Options Newsletter for Investment Advisors

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Dividend Capture with the Covered Call Strategy

Many portfolio managers have developed an expertise in managing a portfolio composed of dividend paying stocks. Stocks that have continuously paid out a dividend in the last 5 to 10 years, and that have increased their dividend in each of the last 3 to 5 years are strong candidates to be included in a dividend paying stock portfolio. Even though attractive results can be obtained with a dividend reinvestment policy, returns can be enhanced with the implementation of a very simple strategy, the covered call. The covered call strategy consists of selling one call option contract for every lot of 100 shares held. The premium collected from the sale of the call options represents additional income over and above the dividend received.

The challenge with the covered call strategy implemented on dividend paying stocks is to avoid being assigned on the short call position, and as a result, being obligated to sell the underlying shares, and at the same time, forego the dividend issued by the company. This situation is caused by the nature of equity options which are American style, i.e. they can be exercised at any time up until the expiration date by the holder (the buyer) of the call options. It is common knowledge that call options should not be exercised before the expiration of the options if the underlying does not pay a dividend, since call options act as an insurance policy should the stock price fall below the strike price before the expiration of the options. Furthermore, by holding call options, the holder can use the available capital on other investments up until the expiration of the call options. By exercising their call options early, holders are moving up the expiration date of the call options and foregoing the time value portion of the option premium that is linked to the time remaining until the expiration of the call options. Therefore, the main reason that can justify the early exercise of call options is when the underlying stock pays a dividend that is higher compared to the time value portion of the premium foregone of the call option. And the best time to exercise a call option is the day before the ex-dividend date on the last dividend close to the expiration of the call options. Hence, the more a call option is in-the-money and the ex-dividend date is close to the expiration of the call option, the greater the probability of early exercise. Conversely, when a call option is out-of-the-money, the probabilities of early exercise are close to nil.

Consequently, portfolio managers who desire to implement and manage a covered call portfolio on dividend paying stocks should be prepared to not receive all the dividends issued by the underlying securities. However, this risk is compensated by the premium collected from the sale of the call options in the strategy which provides an additional source of cash flow for the portfolio. In the best case scenario, portfolio managers will collect all the dividends issued as well as the premium collected from the sale of the call options. Whereas in the worst case scenario, the total return of the portfolio will be limited to the premium collected from the sale of the call options plus any capital gain that correspond to the difference between the stock price and the strike price. Since the capital gain is limited to the level of the strike price of the call options sold, portfolio managers should pay attention to the selection of the strike price when implementing

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the covered call strategy. When the need for protection is more important compared to the need for capital gain, portfolio managers can choose to sell in-the-money call options since the larger premium provides a lower breakeven point. However, the probability of early exercise is greater for in-the-money options. When the need for protection is less important compared to the need for capital gain, portfolio managers can choose to sell out-of-the-money call options which provide more room for capital appreciation depending on the level of the strike price chosen. The disadvantage with out-of-the-money call options is that their premium is small due to low probability of early exercise. Consequently, the strike price selected by the portfolio manager is a compromise between the need for protection and the need for capital appreciation.

The issue of early exercise exists mainly when the price of the underlying rises above the strike price and the call options become in-the-money. In order to avoid the early exercise of the call options, portfolio managers should use call options that expire before the ex-dividend date when possible. Call options with longer expiration dates (6 months or more) can nonetheless be used, however, portfolio managers must manage the risk associated with early exercise at the time it arises by rolling the position, which implies to buy back the call options sold and selling call options with a longer expiration date, or by simply closing the position by buying back the call options sold.

Conversely, when the market is bearish and the stock price falls below the level of the strike price, the risk of early exercise is mitigated and the call options have a greater probability of expiring worthless. In this context, a covered call portfolio will show better results compared to a pure buy and hold strategy since the premium collected from the call options sold compensates for a portion of the losses incurred in value of the portfolio.

A concrete example

The shares of National Bank of Canada (stock symbol: NA) generally issue a quarterly dividend close or immediately after the following options expiry months: September, December, March and June. Therefore, portfolio managers could easily implement a covered call strategy by selling call options in one of these expiry months. In the November 2010 newsletter (http://m-x.ca/f_bulletins_en/November2010.pdf), we show that over a certain period of time, the systematic use of the covered call strategy could provide potentially superior returns compared to the buy and hold strategy, and that when the price trend was taken into account, it was possible to even improve on such returns. Consequently, the same results should be obtained when using dividend paying stocks with the covered call strategy. Timing plays a major role when implementing an investment strategy and portfolio managers that aim to succeed with the covered call strategy should implement it ideally when the price of a particular stock shows obvious signs of a slowdown or consolidation. For example, the strategy could be implemented right after a strong rally confirmed by a technical indicator, such as the Relative Strength Index (RSI) or the Stochastics Indicator (STO), that shows a loss of momentum and falls below a critical level.

