Combining Covered Call Writing and Dividend Capture

Recently several of our members have inquired about setting up a covered call portfolio using securities that generated significant dividend distributions. I am writing this article to provide information to the key facts highlighted in these inquiries as well as to present another perspective as to how and why such a covered call portfolio can be constructed and managed.

Covered call writing is a strategy where retail investors can sell options against securities (stocks or exchange-traded funds or ETFs) they already own to generate monthly cash flow. In its traditional sense, profits can be gleaned both from the sale of the option and from share appreciation if the option selected has a higher value than the current market value of the stock (for example, you buy a stock for $48 and sell the $50 option. This known as an out-of-the-money strike). If the option selected had a strike price (agreed upon sales price) the same (called at-the-money) or less than the current market value (called in-the-money), the maximum return would be the time value component of the option premium only.

Some members have proposed a third component or potential income stream was added by using securities that also generated quarterly dividends. What makes this approach appealing in that it presents opportunities to generate three income streams with each trade: option premium, share appreciation and dividend distribution. However, like every other strategy available to us there are advantages and disadvantages to consider and that is why I am writing this article to present other perspectives to factor in to your decision as to whether covered call writing is right for you and if so, how to approach and manage your positions.

Managing the Strategy

I am a firm believer that before we invest even one penny of our hard-earned money we must become a master of that strategy, in this case covered call writing. That is about three levels above being pretty good at it. To become an elite covered call writer there are three areas we must excel at:

- Stock or ETF selection
- Option selection (strike price and expiration date)
- Position management (exit strategy executions when the opportunities arise)

Being proficient in two of these areas is not adequate to justify using this strategy, it must be all three. We must be adept at “juggling all three balls” By adding a fourth ball, dividend capture, our task is a bit more involved and it becomes more challenging. Some of us can take on the challenge and excel in all four areas; some may not. Suffice it to say that the more aspects we add to the strategy, the more time
and energy we must devote to the strategy and the question arises as to whether it is worth adding another tier to an already multi-tiered strategy.

Tax Issues

I am not a tax expert and will not attempt to address specific tax issues as they relate to covered call writing. However, I certainly appreciate the rationale for the advantages of long-term capital gains versus short-term capital gains in non-sheltered brokerage accounts. The question then arises should we tailor our strategy for tax avoidance rather than focus like a laser on appropriate methodology for the strategy we are considering? I am also a firm believer that we should maintain our focus on the strategy itself rather than on avoiding taxes especially if tax avoidance will lead us to less-than-favorable covered call writing decisions. Let me present an example. We can write long-term call options (LEAPS) that expire in more than one year and one day to construct long-term capital gain (loss) tax positions. No question that such an approach will decrease our tax liability but is it in the best interest of our covered call writing strategy? Respectfully, I say no for three reasons. First, the annualized returns for a 1-year option is much lower than if we wrote monthly options...check any options chain on any security. Second, we are forced to be in our position through three to four earnings reports, a very risky scenario. One disappointing earnings report can crush our returns for the entire year. We are taking a low risk strategy and converting it to a higher-risk strategy three or four times a year. Finally, we are making a long-term commitment. Why did we enter the trade to begin with? Well, we had our fundamental, technical and common sense reasons to do so as well as the returns meeting our goals. If those terms were met in August how do we know they will still be met in November? By writing shorter term options, we can navigate around earnings reports, generate higher annualized returns and re-evaluate our positions on a monthly basis. What is best for tax-avoidance may not be best for covered call writing, our focus strategy. Plus, now we would be juggling five balls. Covered call writing is one of the few options strategies that most brokerages will permit in self-directed IRA accounts. If we can use a sheltered account there are no tax issues. This reminds me of the time Indiana Jones came face-to-face with a terrorist who was wielding two humongous swords and the situation appeared hopeless, much like paying short-term capital gains tax. As we all sat at the edge of our seats thinking that there was no way he would overcome this bleak situation, Indiana took out a gun and shot him. He put his trades in a sheltered account. If we are not in a position to use a sheltered account, so be it, we pay our taxes. Covered call writing is a short-term strategy.

