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Enjoying the High Wire -- and the Safety Net

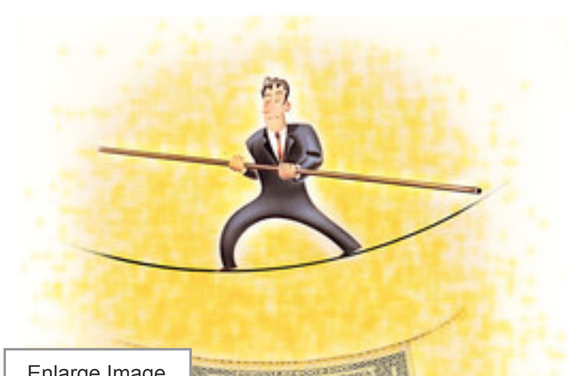
By S.L. MINTZ

Top 100 Women Financial Advisors: The stock market set new record highs in recent weeks. Covered call options can protect against a tumble.

Steep market gains in 2013 have given money managers ample reason to celebrate, but worrying how long it will last has put investors on edge. Last Wednesday's 217-point plunge was just the latest sign. Many shareholders want to protect their gains without beating a hasty retreat to cash or bonds. Covered call options, also known as buy-write options, can furnish a welcome alternative.

Most of today's investment selections have unwanted side effects. Selling shares to lock in gains would impose significant 2013 tax liabilities and reinvestment risk. Meanwhile, rising interest rates imperil bond portfolios, and cash almost always seems to trail inflation. Investors who opt for the sidelines will kick themselves if a strengthening economy propels the stock market to even loftier territory later this year.

Anxious investors also could buy put options that bestow the right to sell shares at an agreed-upon price if the market stumbles. Put options suit investors who don't mind paying a stiff price for insurance, sometimes as much as 4% or 5% of a position for a six-month hedge. "Put markets are fairly expensive relative to history because everybody has figured this out," says Merrill Lynch Chief Investment Officer Chris Wolfe.



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Instead of paying through the nose for puts, however, you can sit back and collect covered-call-option premiums, says John Kulhavi, a Merrill Lynch financial advisor in Farmington Hills, Mich. Stock portfolios that Kulhavi manages all deploy covered calls, a hedge he has used continually for 25 years. He reckons more investors are catching on, based on the portfolios other financial advisors are asking him to manage.

Investors or fund managers who want to generate more cash flow can issue, or sell, covered call options on stocks they own. The seller, of course, doesn't have a cost to deal with. In exchange for premiums, covered call options confer the right, but not the obligation, to another investor to buy the stock at a predetermined, or strike, price on or before a certain, or strike, date. Growth prospects and market volatility govern premiums. American-style call options which give the buyer the right to exercise options ahead of strike dates tend to fatten premiums a bit more.

THE UGLIEST STOCK MARKET since the Great Depression rewarded Kulhavi's faith in covered calls. As falling prices slammed investors after 2008, Kulhavi stayed the course. "During three years," he explains, "income from options, plus stock dividends and interest from bond portfolios met income needs without liquidating. When the market stabilized, the stock portfolios came right back."

Covered call options essentially combine two wagers, says finance professor Joshua Coval at the Harvard Business School. One bet says a sound stock will grow over time, periodic downturns notwithstanding. A simultaneous wager on volatility says the stock won't move up enough to hit its strike price by its strike date.

It's not an ironclad guarantee against losses. "In years when the market declines modestly or the stock you own goes sideways, the premiums might be sufficient to make you money," says Coval. "But if the market drops 20% to 30%, you're going to lose. You're not avoiding that."

On the flip side, bull markets test patience. A covered call surrenders stock-price gains once it hits the strike price. As a result, this middle course can fray nerves. "We can't compete in a market going straight up," Kulhavi concedes. "But the number of times the market has gone straight up, you can count on one hand." In any climate, he adds, his investors readily trade some upside for wider margins of safety on the downside.

"It's rare that we have a surprise on the upside," says Kulhavi. Last fall, though, a large position in **Verizon Communications** (ticker: VZ) triggered a call at $46. The stock then climbed to more than $54 in late April, hurting those who had to get out at the lower price. Verizon now trades near $48.

