Lease Your Stocks for Extra Cash with Covered Calls

By Jeff Kohler

Profit-oriented real estate investors would never leave their vacant properties idle and not use them to generate income. Investors will rent or lease these properties to create a steady cash flow. Did you know that you could do this with your existing stock positions?

Consider all the stocks you own, or are planning to own. While you take ownership in these stocks believing they will increase in value, not all stocks move as quickly or as much as you would like them to. This is when an investor can use these shares that are experiencing slow or stalled growth to generate additional returns with covered calls. As we discuss this strategy, here are a few items we will cover:

- Define the strategy
- Introduce where the income comes from
- Take a glance at the strategy from both sides of the trade
- Mention how this offers downside protection

A covered call is a way to use call options as a method of leasing your stock position. An investor simply sells a call option against existing shares of stock. The term “covered” means you own shares of stock to cover the call option you are selling. A call option is a contract that gives the buyer the right to buy 100 shares of the underlying stock from the seller and obligates the seller to sell 100 shares of stock to the buyer. By selling this option, you are entering into an agreement to sell your stock, so make sure this is stock you would be willing to sell.

To take full advantage of this strategy, you would go to your thinkorswim account and bring up the available options on your stock. Let’s assume you hold a position in Microsoft (MSFT). The company has experienced nice growth during the last five months. However, let’s assume that MSFT might start to slow down and hover for a while. Since you do not want to close your position and you still want to use this stock to create as much profit as you can, you will look at the listed call options to consider the covered call strategy.

Since MSFT is trading at $29 per share, let’s say you sell a November $30 contract. The buyer of this contract pays you a premium of $1.00 per share and has the right to buy this stock from you at $30 per share through the third Friday of November. Under this contract, you are obligated to sell your 100 shares of MSFT if the buyer decides to exercise his or her right to buy the stock.
Imagine that MSFT is trading at $32 at expiration. The buyer of your option has the right to purchase the stock from you at $30. With the current market price at $32, if the buyer bought your shares at $30 and sold them back to the market at $32, the buyer would yield a $2 profit on the stock. Once the $1 premium is subtracted from the gain, the buyer makes a $1 profit on this trade ($32 - $30 = $2) ($2 - $1 = $1).

Let’s look at this trade from your perspective. If you purchased the stock at $29 per share, and then you fulfilled your call obligation to sell the stock and sold it for $30, you would have made a $1 profit. But wait, the option buyer also paid you a $1 premium to buy the call. Therefore, you make a total return of $2.

What if MSFT remains at its current price at expiration? If the price per share at expiration is $29, the buyer of this contract would have no incentive to exercise the option and buy the stock from you. There is no reason to pay $30 for a stock when it is trading at $29 per share. The option would expire worthless and the premium you collected is yours to keep. So if you had paid $29 for the shares of MSFT and the price has not moved, you would still have made $1 on this trade.

Another added benefit to this strategy is your downside protection. The premium you receive in this trade brings your cost basis for the trade down, meaning you can weather some price movement to the downside without losing ground in the trade. Going back to the example, if your original cost basis is $29, and you are paid a $1 premium, your new cost basis, or breakeven point, drops to $28 ($29 - $1 = $8). If MSFT pulls back to $28, your $1 premium offsets this loss in the stock price, and you are still breaking even on the trade.

Selling covered calls can help you generate consistent streams of income while simultaneously offering you downside protection. Here are a few key points to remember:

- **Aim for selling calls month to month when appropriate.** This will bring cash into your thinkorswim account every month.
- **Make sure you don’t limit your upside.** If you expect the stock to move increasingly higher, a covered call will allow you to profit only up to the strike price you are selling. Covered calls aren’t appropriate for all stocks.
- **Don’t use this strategy on stocks you aren’t willing to sell,** because you might be required to sell.
- **Don’t use this strategy to rationalize holding on to a bad stock.** If you see the stock moving below your breakeven point, research the condition of the company to ensure it is worth owning.
The covered call strategy is a conservative, income-producing strategy. Start analyzing your current stock trades and see how covered calls would supplement your investment approach today.