Which Stocks to Select

If we focused specifically and only on covered call writing the best underlying securities are the ones that have modest implied volatility (market expectation of price movement) and are most likely to appreciate in value or at the very least not go down in value. These equities will generate significant returns as long as the price declines slightly, remains the same or appreciates in value. Therefore, we should focus on stocks with strong earnings and sales growth, bullish and confirming chart technicals as well as those that comply with our common sense principles such as avoiding earnings reports and minimum trading volume. When we locate stocks that meet these three rigorous screens we have then found “gold” as it relates to covered call writing. By focusing in on stocks that have a certain % dividend yield as a primary criteria we will be missing out on a myriad of growth stocks that do not distribute
dividends at all. On my watch list for covered call writing I would estimate that about half distribute dividends but very few yield more than 2% annually. Another factor to consider when deciding how to construct your covered call portfolio is that when an ex-dividend date is prior to contract expiration, the call premium will be lower due to the anticipated share depreciation by the dividend amount. Given that the option holder may exercise early to capture that dividend, we may be victimized by a lower call premium plus no dividend capture as well...ouch! Let me stress that early exercise is most likely (but not guaranteed) when the strike is in-the-money, the ex-dividend date is near expiration of the contract and the time value of the option premium is less than the dividend about to be distributed.

Which Options to Select

The selection of the most appropriate option is just as critical as the selection of the underlying security. There are two aspects of the options contract that need to be evaluated before executing the trade: the “moneyness” of the option and the time to expiration. For a covered call writing portfolio that incorporates dividend capture and tax avoidance, we would favor out-of-the-money LEAPS (options that expire in more than 1 year and 1 day) which have strike prices higher than the current market value of the underlying security. Let’s focus on the two aspects of options selection as they relate to traditional covered call writing:

Moneyness

Most covered call writers only sell out-of-the-money strikes. The reason is that these strikes afford us the opportunity to generate two income streams; one from the sale of the option and the other from share appreciation from current market value up to the strike price. In normal and bull market situations where chart technical are bullish and confirming, these are the best strikes to choose and we should absolutely take advantage of these opportunities to capture both income streams. However, in bearish or volatile markets or when chart technical are mixed and of concern, the in-the-money strikes should be given priority because of the protection afforded to us. Here’s an example as to how this works:

- Buy Company XYZ @ $32/share
- Sell the in-the-money $30 call option for $3 ($300 per contract)
- The time value or initial profit is $1; the intrinsic value (amount the strike is in-the-money) is $2
- When the trade is first initiated, we use the intrinsic value to “buy down” our cost basis from $32 to $30
- Our initial return is then $1/$30 = 3.3%
- This initial profit is guaranteed as long as share value does not dip below $30
- Our downside protection of the time value initial profit = $2/$32 = 6.25%

This means that we are guaranteed a 3.3% return as long as share value does not decline by more than 6.25%. Are we not better off selling in-the-money strikes in bear or volatile market environments or when chart technicals may reflect a red flag or two?

Time to Expiration

I have alluded to this earlier in this article. Selling long-term options does have tax advantages, no question. But it also has some serious disadvantages. The first is that annualized returns will be lower with LEAPS. At the time that I am penning this article Facebook, Inc. was trading at $74.59 and the 1-
month $75 call was trading at a bid price of $2.19. That annualizes to 35%. The 17-month $75 call option showed a bid price of $13 which annualizes to 20.9%. The second, and just as critical, concern for long-term obligations is that we are required to hold our positions through multiple earnings reports. Earnings reports are risky. They can miss market consensus. They can miss the “whisper number” or the stat Wall Street Insiders are looking for. Negative guidance can result in the market punishing the price of a stock. I submit that this represents too much risk for a low-risk conservative strategy. Never sell a covered call option when there is an upcoming earning report prior to expiration.

Mastering strike selection is a key requirement to becoming an elite covered call writer.

