Selling covered calls: An options strategy that can potentially generate income on your portfolio.

Covered call writing is an options strategy that provides the ability to produce income and may be less risky than simply buying dividend paying stocks. This basic strategy is designed to help generate income from stocks you already own.

There are two types of options: calls and puts.

Calls**:** The buyer of a call has the right to buy the underlying stock at a set price (strike price) until the option contract expires (expiration date).
Puts: The buyer of a put has the right to sell the underlying stock at a set price until the contract expires.

There are many different options strategies, all are based on the buying and selling of calls and puts.

When you sell a covered call, also known as writing a call, you already own shares of the underlying stock and you are selling someone the right, but not the obligation, to buy that stock at a set price until the option expires. If you did not own the stock, it would be known as a naked call which is a much riskier.

The reason you want to sell the rights to your stock is because you receive cash for selling the option (also known as the premium).

How a covered call strategy works: For example, in June, you already own 100 shares of XYZ stock, which is currently trading at $20 a share. You decide to sell (a.k.a., write) one call, which covers 100 shares of stock (if you owned 200 shares of XYZ stock, you could sell two calls, etc.).

1) The strike price:

You agreed to sell those 100 shares at an agreed upon price, known as the strike price. There are an assortment of differing strike prices. The strike price we choose is one determinant of how much premium you receive for selling the option. With covered calls, for a given stock, the higher the strike price is over the stock price, the less valuable the option.

Therefore, an option with a $22 strike price is more valuable than an option with a $25 strike price because it is more likely for XYZ stock to reach $22 than it is for it to reach $25, and therefore more likely that the buyer of the call will make money. Because of that, the premium is higher.

2) The expiration date:

In addition to deciding on the most appropriate strike price, you also have a choice of an expiration date, which is the third Friday of the expiration month. For example, in June, we choose a July expiration date. On the third Friday in July, trading on the option ends and it expires. Either your option is assigned and the stock is sold at the strike price or you keep the stock.

3) A covered call trade:

Here is a more specific example.

1. In June, you own 100 shares of XYZ stock, which is currently trading at $20 a share.
2. You sell one covered call with a strike price of $23 and an expiration date of July. The bid price (the premium) for this option is $1.25.
3. If the call is sold at $1.25, the premium you receive is $125 (100 shares x $1.25) less commission.

Scenario 1: The underlying stock, XYZ, is above the $23 strike price on the expiration date.
If the underlying stock rises above the strike price any time before expiration, even by a penny, the stock will most likely be "called away" from you. You are obligated to sell the stock at the strike price (at $23 in this example). If you sell covered calls, you should plan to have your stock sold or called. After it is sold or called away, you can always buy the stock back and sell covered calls on it the following month.
One of the dilemmas of selling covered calls is there is limited gain. In other words, if XYZ suddenly rallied to $27 a share at expiration, the stock would still be sold at $23 (the strike price). You would not participate in the gains past the strike price.
Advantage: You keep the premium, any stock gains/appreciation up to the strike price, and any potential accrued dividends.
Disadvantage: You lose out on potential gains past the strike price. In addition, your stock is tied up until the expiration date.

Scenario 2: The underlying stock is below the strike price on the expiration date.
If the underlying stock is below $23 a share (the strike price) at all times before expiration, the option expires unexercised and you keep your stock and your premium. You could also sell another covered call for another month to keep collecting your premiums.
For example, if XYZ drops a lot, for example, from $20 to $15 a share, although the $125 premium you receive will reduce the pain, you still lost $500 on the underlying stock.
Advantage: The premium will in all likelihood reduce, but not eliminate, stock losses.
Disadvantage: You lose money on the underlying stock when it falls.

Scenario 3: The underlying stock is near the strike price on the expiration date.
Some might say this is the most satisfactory result for a covered call. If the underlying stock is slightly below the strike price at expiration, you keep your premium and your stock. You can then sell a covered call for the following month, bringing in extra income. If, however, the stock rises above the strike price at expiration by even a penny, the option will most likely be called away.
Advantage: You may be able to keep the stock and premium, and continue to sell calls on the same stock.
Disadvantage: The stock falls, costing you money. Or it rises, and your option is exercised.

4) Covered call strategies:

1. You may use the covered call strategy to sell stocks you no longer want. If successful, the stock is called away at the strike price and sold. You also keep the premium for selling the covered calls. If you simply sold the stock, you are closing the position out. Alternatively, if you execute a covered call strategy, you have the opportunity to both close the position out and take in income on the stock. However, with this strategy, if the stock declines in value and the option is not exercised, you will continue to own the stock that you wanted to sell.
2. If you want to avoid having the stock assigned and losing your underlying stock position, you can usually buy back the option in a closing purchase transaction and take back control of your stock.