Making Money Now: Covered Calls

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Making money in this market reminds me of a farmer trying to grow crops when weather conditions are unpredictable. Few farmers achieve it. Likewise, hardly any investors are making money now during a stormy market.

One reason is that only a minority of investors, just like farmers, are able to break their routine of relying on optimal conditions, whether for growing money or crops. For investors, a rising stock market floats virtually all investment portfolios. For farmers, good weather grows a good crop. However, when volatility in the market or weather occurs, it is the rare investor or farmer that is willing to break old habits and gain new skills to meet the crises at hand. Those who can will be richly rewarded.

Here is one intervention that can potentially help investors: writing covered calls* on stock or exchange traded funds (ETF's) just purchased. This means buying a stock and selling the rights to it at the same time. Of course, with the Dow dipping below 8,000 recently, buying into the market now is not without risk—it could go lower. Nevertheless, if an investor thinks the market is near bottom, one way to make money now is to buy a good stock or exchange traded fund (ETF) and write a "covered call" on it simultaneously. By selling a call on this newly owned stock and gaining some money, the overall cost of acquiring the stock is diminished.

The risk is that the stock/ETF will go up and be "called" away and lost. Nevertheless, the money earned for writing the covered call will be retained. The worst possible case is that the stock/ETF will go lower and covered calls can no longer be written because the stock/ETF would be "called away" and sold at a loss. This is avoided by simply holding the stock/ETF if it is under the buying price minus the revenue from the covered call.

In this scenario, a stock/ETF that pays dividends will still bring in revenue. For example the stock Johnson & Johnson (JNJ) is currently paying a dividend yield** of 3.20%, much better than the current return of most treasuries. Likewise, Vanguard high dividend yield ETF (VYM) is paying a yield of 4.31%, again much higher than most treasuries.

Here are the mechanics for writing covered calls. Go to Yahoo.com/finance (or your brokerage site, which will have similar possibilities). Put in the symbol of your recently purchased stock/ETF, for example, JNJ for Johnson and Johnson. The last trade of JNJ before market open on January 21 was $56.75 per share. Go to the option tab on the left side under Quotes for Yahoo.com/finance. Note that you can view the option by expiration date (termination date). Under the February 09 expirations, JNJ can be sold at a strike (sell) price of $60 for $0.70 per share. This means that for every 100 shares the seller receives $70. By going out to April 09, the seller receives considerably more for the same strike

price, $1.90 per share. This means that for every 100 shares at the strike price of $60, the seller receives $190.

By doing a covered call on 1000 shares, the premium would be 10 times as much, or $1,900. More information on the mechanics of covered calls can be obtained on investment websites, from your broker or through investment books. Doing mock trading initially is always a good idea when new investment techniques are used.

Covered calls are meant to reduce portfolio risk and increase income by giving up future gains on stocks/ETF's. In this way, an investor has an opportunity to make money in a neutral or down market. Covered calls can be combined with other techniques (hedging, shorts, market neutral funds) described in my previous articles on Making Money Now.

*Definition of covered call from investorwords.com: "The selling of a call option while simultaneously holding an equivalent position in the underlier. This is an attempt to take advantage of a neutral or declining stock. If the option expires unexercised, the writer keeps the premium. If the holder exercises the option, the stock must be delivered, but, because the writer already owns the stock, risk is limited. This is the opposite of an uncovered call, when the writer sells a call for a stock that he/she does not already own, a dangerous strategy with unlimited risk."

**Definition of dividend yield from investorwords.com: "The yield a company pays out to its shareholders in the form of dividends. It is calculated by taking the amount of dividends paid per share over the course of a year and dividing by the stock's price. For example, if a stock pays out $2 in dividends over the course of a year and trades at $40, then it has a dividend yield of 5%. Mature, well-established companies tend to have higher dividend yields, while young, growth-oriented companies tend to have lower ones, and most small growing companies don't have a dividend yield at all because they don't pay out dividends."

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