGN APR/23-C 2.7 100	2.7	0.8%
0.17	590	0.16	0.18	8'804	CSGN APR/23-C 2.75 100	2.75	+1.0%
0.12	8'431	0.13	0.16	8'812	CSGN APR/23-C 2.8 100	2.8	+2.8%
						19 May 2023	
	6'908	0.30	0.34	5'838	CSGN MAY/23-C 2.55 100	2.55	-6.4%
	6'950	0.27	0.31	5'767	CSGN MAY/23-C 2.6 100	2.6	-4.5%
0.19	7'001	0.24	0.29	6'241	CSGN MAY/23-C 2.65 100	2.65	-2.7%
	7'057	0.22	0.26	6'288	CSGN MAY/23-C 2.7 100	2.7	0.8%
	7'094	0.19	0.24	6'335	CSGN MAY/23-C 2.75 100	2.75	+1.0%
	7'141	0.17	0.22	7'121	CSGN MAY/23-C 2.8 100	2.8	+2.8%

I am going to write one call May 2023 strike 2.80. For this, I will click the red button on the very last line of this table, next to “CSGN MAY/23-C2.8 100”.

Note that on the Swissquote platform, you can only place options orders with a limit, not at market best.

And here is the resulting order, and the short call position (notice the “-1” next to the option position). My covered call selling is complete!



Orders

Symbol	B/S	Quantity	Type	Price	Ccy	Validity	Date	Status	Last	Order
CSGN MAY3 2.8C	SELL OPEN	1	Limit	0.17	CHF	DAY	16:45:31	Executed		129466051
CSGN	BUY	100	Market		CHF	DAY	16:14:36	Executed	2.70	129461283

Positions

	Symbol	Qty	Unit Cost	Total Value	P&L EUR	BID	ASK	Last	Chg %	Ccy
Shares										
Trade	CSGN	100	2.708	269.90	-1.32 (-0.48%)	2.699	2.701	2.70	1.62%	CHF
			Shares subtotal	272.81	-1.32 (-0.48%)					
Options & Futures										
Trade	CSGN MAY3 2.8C	-1	0.17	-21.00	-4.03 (-23.46%)	0.17	0.21			CHF
			Options & Futures subtotal	-21.23	-4.03 (23.46%)					

Now we have our full trade, let’s see what are the benefits and obligations of this combined position.

We own 100 shares, which on their own are a bullish position – we will profit if the share price rises. But we also sold the call, which is bearish as we saw in chapter 4. Do these two trades cancel each other out?

To answer this question, let’s see the three possible scenarios between now and the May 2023 expiration.

1. The price of CSGN rises a lot above the CHF 2.80 strike price – say to 4 CHF

If this happens, I can be confident that my short call with be assigned at or before expiration. "Assigned" means that the counterparty, the call buyer, will exercise it and buy my hundred shares for CHF 280: the strike price 2.80 x 100.

When this happens, my -1 call position, as well as my 100 shares, will be taken off the account.

The end-result will be for me (to keep things simple, I am ignoring all commissions):

CHF - 270.80	CHF + 17	CHF +280	Total
purchase of 100 CSGN shares	Sale of 1 call May 2.80	Sale (assigned!) of 100 CSGN shares	**profit CHF 26.20** from February to May 2023

This small profit represents 9.67% of our initial stock investment of CHF 270.80, over three months. When extrapolated, this is an impressive annual yield of nearly 40%.

(However, despite these good numbers, there is a negative aspect to this trade, maybe you've already seen it? We will get into it a bit later in the chapter)

2. The price of CSGN stays more or less flat

If my call never gets assigned, and the stock price stays stable for the three months to expiration in May, due to the time decay we discussed on an earlier chapter, the call will expire worthlessly. The CHF 17 call premium will be ours to keep. And we will still own our 100 shares, since there will be no benefit for the call buyer to exercise.

CHF - 270.80	CHF + 17	Total
purchase of 100 CSGN shares	Sale of 1 call May 2.80	**expense of CHF 253.80** for the 100 shares I own

All considered, I have reduced my average unit cost by CHF 0.17, or 6.27%; and if I want, I have the possibility to sell another call again, reducing my average cost further in following months.

3. The price of CSGN goes down from its current level

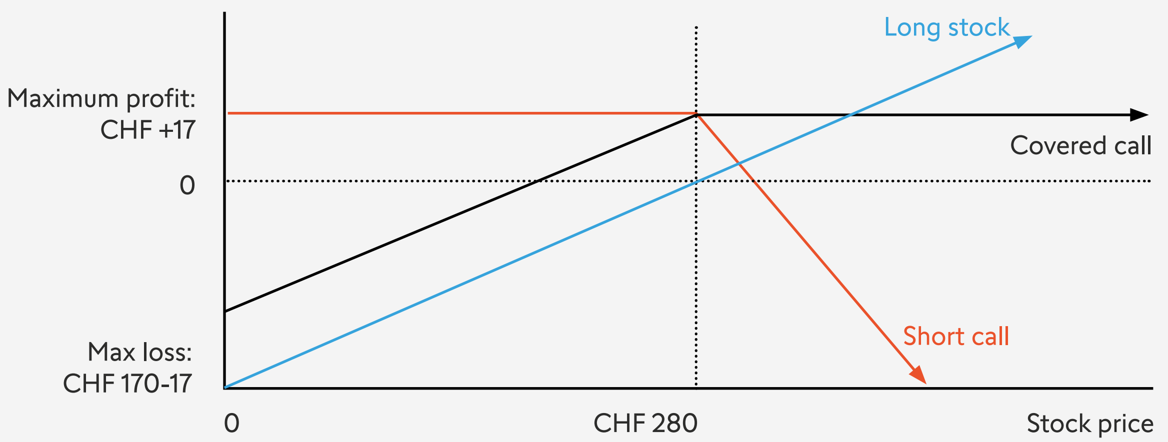
Like in scenario 2, my call will not be exercised by its buyer, and will expire worthlessly. Unlike scenario 2, I will lose out if the share price falls more than my call value of CHF 0.17 per share. But at least, I will have reduced my average unit cost. And I will still own my shares and can hope for a bounce back. Still, this is the least appealing of the three scenarios.

CHF - 270.80	CHF + 17	Total
purchase of 100 CSGN shares	Sale of 1 call May 2.80	**expense of CHF 253.80** for the 100 shares I own

Let's return to our scenario 1. What's the drawback we mentioned?

The drawback is that your stock position, if you had not sold the covered call, would now be worth CHF 400 – you would be sitting on a 48% profit over three months. Your short call prevented you from taking the full benefit of the share price rise.

Selling covered calls to open: P&L Chart



Here is the profit and loss chart for the written covered call.

A few final remarks on covered calls

- In flat markets, this strategy is particular interesting to investors with an existing portfolio, who want to boost their income.
- You can **buy to close** your short call at any time during its lifespan.
- You may also keep your short call and decide to sell your shares, but beware! You will find yourself with a short naked call, which is a much more risky strategy. See chapter 4 for more details.
- One added advantage of selling covered calls, is that the call premium is available instantly for you to reinvest – or spend!

Two line summary

Writing covered calls offers a partial protection against a loss in your portfolio, and offers instant revenue at little risk. The main trade-off is relinquishing some of the profit in a booming market.

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