

# The 21<sup>st</sup> Century Covered Call Strategy



**The Optionomics Group LLC**

Around 2010, the SEC decided that if monthly options were good, options that expired each week would be great. They figured that if selling covered calls four times a year was a good deal, it must be a much better proposition to write them fifty-two times a year. They were right. They started a pilot program using weekly options which evolved into the biggest option product in the world. Several years later, I developed what I call the 21<sup>st</sup> Century Covered Call Strategy. This strategy gives traders and investors alike a much better chance to make money than the old fashioned covered call approach. Let's take a look at how this strategy works.

First, you must address the number one problem when writing covered calls which is that the strategy doesn't provide any upside potential if the stock takes off. **We solve this problem by selling a weekly call - credit spread instead of simply selling an out of the money call.** To see how this works, let's look at the option chain below for Tesla Motor Co. (TSLA), when the stock closed at \$320.87 (Last X).

	Last X	Net Chng	Bid X	Ask X	Size	Volume	Open	High	Low	
	320.87 Q	0	320.25 P	320.87 P	3 x 1	0	0	0	0	
Trade Grid										
Option Chain   Filter: Off   Spread: Single   Layout: Last X, Net Change										
	CALLS			Strikes: 18		PUTS				
	Last X	Net Chng	Bid X	Ask X	Exp	Strike	Bid X	Ask X	Last X	Net Chng
▼ 3 NOV 17 (5) 100 (Weekly)										72.98% (+23.598)
	24.40 H	0	23.65 Q	25.15 B	3 NOV 17	300	3.70 Q	3.90 Q	3.80 C	0
	25.77 M	0	21.60 A	23.65 A	3 NOV 17	302.5	4.20 Q	4.55 X	4.59 I	0
	21.00 Z	0	20.00 A	21.55 X	3 NOV 17	305	4.80 Q	5.15 C	5.30 C	0
	0	0	18.35 A	20.05 X	3 NOV 17	307.5	5.65 Q	6.10 X	5.98 Q	0
	17.33 I	0	16.55 Q	18.25 A	3 NOV 17	310	6.30 Q	6.80 Q	6.80 N	0
	15.95 Q	0	15.25 A	16.75 X	3 NOV 17	312.5	7.35 Q	7.80 Q	7.60 N	0
	14.00 I	0	13.80 X	15.10 M	3 NOV 17	315	8.05 Q	8.95 I	8.83 Q	0
	12.61 I	0	12.35 A	13.55 B	3 NOV 17	317.5	9.50 Q	10.05 C	10.20 H	0
	11.80 M	0	11.60 X	12.05 A	3 NOV 17	320	10.80 Q	11.10 M	11.00 N	0
	10.40 I	0	10.35 Q	11.00 Q	3 NOV 17	322.5	11.45 II	12.60 Z	12.09 C	0
	9.49 X	0	9.10 Q	10.10 X	3 NOV 17	325	13.10 Q	13.85 Q	13.44 C	0
	8.35 N	0	8.05 O	8.80 Q	3 NOV 17	327.5	14.05 Q	15.70 A	14.15 I	0
	7.30 /	0	7.35 Q	7.50 Q	3 NOV 17	330	15.75 A	16.90 Q	16.50 M	0
	6.45 C	0	6.00 Q	6.80 Q	3 NOV 17	332.5	17.10 X	19.00 X	18.68 I	0
	5.53 I	0	5.25 Q	5.70 Q	3 NOV 17	335	18.80 Q	20.05 Q	19.75 Q	0
	4.65 X	0	4.60 Q	5.00 A	3 NOV 17	337.5	20.45 Q	22.90 A	22.20 Q	0
	4.20 H	0	4.05 Q	4.30 Z	3 NOV 17	340	22.30 Q	24.70 Q	23.37 X	0
	3.65 H	0	3.40 Q	3.90 Q	3 NOV 17	342.5	24.20 A	26.60 Q	25.50 N	0

The ATM (At-The-Money) call is the 320 and it is trading at approximately 11.60 Bid – 12.05 Ask. You would want to use the ATM strike for the short call leg of the spread since it gives us the most premium. Under the old method of selling covered calls, you would buy the stock at \$320.87 and sell the 320 call for \$11.60. If the stock settled above \$320, you would lose the stock but would keep the \$11.60 premium. Not a bad deal but if the stock went on to \$360, you would miss out on any profit past the \$11.60 credit.

Under The 21<sup>st</sup> Century Covered Call Strategy, you would buy the stock at \$320.87, sell the 320 call at \$11.60 and buy another call at a higher strike price with the same expiration date. You can use any strike that you like but I recommend one that is no more than 15.0 points higher than the ATM which in this case would be the 335 call (ATM +3).

