Covered Call Options
&
Hedging

Introduction

Brokers sometimes recommend that investors holding concentrated stock positions sell call options against their stock to hedge risk.

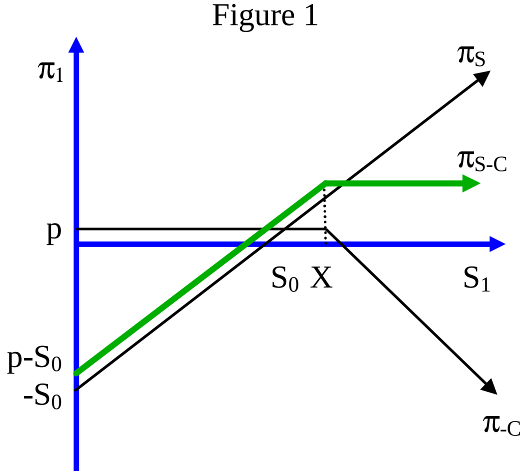
Covered call writing typically does not meaningfully reduce risk. After the calls are written, the investor is still exposed to a reduction in their wealth dollar-for-dollar for every one dollar decline in the stock price.

Covered Calls Options

In the covered call writing strategy, an investor who holds stock sells someone the right to buy the stock in the future at fixed price. An investor selling call options gives up the upside in the stock position beyond the exercise price in exchange for the premium received.

Covered call writing is, at best, equivalent to holding cash equal to the proceeds from selling the covered shares at the current stock price, S_0, and from selling naked put options with the same strike price, X, and expiration as the call options. Figure 1 illustrates this fundamental result based on *put-call parity*.

Figure 1

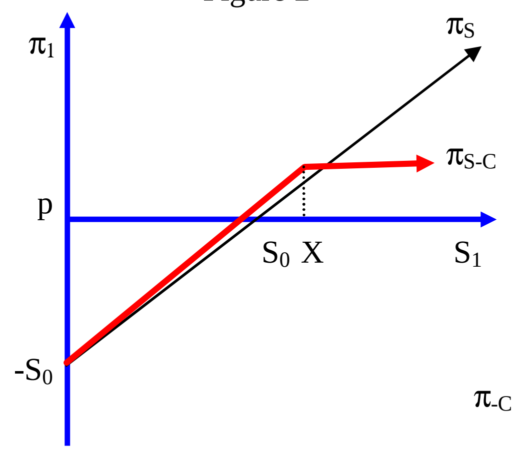


That is, covered call writing is equivalent to liquidating the concentrated position and being short in-the-money naked puts.

It Gets Worse

But covered call writing is often much worse than Figure 1 suggests. Figure 2 illustrates the shockingly common case when - rather than holding cash - proceeds from selling call options are reinvested in other, highly correlated stocks.

Figure 2



In this common case,

- there is no "cash cushion" as is often claimed for covered calls,
- if stock prices fall, with each dollar decline the losses suffered by the investor are greater than they would have been, and
- the upside is still severely limited.

Conclusion

Perversely, the covered call writing strategy leaves investors exposed to all the downside in continuing to hold concentrated positions while eliminating any benefit from increases in the stock price. If the option sales proceeds are reinvested in stocks the result is even worse. Often sold as a conservative strategy, covered call writing delivers exactly the opposite.

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 SLCG Practice Notes are intended to deal briefly with narrow topics. More substantial working papers available at www.slcg.com. A companion note deals with the misconception that selling covered call options generates income. Craig McCann, PhD, CFA craigmccann@slcg.com, 703-246-9381; Dengpan Luo, PhD, dengpanluo@slcg.com, 703-246-9382.