5 Tips for New Covered Call Writers

This is an extra resource to go along with the original article:
How to Write Covered Calls With Better Yields

Writing covered calls is a great investment strategy to produce income in retirement, but if you've never written one before you may not know the best ways to do it. Here are some tips for writing higher-yielding covered calls.

Tip 1: Choose stocks with medium volatility

Volatility – the likelihood a stock will move – is important when writing covered calls. You want a stock to move, but you want it to move predictably. High volatility stocks could move quickly in your favor, but could also move against it. Low volatility stocks may not move as much as you need and have lower premiums. Stick to medium volatility stocks with track records of positive movements through the market.

Tip 2: Pay attention to time decay

All options lose value as time passes, so covered call writers need to decide which expiration date to write on the call. Near-term options will allow you to take advantage of rapid time decay, while longer-term options will reduce transaction frequency (and costs). Stock volatility may play a role in whether or not you decide to write near-term or long-term calls. Low-volatility stocks may not offer enough time to make the trade worthwhile if you write a near-term date, for example.

Tip 3: Avoid options with low open interest

Open interest is the number of option contracts that are open or outstanding for a particular strike and expiration. Options with large open interest have a large market of buyers and sellers, meaning that it will be traded at an efficient price. You don't want to be in an option series that has low open interest, because if you need to exit early you are unlikely to get a fair price. Any series you choose should have at least 1,000 contracts of open interest.

Tip 4: Plan in case of downward movement

Selling a call doesn't lock you into your position until expiration. You can always buy back the call and remove your obligation to deliver stock. If the stock has dropped since you sold the call, you may be able to buy the call back at a lower cost than the initial sale price, making a profit on the option position. The buy-back also removes your obligation to deliver stock if assigned. If you choose, you can then dump your long stock position, preventing further losses if the stock continues to drop.

Tip 5: Plan in case of rapidly upward movement

If you write a covered call and your underlying stock shoots skyward, exceeding the option's strike price, you will be forced to sell your shares at the strike price. While you could purchase back your covered call, it will likely cost you significantly more than the original premium. Even though you may part with the stock, you still receive benefits from the call option. When you sell a covered call, you should be willing to sell the shares at the strike price.

Any time you plan to use options, including covered calls on your investments, it is critically important to have a comprehensive plan. To learn more about our long-term investment strategy that includes covered calls as a primary component, check our our Strategy web page.

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