So, you would initiate a 320 - 335 call - credit spread by selling the 320 call for \$11.60 and buying the 335 call for \$5.70 which would result in a net credit of \$5.90 (\$11.60 - \$5.70). The trade would look like the following:

**The Market Edge - Market Posture:** Bullish

Stock	Initial		Current		Short Call	Long Call		
	Stock	# Of Weeks	Stock	Price	11/03/17	11/03/17	Credit	Best Bet
	Price		Strike	Strike	Spread			Week %
TSLA	\$320.87	1	\$320.87	320.0	335.0	\$5.90	2.3	1.8%

Now here is the good news. Even if the spread loses the maximum amount (\$9.10) which is the difference between the strikes (15.00) and the credit (\$5.90), you still make money. Although you lost \$9.10 on the spread, you would make \$14.13 (\$335.00 - \$320.87) on the stock for a net gain of \$8.23 (\$14.13 - \$5.90). That is quite a difference from the old fashioned, covered call strategy which would have resulted in losing the stock and maybe even creating a taxable event while limiting the upside potential.

What about the downside? If Tesla's stock were to close down for the week, you would keep the \$5.90 credit which would limit your stock loss for the week. **No matter what happens, if you write the 21<sup>st</sup> Century Covered Call for a \$5.90 credit - 52 times a year, it will give you \$306.80 (\$5.90 x 52= \$306.80) of downside protection, which is 95.6% of the initial purchase price of the stock (\$320.87).**

So how does all this work in real time? Ideally you want to do this covered call strategy with stocks that have a good chance of trending higher over the near term and have liquid, weekly options. Selecting stocks that meet these criteria is handled once again by Market Edge ([www.marketedge.com](http://www.marketedge.com)). Market Edge tracks approximately 120 tradable option stocks which have average daily volume of over one million shares in addition to favorable weekly options. These stocks are good candidates for this strategy. Each Monday morning at the opening, the guys at Market Edge select two stocks from this list which have a Market Edge 'Bullish' Opinion along with other favorable characteristics. These Selections, along with the suggested option spreads are listed in the Open Positions report and in the 21<sup>st</sup> Century Covered Call Model Portfolio on the Optionomics web site. ([www.optionomicsgroup.com](http://www.optionomicsgroup.com)). New option spreads are added weekly. The stocks remain in the Model Portfolio for eight consecutive weeks or until the Market Edge Opinion is downgraded.

The stock selections and options spreads are posted every Monday around 11:00 AM EST on the Optionomics web site ([optionomicsgroup.com](http://www.optionomicsgroup.com)). An example of the Week's Covered Call Selections, the Market Edge Opinions for the New Plays and the Model Portfolio - Track Record follow:

## The Market Edge - Market Posture:

**Bullish**

Stock	Initial Stock	Current Stock	Short Call	Long Call	Credit	Best Bet	Week % Return
	Price	# Of Weeks	Price	11/03/17 Strike	11/03/17 Strike		
XOM	\$83.75	1	\$83.75	84.0	85.0	\$0.22	5.3 0.3%
ATHN	\$133.84	1	\$133.84	134.0	136.0	\$0.48	4.8 0.4%

Stocks Have Strongest Market Edge Opinions. Weekly % Return: The Higher The Better. Besty Bet: The Bigger The Better.

The maximum number of stocks in the portfolio at any time is ten. The # Weeks In Play column shows how long the stock has been in Play with eight being the maximum. Best Bet is a numerical value that measures the relationship between the credit amount and the underlying stock's price (Weekly % Return) plus the correlation between the width of the spread and the stock's price. Additional points are assigned if the stock is scheduled to pay a dividend within the next 30-days and the dollar amount of that dividend. Stocks with the highest values are considered to be the best plays. If there are any new selections, the Market Edge technical opinion is displayed below the selections.

### Market Edge Opinion: XOM

The current technical condition for XOM is strong and the chart pattern suggests that upward momentum should continue. Over the last 50 trading days, when compared to the S&P 500, the stock has performed in line with the market. The MACD-LT is confirming that the intermediate-term trend is bullish. Chart formation indicates a strong rising trend. Upside momentum, as measured by the 9-day RSI indicator is very strong. Over the last 50 trading sessions, there has been more volume on up days than on down days indicating that XOM is under accumulation, which is a bullish condition. The stock is trading above a rising 50-day moving average. This validates the strong technical condition for XOM. The stock is above its 200-day moving average which is pointed up indicating that the intermediate term trend is bullish.

