The Covered Call Income Machine
With people living longer than ever before, the need for income has never been greater. Many retirees can expect to live another 20 or 30 years. That’s fantastic. But it also means that you will have to make your savings last for a very long time.

Ideally, you want to live off income from your savings without spending the principal. Otherwise, you might have to spend and deplete your nest egg. When the money runs out, then what?

At a time when generating investment income has never been more crucial, interest rates are at rock bottom levels. Traditional fixed and safe haven investments often won’t even keep up with inflation and taxes. The only place left to earn a decent return is through dividend stocks and income-paying securities. But it’s still difficult to earn enough income.

Fortunately, there’s an answer. There is a fantastic strategy you can use to greatly enhance the level of income from a given stock. And it’s safe. In fact, employing this income-saving strategy is actually safer than just owning the individual stock.

Investors today have opportunities that simply weren’t available in the past. The proliferation of information and new investment vehicles have created strategies to perform well in just about any market.

A strategy particularly well suited for today’s world is covered call writing. Most investors are unaware of the strategy; but it’s one of the best and most low-risk sources of income. A good covered call writing strategy can provide an enormous boost to your regular payouts.

A call option is essentially a right to buy a stock at a certain price at a specific date in the future. It is generally a bet that the price of the stock will go up. Buying a call is highly speculative because it is likely that the stock will not rise to meet the price and the option will expire worthless, and the investor will lose 100% of his capital.

However, selling, or “writing,” a call when you own the underlying stock position is a very conservative, low-risk options strategy. Statistics show that about 83% of all options expire worthless. So consider the buyer of a call to be like a gambler at a casino. Every once in a while, he may win, but the odds are stacked against him. When you sell a call you are like the house. In effect, you get on the smart side of the deal.

Here’s how covered calls work, in more detail:
Let’s say you own 1000 shares of a $40 stock. You write (or sell) 10 calls (each call represents 100 shares) at a strike price of $44 expiring 3 months from now for $3 each, or $3,000 total. The stock price must rise above $44 for the option to be in-the-money, otherwise it expires worthless. But either way, you collect the $3 premium.

If you write the call option under the above scenario one of three things will happen.

1. **The stock trades flat, anywhere below $44**

   In this case the options you sold will expire worthless and you will simply keep the $3,000 premium, supplementing your income. Let’s say the stock price remains at $40. You collect a $3 premium and enhance your percentage income on the stock by 7.5% (the $3 call premium dividend by $40 share price) in just three months.

2. **The stock price falls**

   Here, the options also expire worthless and you pocket the $3,000 premium. While you still own a stock that has gone down, because of the $3,000 premium you still outperform a buy-and-hold investor who just owned the stock.

3. **The stock rises above $44**

   Under this scenario, you must sell the stock (as it is “called away”) and your upside is capped at $44 plus the $3,000 premium collected. While you lose the underlying stock, you do get an impressive income in a short amount of time.

   Let’s say the stock price rises to $44. You total return would be the $4 appreciation in the stock price ($44 minus $40) plus the $3 call premium. The total of $7 per share would be a 17.5% return ($4 plus $3 dividend by $40) in just three months, plus any dividend received during that time.

Covered call writing works best with a stock that you would be happy to continue owning over the longer term. However, in the short term you believe the stock will trade flat to down, or you are happy to sell it at the higher price. You can generate income from the stock by selling calls against your position. If the stock does rise above the strike price, you sell the stock. So, you should be willing to sacrifice some capital appreciation potential for extra income in the short term.

Premiums are often 4%, 5% or even 6% of the stock value and can be written on the same security several times a year.
About the Expert

Tom Hutchinson is the Chief Analyst of Cabot Dividend Investor, Cabot Income Advisor and Cabot Retirement Club. He is a Wall Street veteran with extensive experience in multiple areas within the financial world. His experience includes specialized work in mortgage banking, commodity trading and as a financial advisor at several of the nation’s largest investment banks.

For more than a decade Tom created and actively managed investment portfolios for private investors, corporate clients, pension plans and 401Ks. He has a long track record of successfully building wealth as well as providing a high income while maintaining and growing principal. With Cabot Dividend Investor, Tom combines a scientific, quantitative approach to stock analysis with the practical, personal and honest advice that have characterized Cabot’s services since 1970.