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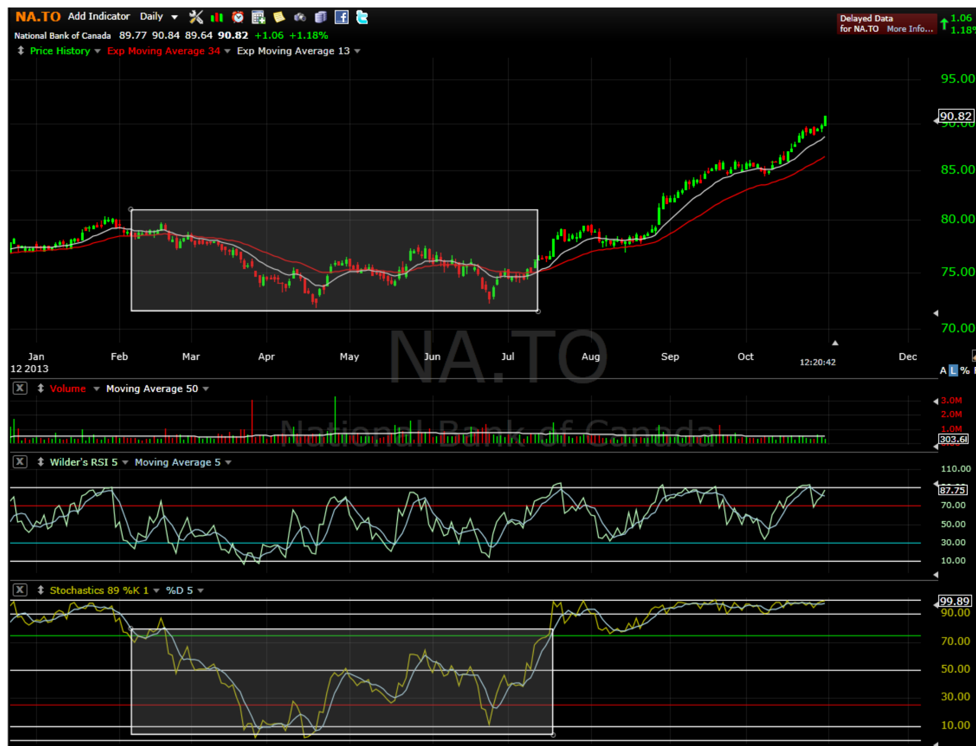
Daily chart on NA shares



As we can observe in the preceding chart, the STO indicator (at the bottom) has remained under the level of 75 from February 8 to July 12, 2013. This period would have offered a good opportunity to sell call options on the shares of NA held.

The following table shows the returns that could have been obtained from the implementation of the covered call strategy on the shares of NA using one-month at-the-money call options compared to the buy and hold strategy from February 8 to July 12, 2013[1].

From February 8 to July 12, 2013	**NA (Buy & Hold)**	**NA (Covered Call)**
Profits (Losses) on NA	($2.51) ($76.17 - $78.78)	($2.51) ($76.17 - $78.78)
Dividend Income	$1.70	$1.70
Call Options Income	$0.00	$6.69
Call Options Bought-Back	$0.00	($2.68)
Total for the period	**($0.81)**	**$3.00**

[1] Excluding commissions

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Although past results are no guarantee of similar future results, we can observe that the covered call strategy, for the period when the price of NA shares was consolidating sideways, provided a total profit of $3 per share, whereas the buy and hold strategy generated a loss of $0.81 per share. Over this period, $1.70 in dividends were received using each strategy, however as we can observe, it is the profits from the sale of the call options that are responsible for the superior returns of the covered call strategy compared to the buy and hold strategy.

Conclusion

A portfolio of dividend paying stocks can, when it is well managed, generate attractive long term returns which can be enhanced with the use of options strategies. The covered call strategy can provide an additional source of cash flow to complement the dividends received for the portfolio. Since this strategy exposes portfolio managers to the risk of the sale of the underlying shares held in the case of early exercise the day before the ex-dividend date, the selection of the strike price (in-the-money, at-the-money, or out-of-the-money), the expiration date (which should occur before the ex-dividend date if possible), and the timing of the market (when the shares are showing signs of weakness) are important factors to take into consideration before implementing the covered call strategy. However as we have been able to observe, the potential results are quite attractive.

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