## Market Edge Opinion: ATHN

The current technical condition for ATHN is strong and the underlying indicators should keep the current uptrend intact. The stock has outperformed the market over the last 50 trading days when compared to the S&P 500. The MACD-LT is confirming that the intermediate-term trend is bullish. Upside momentum, as measured by the 9-day RSI indicator is positive but is beginning to slow. Over the last 50 trading sessions, there has been more volume on up days than on down days indicating that ATHN is under accumulation, which is a bullish condition. The stock is trading above a rising 50-day moving average. This validates the strong technical condition for ATHN. The stock is above its 200-day moving average which is pointed up indicating that the intermediate term trend is bullish

## Risk Capital Needed To Trade The 21<sup>st</sup> Century Covered Call Strategy

The suggested amount of risk capital needed to trade this strategy depends on the number of positions that you want to initiate. Stock selections for this strategy are usually around \$125 per share. In a cash account, 100 shares would cost around \$12,500. There are a maximum ten stock positions in the portfolio. If you wanted to position all ten selections in a cash account, you would need to have about \$100,000. Five positions would require \$50,000 in cash and so on.

## Managing Your Spreads

The 21<sup>st</sup> Century Covered Call Strategy requires you to manage your expiring spreads. This should take you about 30 minutes per week. There are only three scenarios that can occur: 1) The stock closes at or below the short option's strike price, 2) The stock closes above both the short and long option's strike prices or 3) the stock closes in between the short and long option's strike prices. The following actions address each scenario.

- 1) The stock closes at or **below** the short option's strike price. The spread expires worthless. You would do nothing. Both option contracts would be removed from your account.
- 2) The stock closes **above** both short and long option's strike prices. In this situation, both legs of the spread are in the money. You can either buy the spread back as close to parity as possible or the Option Clearing Corp. (OCC) will **assign** the short leg and **exercise** the long leg leaving you flat. Your brokerage firm may charge you a fee for this, so you need to check it out. In either case, this will have no effect on your underlying stock position.
- 3) The stock closes **in between** the short and long option's strike prices. The stock is trading above the short leg's strike price but below the long leg's strike. In this case you have a couple of choices. You can either buy back the spread or buy back the short leg and allow the long leg to expire worthless. If the short leg is early assigned, you will have both a long and short stock position. If you want to maintain your original long stock position, simply cover the short stock position. You will maintain your original long stock position and also own the long option leg for free. In this case, if the stock continues to rally, you have a 'Free Roll' since you have no risk and unlimited upside going forward plus you maintain your original stock position. If you don't care about your original stock position, the short stock position will be covered by your long stock position.

## Profit Or Loss Scenarios

For illustration purposes, let's assume that all of the option positions are closed on the weekly expiration date resulting in a realized gain or loss, while the stock position remains open. We will use TSLA once again as an example. The initial trade is long the stock at \$320.00, short the 320 call and long the 335 call for a \$5.90 credit.

- 1) The stock settles unchanged at \$320. This is a no brainer. You pocket the \$5.90 credit and initiate the 320.0 - 335.0 call credit spread once again for a \$5.90 credit. Profit/Loss: Option Account: +\$5.90. Stock Account: \$0.00. **Total P/L: +\$5.90.**
- 2) The stock rallies by about 5% to \$335. You lose \$9.10, the maximum loss on your call credit spread but make \$15.00 in the stock. You get assigned the stock at \$320.00 and exercise your long option at \$335.00. You initiate the 335.0 - 350.0 call credit spread once again for a \$5.90 credit. Profit/Loss: Option Account: \$5.90 credit - \$15.00 short option = -\$9.10. Stock Account: +\$15.00. **Total P/L: +\$5.90.**
- 3) The stock drops by about 5% to \$305. You pocket the \$5.90 credit and initiate the 305.0 - 320.0 call - credit spread once again for a \$5.90 credit. Profit/Loss: Option Account: +\$5.90. Stock Account: \$0.00. **Total P/L: +\$5.90.**
- 4) The stock rallies by about 5% to \$335 at the end of WK #1. You would initiate the 335.0 - 350.0 call - credit spread once again for a \$5.90. Then the stock drops by about 5% at the end of WK #2 to \$320. You initiate the 320.0 - 335.0 call credit spread for a \$5.90 credit. In this scenario, you pocket \$11.80 credit which reduces your cost basis of the stock to \$308.20 and you still own the stock. Profit/Loss: Option Account: +\$11.80. Stock Account: \$0.00. **Total P/L: +\$11.80.**
- 5) The stock rallies by about 2% to \$327. You pocket the \$5.90 credit and initiate the 327.5 - 342.5 call credit spread for a \$5.90 credit. Profit/Loss: Option Account: \$5.90 credit - \$7.00 short option = -\$1.10. Stock Account: \$7.00. **Total P/L: +\$5.90.**
- 6) The stock drops by about 2% to \$314. You pocket the \$5.90 credit and initiate the 315.0 - 330.0 call credit spread once again for \$5.90 credit. Profit/Loss: Option Account: +\$5.90. Stock Account: \$0.00. **Total P/L: +\$5.90.**

Notice that unlike the old fashioned covered call strategy, at no time is the stock called away from you. Also, you would always be writing the ATM call option, not one which is below your cost basis for the stock. Over the eight-week period, your cost basis for the stock is reduced every week by the amount of the credit. When you close the stock position, you will realize either a gain or loss. If you sell the stock at a price above the **Adjusted Stock Cost**, you will have a gain. If you sell the stock below your **Adjusted Stock Cost**, you will have a loss but the loss will be a lot less than if you had not initiated the credit spreads.