THE PERFORMANCE of a benchmark index for this strategy helps make the long-term case for covered calls. The **CBOE S&P 500 2% OTM BuyWrite Index** (BXY) uses S&P 500 covered call options priced 2% over the market, or *out of* the money, when issued each month.

In the two decades ending on May 31, a dollar invested in the BXY became $6.12, versus $5.35 for an equivalent bet on the S&P 500, according to the Chicago Board Options Exchange (see chart). These total returns include reinvested dividends but not taxes or transaction costs. Better still, BXY outpaced the S&P with less risk, as indicated by a lower standard deviation.

A growing roster of funds pegs performance to the BXY or its cousin, the BXM, which tracks S&P 500 covered calls *at* the money when issued. Be warned, however. Funds that outpace only the BXM have less to brag about. While the BXY poised to capture 2% of the price upside beat the market over two decades, BXM at-the-money covered calls with no room to capture price increases trailed the underlying S&P 500 by a margin about equal to BXY's advantage.

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None

Kulhavi likens an investment in covered call options to a house for sale down the street. You know the neighborhood and the value of the house. So you buy it and collect rent from tenants until the house's price reaches a target. Then you sell and start over.

When covered calls go according to plan, shareholders rent their stock to prospective owners. Rent constitutes a fraction of the expected rise in price, a premium that options sellers keep whether or not renters exercise options to buy. Market conditions and growth expectations govern premiums. Strike dates can be days, weeks, or years away. Provided the stock's long-term gain tops inflation and an investor has staying power, the worst scenario generates premium cash flow until patient investors cash in.

In options calculus, higher volatility fetches higher premiums. Calls are cheap when volatility is low and dear when volatility is high. The core Volatility Index -- or VIX -- has furnished a popular benchmark for volatility since the CBOE unveiled it in 1993. A weighted blend of active puts and calls attempts to predict volatility out 30 days. In early June, the VIX hovers around 17, near its floor. Upticks in the VIX can be expected to widen covered call premiums.

ON SLOW DAYS, Kulhavi and his group write a few dozen covered call options. In volatile markets, they write options in bulk. The tough bit lies in setting covered-call strike prices low enough to fetch premiums but high enough so they will expire before hitting the strike price. That requires old-time fundamental research, prowling for factors that propel growth, then setting strike prices and dates accordingly.

Call options can supplement dividend cash flows or produce income from stocks that pay no dividend. Meantime, equities reside in the portfolio, hopefully appreciating over time in increments just short of successive strike prices. Altering strike dates and strike prices can inch up premiums, subject to risk appetites.

Covered calls augment buy-and-hold or active-trading strategies. Say you own an S&P 500 company whose stock has had a nice run and is trading a few dollars below your target exit price, says A.J. Fechter, a senior vice present at Morgan Stanley. You might want to sell a covered call on it. When it does hit your target, you can sell and also pocket the premiums you've collected. There's a potential tax break, too. The Internal Revenue Service treats a premium as a long-term gain so long as the stock qualifies.

Fechter warns that premiums shrink as bull markets age. In the current climate, he urges selectivity before buying a stock with an eye to issuing covered calls. If the market falls, as it did early last week, Fechter says, call premiums are unlikely to fall as fast as stocks. That would renew chances to buy stock cheaply and sell corresponding calls for excess annualized returns.

Covered calls look plain vanilla next to an exotic array of spreads, strangles, and straddles that hedge specific risks. That's a virtue, Fechter finds. His clients prefer simplicity.

Big, brawny companies make the best candidates for covered-call strategies. Small- or even mid-caps are too sensitive to market orders that can jostle prices. Companies vulnerable to takeovers and other event risk also aren't good candidates for covered calls. These hurdles constrain the temptation to juice covered call premiums by sliding down the size and quality scale, a perennial lure on Wall Street.

All things considered, Fechter sounds hard-pressed to say why investors would forgo covered calls to hold on to gains. "You have to have a very bullish outlook to walk away" from this option, he says.

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