EQUITIES

Covered Calls and Their Unintended Reversal Bet

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Equity index covered calls have historically realized returns not much less than their underlying index with significantly less volatility. They have realized this performance by providing an exposure to the volatility risk premium in addition to the equity risk premium.

However, another important characteristic of covered calls is nearly universally ignored. Covered calls have a remnant exposure to equity market timing, an artifact of selling options. While portfolio managers typically focus on a covered call's exposure to volatility, equity timing may contribute more than three times the risk of short volatility and nearly half the risk of its passive equity exposure. In fact, over a quarter of a covered call's risk may be attributed to equity timing. More than likely an unintended risk exposure, equity timing is a significant component of a covered call's return. This paper seeks to further our understanding of covered call strategies by shining a light on covered calls' embedded timing of the equity market.

It is important that investors and portfolio managers understand the risks they are taking when owning a covered call. By exposing these risks, we invite investors to assess the appropriate course of action for their portfolios. We believe the portfolio can and should be hedged against exposures to market timing so that the limited risk budget may be allocated to compensated risk premia.

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