## Q: What Can Go Wrong?

**A:** As noted earlier, The 21<sup>st</sup> Century Covered Call Strategy is somewhat similar to the Old Fashioned Covered Call Method (OFCCM) whereby you buy a stock and sell an out of the money call. The difference is that you buy a stock and sell a weekly vertical call spread. This is a much better approach in that you have unlimited upside potential while at the same time reducing the cost basis of the stock.

Like the OFCCM, you are exposed to unlimited risk on the stock position even though it is somewhat buffered. If the stock closes down for the week, you keep the credit which limits the stock's loss for the week. You continue to sell the ATM - ATM +1 call credit spread every week whether the stock goes up or down. You can't do this under the OFCCM because if the stock rallies, your position will be called away. If the stock declines, you keep your position but you must now sell a call at a lower strike price to realize any premium. Under The 21<sup>st</sup> Century Strategy, you continue to write the credit spread and reduce your cost basis until theoretically it would go to zero. So while there is risk to your stock position, the negatives are a lot better than those associated with the OFCCM.

## **Q: What's The Catch?**

**A:** Sound good? There must be a catch, right? The catch, if you want to call it that, is that you are limiting your upside somewhat every week. Here's why. In the TSLA example, you are long the stock, short the ATM 320 call and long the 335 call for a \$5.90 credit. The 15 wide strikes give you a maximum risk of \$9.10 (\$15.00 – \$5.90). If the stock takes off, you have unlimited upside potential minus the \$9.10 maximum risk in the call spread. If you are long TSLA at \$320 and it closes the week at \$360, you would make \$40.00 on the stock, but would lose \$9.10 on your call spread for a net gain of \$30.90. If you had written an old fashioned covered call, you would have had the stock called away at \$320 while keeping the \$5.90 credit for a net gain of only \$5.90.

But there is more. One of the biggest problems individuals face when trading stocks or options is the psychological wear and tear that they must overcome on a daily basis. They are constantly confronted with making buy and sell decisions without much of a disciplined approach. The result is they usually buy when they should sell and vice versa as their emotions take over. The strategy outlined above eliminates much of this problem. If the stock goes up, you make money on the stock and on the long option position and don't lose the stock. That is quite a difference from the old fashioned covered call strategy which would result in losing the stock and maybe even creating a taxable event while limiting your upside.

What about the downside? If the stock closes down for the week, you keep the credit which limits the stock's loss for the week. As noted above, had you created The 21<sup>st</sup> Century Covered Call for TSLA when the stock was trading at \$320.87 and received a \$5.90 credit, 52 times a year, it would give you \$306.80 (\$5.90 x 52 = \$306.80) of downside protection, which is 95.6% of the purchase price of the stock (\$320.87).

## **What You Can Expect**

Frequency Of Play: Weekly

Investment Option Time Horizon: One – Eight Weeks

Maximum # Of New Plays Per Week: Two

Maximum # Of Open Positions: Ten

Risk Tolerance: Medium

Option Experience: Low

Suggested Risk Capital - Fully Invested: 100 Shares Of Stock

And One Option Spread Per Recommendation:	\$100,000
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## Summary

The 21<sup>st</sup> Century Covered Call Strategy is an ideal approach for those who have an intermediate-term investment time horizon and a low tolerance for risk. The average price for the stock selections is around \$125 per share while the maximum number of Open Positions at any time is ten. Therefore, a fully invested cash account would require risk capital of around \$100,000. While the strategy is designed to hold stock positions for four weeks, the holding period can be reduced if the Market Edge Opinion for an underlying stock is downgraded. While the maximum number of Open Positions at any time is ten, that number may be smaller at times due to adverse market conditions. Finally, it is not necessary to purchase all of the recommendations since each is an independent event with similar technical characteristics so the performance should be similar. That being said, diversification into a number of selections is always recommended.

I think you will agree that the 21<sup>st</sup> Century Covered Call Strategy makes a lot of sense and can be a very profitable approach. Once again, combining this credit spread strategy with the power of the Market Edge Opinions produces a solid approach which over time, should prove to be profitable endeavor in any market environment.

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## 21<sup>st</sup> Century Covered Call Worksheet