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Understanding Options: The Hidden Risks of Covered Calls

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Covered calls are often marketed as an easy way to generate extra income, but every options strategy involves tradeoffs. In Part 2 of our Understanding Options series, Portfolio Manager Chris Deeley explains how covered calls work, what investors give up in exchange for option premium, and why the income they generate isn't free. Building on the options fundamentals from Part 1, Chris explores when covered calls may make sense and when they can create unintended consequences. Learn how this widely used strategy fits into a thoughtful approach to risk management and portfolio construction.

OTHER VIDEOS IN THIS SERIES:

- Understanding Options: Understanding Calls, Puts, and Why Options Exist
- Understanding Options: Protective Puts and Collars
- Understanding Options: How We Think About Options

VIDEO TRANSCRIPTION:

Hi, I'm Chris Deeley, Portfolio Manager at Grimes & Company. Today, we're going to discuss one of the most popular options strategies used by individual investors: the covered call.

Before we begin, it's important to acknowledge that the appeal is completely understandable. In fact, at first glance, it sounds almost too good to pass up.

The conversation usually goes something like this: "You already own the stock. You don't plan on selling it. So why not

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generate some extra income while you wait?"

Maybe it's four percent. Maybe six percent. Maybe more. And if you're already comfortable holding the stock, generating additional cash flow seems like an obvious improvement.

But this is where investors need to slow down, because a covered call is not simply an income strategy. It's a trade, and like every trade, something is being exchanged.

The question is: what exactly are you giving up?

Let's revisit what happens when you sell a call option. The buyer receives the right to purchase your stock at a predetermined price, and in exchange, you receive cash today.

That cash is the option premium, and that's where most of the attention tends to go.

But the premium isn't the important part. The important part is what you're selling to receive it.

You are selling future upside. That is the transaction.

The option buyer is purchasing upside potential, and you are giving it away. Once you view the strategy through that lens, the tradeoffs become much clearer.

The premium isn't free income. It's compensation for surrendering part of the stock's future appreciation, and that distinction becomes very important when things don't go according to plan.

Let's start with the scenario investors actually hope for: the stock rises.

Suppose an investor owns a highly appreciated stock position. Perhaps it's company stock, or perhaps it's a long-term holding with substantial unrealized gains.

The investor sells covered calls to generate income. Everything looks fine at first: the premium arrives, the stock behaves normally, and the strategy feels successful.

Then the stock begins to rally. Eventually, it rises above the strike price, and at that point the investor has a problem.

The call option they sold is now valuable, and the buyer has the right to purchase the shares. The investor now faces a decision.

Option one is to allow the shares to be called away. That may trigger a taxable gain, create a diversification event the investor wasn't ready for, and perhaps most importantly, take away control over timing.

Option two is to buy back the call, but now the investor may need cash, potentially a significant amount of cash.

And where does that cash come from? It may come from selling other investments, adding outside capital, or selling more options.

The original goal was supposedly to create income, yet suddenly the strategy can require additional liquidity.

Now to be clear, if the investor already intended to sell the stock at that price, this outcome may be perfectly acceptable. In fact, later we'll discuss situations where that can be a very effective use of covered calls.

But if the investor's true goal was, "I never want to sell this stock," then the strategy may be creating exactly the outcome they were trying to avoid.

Now let's look at the opposite scenario: the stock falls.

This is where many investors discover a second misconception about covered calls. The premium provides some cushion, but it does not provide meaningful downside protection.

Let's use a simple example. An investor sells a covered call and collects a premium equal to 3% of the stock value. That sounds helpful.

But then the stock declines 20%, and the investor is still down roughly 17%. The premium softened the loss, but it didn't eliminate the loss.

Importantly, it also didn't eliminate concentration risk, company-specific risk, or market risk. The investor still owned the stock the entire time.

This is one of the most important concepts in today's discussion: covered calls do not fundamentally change the downside characteristics of stock ownership.

The investor keeps most of the downside while simultaneously giving away part of the upside. That is not usually an attractive long-term risk-reward trade.

At Grimes, we spend a great deal of time thinking about risk and reward.

Stocks are risky assets, but investors accept that risk because of the potential upside. The opportunity for appreciation is the reason investors tolerate volatility.

So let's think about what a covered call does. It removes part of the upside while leaving most of the downside intact.

In other words, you are selling away the good risk while keeping much of the bad risk.

That's why we believe investors should be extremely careful when using covered calls solely as an income strategy.

Now, none of this means covered calls are inherently bad. In fact, we often think they can be useful when used intentionally.

The key word is intentionally.

Suppose an investor owns a concentrated stock position and has already decided that they would be comfortable selling a portion of the stock if it rose another ten or fifteen percent.

Now the conversation changes. Instead of asking, "How do I generate income?" the investor is asking, "At what price would I be willing to sell?"

In that situation, a covered call can function almost like a paid limit order. The investor receives premium income today and agrees to potentially sell shares at a future price they already consider attractive.

In addition, we can independently look at the valuation on a stock to provide additional insight on whether a certain exit price makes sense. Finally, and somewhat simply, calls do not have to be written on the entire position. Targeting only a portion of a position can allow the client to start working down a concentrated position.

That is very different from selling calls while insisting the stock can never leave the portfolio. One is intentional portfolio management, while the other can create unintended consequences.

There is no such thing as free income. Every options strategy involves tradeoffs.

Covered calls can be useful tools when they support a broader objective such as diversification, liquidity planning, or reducing a concentrated position.

But investors should fully understand what they're exchanging for the premium they receive, because the premium isn't free. It's payment for giving away future upside, and in many cases that may not be the trade investors actually want to make.

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