Covered Call Writing Strategy

A Conservative Method For Private Foundations To Generate Cash Flow

Abstract

For Private Foundations and charitable endowments seeking a consistent 5% cash flow to satisfy their minimum gifting requirements the current investment climate, with its persistent low interest rates on credit instruments and the stretched valuations on equities, has been a difficult one to navigate (for the prudent- minded trustee). Typically private foundations and endowments have subscribed to the well-known "60/40 portfolio", whereby 60% of the portfolio is allocated towards a well-diversified equity portfolio and the balance towards a well-diversified fixed income portfolio. However since the Great Financial Crisis of 2008, fixed income returns have come down dramatically –where the 10-year Treasury bond (the fixed income benchmark) is currently yielding approximately 2.5% making its contribution to the 60/40 portfolio about 1%. That means the 60% of the portfolio in equities needs to appreciate more than 10% annually in order for the 60/40 portfolio to return anywhere close to 7.5% (the typical required total return of these conservative, albeit long term time horizon, funds). Of course since the market bottom in 2009 the equity markets have responded to this call by appreciating well-above that level (and credit instruments have done similarly on the heels of extraordinary monetary accommodation) but now we find both equities and credit investments somewhat (if not meaningfully) above their historical value-based metrics. What is a prudent trustee or investment committee to do in the face of such an environment? Continue to hope for extraordinary market returns? How can these stewards of a charitable legacy insure that their portfolio can generate consistent cash flows needed to run their operations and make the 5% Minimum Distribution Requirements? Of course reducing risk in light of the empirical evidence that states the current stretched valuations of both equity and credit instruments could be deemed prudent but who is to know if the markets aren't to stay elevated for some time and, moreover, where does one allocate the expected proceeds given that cash is yielding dismally low returns?

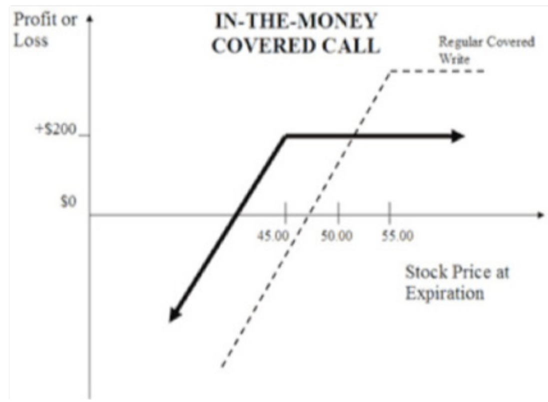
This is a real conundrum for the mindful (of risk) investors.

We believe that a conservative strategy of writing (selling) call options as an overlay to a portfolio of equities (hence, "covered call options") can provide the portfolio with a fresh source of income (in addition to the dividend income from the equity portfolio) without any increase in the risk profile of the portfolio (in fact, it would reduce risk given the increased cash flow generated by this strategy).

ALINE WEALTH

Covered Call Strategy

A covered call strategy is a type of options strategy that involves holding a long position in an asset (equity or stock) and subsequently selling (or "writing") call options (the right for the buyer of the call option to buy the underlying stock at a certain price—the strike price—before the expiration date of the option) on said asset. By doing so the seller of the call option intends to generate short-term income from the asset. Similarly, a portfolio of stocks can utilize, at any time, this strategy to glean positive cash flow. This strategy uniquely allows for the flexibility that comes with listed options in conjunction with the benefits of stock ownership. This is a relatively 'low-risk' and conservative strategy which provides insular protection from declining markets at the"risk" of giving up profits above the strike price.



Source: CBOE

Profit/Loss

To employ the strategy an investor purchases a stock and subsequently sells a call option (or options) on shares already owned (hence "covered"). In the short-term, the writer receives an immediate cash payment for the sale of the call, this is known as a "premium". Typically the writer or seller sells a call option with a strike price (the price that the buyer of the call option will pay the seller or writer of the call option) somewhat above the current market price. If the price of the underlying stock were to rise above that level on the expiration date of the sold call option, then the writer of the option will give the shares of stock to the buyer of the call option. Therefore, investors deploying this strategy must be willing and able to sell (or more likely "transfer") the stock at the strike price (it's important to note that the writer of the option does not have to sell call options on their entire stock position and they are only required to deliver the shares of stock that equals the shares required by the sold option).

Profit potential on the owned ("long") stock position is limited to the appreciation to the strike price plus any dividends that may be received and the premium from the sale of the call option. The downside loss potential is significant, as is the case for any stock ownership, as the stock price dropping to zero would result in a loss of the entire investment. This loss is reduced by the premium received from selling the call. The break-even is determined by the starting stock price adjusted for the premiums received from the call.

Total Return of a Covered Call Writing Strategy *(if the stock price exceeds the strike price on the day of expiration of the call option):*

Stock appreciation to the strike price PLUS

The stock's dividend (if applicable) PLUS

The call option premium received for the sale of the option against the owned stock

Total Return of a Covered Call Writing Strategy *(if the stock price does not exceed the strike price on the day of expiration of the call option)*

Any stock appreciation or depreciation over the period PLUS

The stock's dividend (if applicable) PLUS

The call option premium received for the sale of the option against the owned stock

ALINE WEALTH

Example

Suppose the stock XYZ is currently trading at $50 in June. A private foundation has a position (is currently long or owns) of 2000 shares of XYZ in their portfolio and the Investment Committee of the foundation decides to write (sell) a call option expiring in September with a strike price of $55 for $2 per option. The foundation's portfolio owns 2000 shares of XYZ but only sells options on 1000 shares (each option contract is equal to 100 shares hence in this case they sell 10 option contracts on the 1000 shares). The investor's portfolio is credited $2000 for this covered (because they own the underlying shares) sale of options. Essentially the foundation has sold an option for someone to buy 1000 shares of XYZ from them on the expiration date in September at $55 a share—for that option the portfolio was immediately credited with $2,000.