**Dividend capture**

I love to capture dividends but I make no covered call writing decisions based on dividend capture. As stated earlier, my focus is on three elements: fundamental analysis, technical analysis and common sense principles. If a stock also distributes a dividend prior to expiration, great. The date we will be eligible for that dividend is called the ex-dividend date. If we own the shares on that date, we receive the dividend even if we sell the shares prior to dividend distribution. The option holder controls our shares and has the right to exercise the option and buy our shares prior to this ex-date. If this occurs, it will usually be on the day prior to the ex-date and is most likely when the strike is in-the-money and expiration is close (selling LEAPS makes early exercise less likely until expiration approaches). Also, the time value remaining on the option premium should be less than the dividend to make early exercise most likely to occur. I view dividend capture as “gravy” and not part of my covered call writing strategy. If I receive the dividend, great. If the option is exercised early and the shares sold prior to the ex-date, I have generated a maximum return on my trade and now have the cash available from the sale of those shares to re-invest and generate another income stream. Focusing on dividend capture is one approach to covered call writing. I am presenting another.

**Expectations**

Elite covered call writers should consistently beat the market with the possible exception of rare raging bull markets where capping upside potential may work against us.

**Position Management (Exit Strategies)**

We have discussed stock and option selection, the first two of the three balls we are juggling. Position management is the third and equally as important. The appropriate management actions for traditional covered call writing may not be well-suited for dividend capture and tax avoidance. What if the stock price depreciation dictates that we close our short options position or even our long stock position? We may now miss out on that dividend. What if share price accelerates exponentially and we have maxed out our trade and have an opportunity to close our position and use the cash to initiate another income stream. That would go against the tax avoidance ball we may be juggling. Let’s set up two general hypotheticals:

*Stock Price Declines Significantly Early in the Contract*
When share price declines so does the option value. Although we keep the amount originally generated under all circumstances, we can buy back the option (buy-to-close) at a deeply discounted price and now no longer have an option obligation. Since we are early in the contract (I sell 1-month options) we can wait a few days to a week to see if the price recovers. If it does, we can re-sell the same option in the same month on the same stock thereby generating a second income stream. Preparation + Opportunity = Cash! If avoiding short-term capital gains is a priority we would not consider this as an opportunity.

Stock Price Accelerates Significantly Early in the Contract

One of the characteristics of an option is that as the strike price moves deeper in-the-money (share price appreciates), the time value component of the premium approaches zero. When an option is trading at its intrinsic value only, it is known as trading at parity. We can take this knowledge and convert it into cash. Let’s say we bought a stock for $48 and sold the $50, 1-month call for $1.50 or $150/contract. The price of the stock then moves up to $60 in one week...it can happen! We now have maxed our trade generating $150 per contract from option premium and another $200 per contract from share appreciation. This represents a 1-month return of 7.3%. Keep in mind that our shares can only be worth $50 as long as we are bound by our option obligation. We check the value of the $50 call and we see that it is trading @ $10.10, near parity ($10 of intrinsic value and $0.10 of time value). If we close our short options position for $10.10, we can then sell our shares for $60, not our $50 option obligation. This leaves us an options debit of $10.10 and a share credit of $10 or a net debit of $10 per contract. If the cash freed up from the sale of the shares can generate more than $10 (not much of a challenge) why not institute this exit strategy? If our main concerns were dividend capture and tax avoidance, we may not consider this an opportunity.

In the above two scenarios, I am not attempting to present the “only” way to execute covered call writing but simply another, more traditional approach to this great strategy.

Alternate Strategy and Conclusion

Should we be juggling three balls or four balls or five balls? I hope it is clear from this article that I am from the three-ball juggling camp. However, no one can argue the benefits of dividend capture and tax avoidance. So allow me to present this approach as food for thought: How about constructing a portfolio consisting of two portfolios. One is dedicated to traditional covered call writing and the other to dividend capture and tax avoidance. In one portfolio, we are juggling three balls, in the other only two. This will allow us to focus like a laser on the specific strategies we are employing and at the same time perhaps simplifying the process. There is no one strategy that is right for every single investor. We all learn from each other and none of us ever know everything. My hope is that this article has sparked an interest in this great strategy and has made some points that will be helpful in your investment careers.

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