Are Options a Viable Strategy for You?

Perhaps you, like many of us, have experienced an interest in buying stock in an individual company (say ABC, Inc.). Maybe you have done your research, received a hot tip from your Uber driver (a scary thought!), or have been swayed by a pundit on the internet. So, you buy ABC stock and prepare to roll in the dough, only to find your ABC stock price goes down immediately. This happens all the time, as there is a 50/50 chance that an individual stock price may go up or down on any given day. As further time elapses ABC goes up a little and then down a little, and after 6 months it is at the same share price that you paid. What happened to those predictions that ABC would be higher by the next week? Maybe ABC will go up, but you did not know this time frame would be two or more weeks, or one or more years!

The above risk scenario above plays out in investment portfolios every single day. However, using options you can lower this risk on individual stock purchases, and even generate income on current stock holdings in your current portfolio.

What is an Option?

Simply put, an option is a contract that allows (but does not require) an investor to buy or sell a security, ETF, or index at a certain price over a certain period of time.

To illustrate let us look at an example of a "hot" stock during the COVID-19 pandemic.

Scenario 1 – You are considering purchasing Zoom Stock

We will use a highly popular, widely owned company that has flourished during the recent pandemic, Zoom Video Communications (ZM). When viewed at a defined time on a recent ready day, ZM's price was $356.93. At this same time, the option Call quote looked something like this:

ZM	**Sep17 21**	**390C**	**14.10(B)**	**14.50A**
Ticker	Date Opt Expires	C = Call Price	Quote for bid or current offer	Ask Price

Although this may look confusing, the above table has all the elements of the options chain (series of quotes).

- **Element 1:** represents the underlying equity, Zoom (ZM), to which the option applies.
- **Element 2:** Sep17 21 (Sept. 17, 2021) was the date of this option expired,
- **Element 3:** 390C represents the strike or exercise price ($390) for this "call" (C) option, which provides the option owner with the right to sell this option (100 shares of ZM) at $390 per share.

So, in this example the "call" is the option to purchase 100 shares of the underlying equity, Zoom (ZM), at the strike price ($390 per share).

- **Element 4:** Represented the current quotes for this call option (390C). In this example the 14.10B quote represented a current offer, or bid (B), by investors willing to purchase this call option at a price of $14.10 per share.

- **Element 5:** Represented a current asking price (A) of $14.50 per share of ZM by investors willing to sell this call option.

> **Note:** When using options, it's important that you understand the difference between buying and selling (often referred to as "writing"). When purchasing an option, you pay for the right but not the obligation to purchase or sell 100 shares of apple stock. If you sell the option however you are **obligated to buy or sell shares of Zoom.**

Since options purchases and sales are only conducted on 100 share units, the effective bid and ask quotes for this 390C option is $1410 and $1450 per single option transaction, respectively.

Scenario 2 - You already own 100 shares of Zoom stock from a lower price.

ZM	**Sep17 21**	**390C**	**14.10B**	**14.50A**
Ticker	Date Opt Expires	C = Call Price	Quote for bid or current offer	Asking Price

You normally can either choose to continue holding this stock or sell the shares at the current price. Here are some alternative factors to consider using options:

- Perhaps the ZM share price has been relatively steady over several past few calendar quarters, and you would like to produce some extra income on your ZM holdings without selling your ZM shares.
- You might reconsider selling the shares if ZM was trading $35 per share higher.

In this example, you might have considered selling a Sep17 21 390 Call which was last priced at $14.10/share (or $1410/option).

- If you sold this Call you would have been **obligated** to sell 100 shares of Zoom stock at $390 per share within the next 59 days. For taking on this risk you would have been paid $1410 during this same 59-day timeframe.

> You can choose to hold it or sell it. Perhaps Zoom has been relatively steady like the past few Quarters and you would like to produce some extra income, but you really do not necessarily want to sell your shares but may reconsider if it was trading $35 higher.

So, what is the potential outcome for the sale of this 390C option?

- If ZM was below \$390 on September 17th this option would have expired worthless, and you would have kept the premium (\$1410) that you received, still owning the ZM stock. Effectively you had agreed to sell your ZM holding at \$404.10/share (\$390 exercise price + \$14.10 premium received) with the stock trading at \$356.93.
- Conversely, your risk in this instance would have been an opportunity cost; that is, if ZM was trading at higher than \$390 per share on September 17th, 2021 you would have given up the opportunity keep your ZM shares or sell them at a higher price.

This process can be repeated multiple times per year. In this example, this process could be repeated up to about 6 times per year, thus creating a small annual income stream of \$8,460. Keep in mind that while we used real pricing in this example with ZM, option prices will vary based current share prices, expiration date and volatility of ZM. Therefore, the income amounts generated will vary dependent on the options used.

We hope this clarified how to sell a covered call to create income and mitigate some risk with holdings already in your portfolio.

If you would like a complimentary portfolio analysis to see if this strategy may benefit you give us a call or click here to schedule a chat or click on the following link to connect with Jim Jones to learn more:

https://rb.gy/aswdgd

Next time we will take a look at using "Puts" to purchase an equity.

Jim Jones, CFP®, CCO, Principal Member, spent 10 years working at the Chicago Board of Trade where he worked as a broker and market maker. Jim also served as an advisor to several large Commodity Trading Advisor (CTA) hedge fund clients. He has over 20 years of expertise in helping clients "de-risk" their portfolios by augmenting returns utilizing options. Reach out today to find out if Trading Options might be a good fit for you.