

Lighthouse Financial

"Your Beacon to Financial Security"

Covered Calls Using Dividend Stocks

What are Covered Calls?

Most people consider options to be risky and this is true with most option plays as 7 out of 10 options expire worthless *if you are buying them*. This can be attributed to the fact that there is a time limit to the options rights. The big difference *in selling Calls* is that the passage of time has a positive impact on this strategy. If 7 out of 10 don't get exercised, this simply means that more often than not, you will keep the stock (and the call premium) past the expiration date on the option and sell another call the next month.

An investor who buys a stock and sells a Call can earn premium income without taking on additional risk. In addition to this we focus on dividend paying stocks. The premium received for selling the option belongs to the seller regardless of whether the option is exercised and it can give small downside 'cushion' in the event the stock slides downward. If the stock price rallies above the Call's strike price, the stock is likely to be called away. The downside of this strategy is that if the stock soars above the strike price of the option, the seller will not take part of any of the excess over the strike price. We like getting our dividends and call premium and are not looking for capital appreciation in this strategy.

We would work only with stock that we would not mind losing if it gets called away from us, so we should not use existing stock with lots of long-term capital gains tax. We also should not mind owning this stock thru market down-turns as we will be collecting the dividends and selling the calls frequently. As with any security, there is a risk of substantial loss in this strategy. However, the loss may be offset by the income gained from selling the Call as well as any dividends received. In fact, the premium received may leave the Covered Call writer slightly better off than those who own those dividend stocks without the call.

Example:

Let's say that we bought 1000 shares of Verizon today at \$32.35 per share. We could then sell a covered call on that stock for the next month out at a strike price of \$33 per share. This is essentially giving the right to someone else to buy that stock from us at \$33 per share. For that right they will pay us \$.31 per share. Let's look at two possible scenarios:

- **The stock goes up to \$34 per share. Here we would get the difference between \$32.35 and \$33, and we would keep the \$.31 call premium. This represents \$.65 plus \$.31 = \$.96. \$96 cents divided by our purchase price of \$32.35 is a return of 3% for one month. We can do this multiple times throughout the year. In addition to this, we are also currently getting 6% in dividend annually on Verizon.**
- **The stock drops to \$31 per share. You still keep the \$.31 call premium as well as any dividends received. This \$.31 is money that we would not have if we were just holding the stock without the option.**