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ALTERNATIVE VIEWPOINT

Hedged Equity: A Buy-Write/Covered-Call Primer

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With recent equity market volatility, investors may want to consider hedged-equity investments which seek to deliver equity-like returns over full market cycles while also tempering the volatility of returns and reducing the magnitude of drawdowns. While an improvement in either of these objectives may increase risk-adjusted returns, a stock portfolio paired with a call-writing strategy – called a buy-write or a covered-call approach – holds the potential to both increase investor returns and reduce investor risks.

What Is a Call Option?

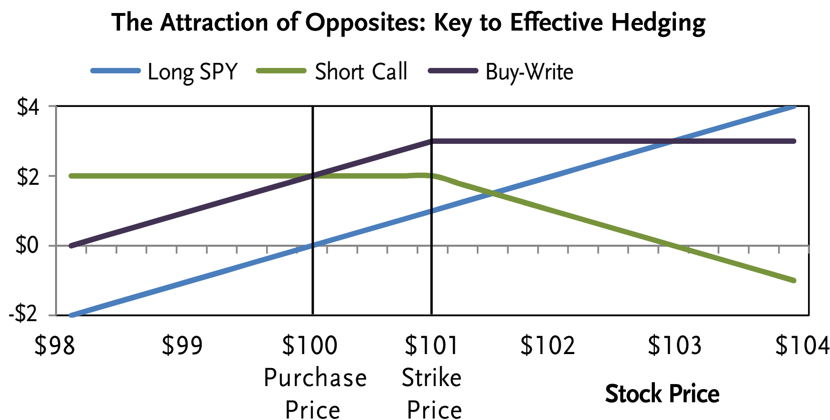
A call option is a contract that gives the purchaser the right, but not the obligation, to purchase 100 shares of a stock or an index at a set price (the "Strike Price") on or before a set date ("Expiration"). A put option is a contract that gives the purchaser the right, but not the obligation, to sell 100 shares of a stock or index at the Strike Price on or before Expiration.

What Is a Buy-Write or Covered Call?

A buy-write is a strategy by which an investor owns or buys shares of a stock and simultaneously writes (sells) one call option (representing 100 shares) on that stock for each 100 shares of stock held. With the advent of index options, the buy-write approach can also be implemented by index investors, whereas an index buy-writer sells one call option on an index for each 100 shares of that index held.

Why Can the Use of a Buy-Write Strategy be Effective?

One reason the buy-write approach can be effective has to do with the return paths of the equities bought or held and the calls sold. The equities bought and the calls sold have a high degree of negative correlation, which provides the potential for hedging benefits.



Source: Gargoyle

Negative correlation – *The value of stocks and of written calls move in opposite directions. When stock prices fall, the written option decreases in value, generating a gain. When stock prices rise, the written call increases in value, generating a loss. In addition to providing downside protection, this negative correlation serves to reduce overall portfolio volatility for investors.*

Simple, static buy-write strategies – selling calls once a month on Expiration - offer a time-tested method of adding income to equity portfolios in flat to modestly rising markets and buffering portfolio declines during market downturns. In more volatile markets, the income or premium generated from writing the calls can increase. Index options offer an additional benefit, as they have historically been systemically overpriced.

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