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Options for income?

Proceed with caution on covered call writing

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TODAY'S PALTRY INTEREST rates have financial advisors searching for investments that offer enhanced income. One strategy is covered call writing - selling call option contracts on a stock or basket of stocks for premium income while owning an equivalent amount of the underlying stock(s).

The combination of the premiums and the dividends from the stock creates an attractive "enhanced" income. Hence, the rush of exchange-traded funds (ETFs) and mutual funds that offer this strategy to advisors.

To gain a better understanding of this strategy, the research team at ***Tacita Capital Inc.*** has analyzed the performance of the CBOE S&P 500 BuyWrite index (CBOE BWI), a passive, total-return index that reflects writing S&P 500 call options on a monthly basis while owning the S&P 500 stocks.

From July 1986 to April 2012, the CBOE BWI had an annualized compound return of 9.2%, marginally less than the 9.4% return of the S&P 500 index. This lower return reflects the fact that the premiums being written using the CBOE BWI strategy were slightly more than offset by the return forgone on the calls that were exercised when in the money.

Your clients need to understand that enhanced income today does not equate to increased total return over the long run. This strategy, at its most fundamental level, involves investors exchanging uncertain future capital gains for certain premium income today.

There were major differences in the timing of returns. The CBOE BWI underperformed substantially during bull markets. For example, from 1995 to 1998, this index's cumulative underperformance relative to the S&P 500 was almost 80 percentage points. Conversely, the CBOE BWI outperformed strongly in bear market periods, such 2000-02 and 2007-08.

Overall, the CBOE BWI was substantially less volatile - during the study period, it had an annualized standard deviation of 12.4% compared with the 17.5% for the S&P 500. The CBOE BWI also had a superior drawdown performance, experiencing fewer drawdowns in excess of 5% than did the S&P 500 - seven vs 12, respectively. Critically, the CBOE BWI had materially lower drawdowns during deep bear markets.

These numbers show the essence of covered call writing: it is a risk-reducing strategy. The cushion of premium income improves performance in falling markets but forgone capital gains in rising markets detracts from long-term performance.

Some studies have found that covered call writing on index options has led to superior risk-adjusted performance because of the frequent overpricing of calls. This viewpoint, however, is debated in academia. In theory, there is no reason that call writers should be at a frequent disadvantage to call buyers, although behavioural explanations have been posited.

Advisors recommending investment funds that use covered calls need to be aware of the drawbacks. The management expense ratios and trading commissions of the ETFs that employ these strategies are considerably higher than those of ETFs replicating broad market indices. Clients also need to consider the heightened tax drag of immediate capital gains from premium income. As well, one study of U.S. mutual funds that used options showed these funds underperformed similar funds that didn't use options. **IE**

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