E Q U I T I E S

Covered Call Strategies: One Fact and Eight Myths

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Call overwriting is a method of simultaneously expressing a view on a security and its volatility, and the CBOE S&P 500 BuyWrite Index (BXM) is one of many ways to get exposure to the equity and volatility risk premia. Investors may change their equity risk premium exposure by buying or selling the index, or change their volatility risk premium exposure by buying or selling straddles.

We suggest that investors ignore the storytelling about obtaining downside buffers and generating income. This strategy may only generate income to the extent that any other strategy generates income, by buying or selling mispriced securities or securities with an embedded risk premium. Avoid the temptation of overly focusing on payoff diagrams. If you believe the index will rise and implied volatilities are rich, the covered call is a step in the right direction of expressing that view. If you have no view on implied volatility, there is no reason to sell options.

Selling volatility is generally (and correctly) considered a risky strategy. In this paper, we attempt to demonstrate that many of the myths surrounding covered call strategies are in fact just that: myths. In our view the myths collectively conceal the simple fact that option overwriting is a version of selling volatility. It may be a good stand-alone strategy when implied volatilities are high relative to expectations and, in particular, a good strategy when combined with earning the equity risk premium.

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