If the stock then rallies to $60 at expiration (the price movement of XYZ over the time period is not a factor—only the market closing price of XYZ on the day of expiration matters) and the call gets assigned and the foundation "delivers" the 1000 shares to the buyer of the call option (this is done via the option exchange or brokerage firm's back office as a seamless process). The investor now has 1000 shares less of XYZ and has received $55,000 for those shares (plus the previously received $2,000 in option premium). The shares were called away at $55 despite trading at $60 at expiration—essentially the foundation "lost" the upside from $55 to $60 on the 1,000 shares they wrote the options against (the other 1,000 shares enjoyed the further upside to $60).

However, should the stock price go down to $45, the foundation's portfolio has received $2,000 in option premium that they would have not otherwise received and could look to sell another call option on the shares going forward. This strategy does NOT impede in any way the investor from receiving any dividends on XYZ over the period up until expiration of the option.

Strategy Rationale

The primary motive behind a covered call strategy is most likely a desire to earn "premium income" (from the sale of the covered option) while maintaining a portfolio of equities. If the strategy is successful, the investor improves overall returns on the stock and lowers the overall volatility of a portfolio by the generation of income. However, the strategy is not without its downside—equity portfolios stand to forfeit a position in their stock portfolios in the event that the option is called (note: portfolios can decide to sell an option against a portion of their equity position rather than the entire position) and as such limiting the upside on that position. Also a successful covered call strategy requires close monitoring of the market and the positions—and hence advocates for an active rather than a passive strategy.

Account Requirements for a Covered Call Writing Strategy

An investment account embarking on a covered call writing strategy will require an executed option disclosure form (each custodian or clearing firm has their own—although all are fairly standardized) and the review of the option disclosure booklet from the CBOE which spells out the risks and particulars with respect to investing in options.

Looking at option strategy usage in ERISA plan accounts is a useful guide to examine the use of option strategies in a private foundation portfolio. At first blush it may appear that margin requirements applicable to investments in options contracts would be considered an extension of credit and, thus, would be a prohibited transaction (note: covered call writing does NOT require an account to be approved for margin use). While there has never been a direct ruling that the use of margin in options contracts is not an extension of credit (under Section 406 of ERISA) and such usage is common practice and has never been challenged by the DOL or any plan participant or party-in-interest. In addition, there is authority to indicate that this concern is unmerited. [1]

The IRS has taken the position in private letter rulings that the use of margin in commodity and financial futures contracts does not constitute "acquisition indebtedness"[2] because the obligation of the investor is contingent upon the delivery of the underlying commodity or financial instrument. In this regard, the futures contract is in the nature of an executory contract to acquire property at a future date. Therefore, the futures contract is not debt-financed property and the income received from such investment is not taxable as unrelated business income.

Like a futures contract, an options contract can be characterized as an executory contract as obligations under it are contingent upon the performance of a future event—the exercise of the option. Therefore, according to the same reasoning, an options contract should not be considered debt-financed property.[3]

Further, the Department of Labor has issued an advisory opinion to the Futures Industry Association stating that as margin is in the nature of a performance bond, margin funds in futures contracts are not considered plan assets. [4]

This opinion clarifies that the use of margin should not be held a prohibited transaction. Margin funds are not characterized as plan assets and, thus, it should be deemed that there is no extension of credit from the plan. Although this opinion only applied to futures contracts, similar reasoning should be applicable to options contracts as the plan assets should be considered to be the rights embodied in the option contract itself. [5] Listed options are flexible investment tools that, when used properly, may help corporate plans meet legal requirements such as the ERISA mandate to diversify so as to minimize the risk of large losses and in a similar vein assist non-profit, private foundations achieve their investment objectives with lower risk. [6]

Conclusion

For Private Foundations with an investment portfolio objective of capital appreciation and income generation and a low risk tolerance, a covered call option writing strategy can provide added cash flow generation and an overall lower portfolio risk. Many private foundations have not subscribed to this strategy given their outmoded thinking that options pose an inherent risk and that regulators (state Attorneys General offices) would deem it imprudent. The goal of this paper is to cast light on this particular low-risk option based strategy as a benefit to private foundations seeking income strategies with a lower risk profile.

Footnotes:

1. ERISA Pension Funds & Listed Options Portfolio Management Strategies CBOE

2. Organizations exempt from tax under Section 501 of the code are still subject to tax on income generated from unrelated business activities. This includes income from property acquired through the use of debt (“acquisition indebtedness”).

3. It is important to note that these rulings were issued by the IRS regarding unrelated business income as opposed to prohibited transaction issues. The DOL has exclusive authority to rule on prohibited transactions under ERISA. However, the logic and position of the IRS should be applicable to the DOL’s analysis on the use of margin as an extension of credit.

4. D.O.L. Ad. Op. 82-049A (Sept. 21, 1982), 9 Pens. Rep. (BNA) 1394 (1982).

5. ERISA Pension Funds & Listed Options Portfolio Management Strategies CBOE

6. ERISA Pension Funds & Listed Options