

PIABA Bar Journal

STRATEGIES AND RESOURCES FOR YOUR PRACTICE

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Analyzing Covered Call Writing Claims

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It is the purpose of this article to dispel a myth and, in the process, tell you a thing or two about covered call option writing, believed by many to be safer than owning a stock. In the end, you will conclude, as I have done after years of research and experience, that there is absolutely no reliable evidence, peer-reviewed studies or documentation that covered call writing actually results in improved returns or reduces risk as claimed. But don't expect your broker to agree with this reality.

Covered Call Writing: The Myth

In the ideal investment world, stock values increase risklessly in a straight line at exactly 11% a year (0% standard deviation). In that ideal world, an investor increases returns simply by "writing" or "selling" a Call, an Option giving the right - to a willing speculator - to call away his stock at a price *above* the market in return for a modest premium. In that world, the option expires worthless in 30 days and the investor keeps both the premium and his stock. The strategy is repeated perpetually, increasing yields and cushioning risk.

Boy, can you ever beat that? It's safe, easy and a win-win situation for the investor, (i.e., lower risk and higher returns). A recent comment written by one of my colleagues illustrates the pervasiveness of the *deception*:

"... putting aside what you give up on the upside (which you do not care about if the sole purpose of the trade is to capture the premium), there is no risk to a covered call. If the stock rises and the stock gets taken away, you capture the entire premium. If the stock falls, just sell the stock and close out the option position."¹

The Basic Truth: Covered Call Writing = Market Timing

According to Ibbotson² and virtually every broker you'll talk to, had an investor missed the 39 best months since 1925 (80 years), a dollar would have grown to \$17.12 today compared to \$2,658 had that investor remained fully invested throughout. Had an investor missed the 17 best months since 1985 (21 years), a dollar would have grown to \$2.34 today compared to \$9.52. In either case, missing the best months assured returns *lower* than Treasury Bills.

¹ This quotation is taken from a member comment posted on the Public Investor Arbitration Bar Association (PIABA) email List-Serve in October 2006.

² Ibbotson Associates Inc, March 1, 2006 Illustration entitled "Dangers of Market Timing". Based upon the Standard & Poor's 500 index. (www.ibbotson.com)

Market timing arguments are important here for one simple reason: Covered Call Writing is the one strategy that, when applied properly, assures that *the investor will always miss the market's best months*. The logical question is whether the premiums taken in via Covered Call Writing are worth giving up the upside, especially considering that Covered Call Writing cushions downside risk only marginally.

The Ibbotson data confirms only the obvious - that stock prices move not in a straight line but in spikes upward or downward followed by periods of lower volatility called "consolidation". The higher the volatility of the underlying security, the greater are its market gyrations and consequently the greater the premiums on the options. In point of fact, Covered Call Writing is a form of "Market Timing" - a short-term bet against the very stocks you own or choose to buy. Covered Call Writing takes the "Growth" out of growth stocks.

Both options traders and stock traders are interested in the market's direction, but the options trader must be extremely sensitive to the speed of the market as well. Writing a Call is a bet that the underlying security will fail to move at sufficient speed to exceed its strike price prior to expiration. The lower a stock's volatility, the more predictable and probable it is that the Call will expire worthless and the lower the premium will be, and vice versa. Expiration is the goal!

A Brief History.

In the 1970s and 1980s, listed options gained traction as liquidity concerns were allayed by Exchanges like the CBOE. Stock and index options were issued across a broad spectrum of strike prices and expiration dates. These efficient markets made it possible for institutional investors to write deep out-of-the-money calls against their billion dollar portfolios, gaining an extra 1/16th to 1/8th point. The captured premiums were originally intended to offset management's operating expenses and institutional investors with their

enormous financial power were able to write calls in high volume at very nominal cost. Cost was the key.

Where It Went Wrong

Aside from market risk (volatility), trading costs are the single most important consideration in Covered Call Writing. Covered Call Writing simply does not work with round-trip commissions. For the unfortunate retail investor with at most a few hundred shares of a stock, transaction costs make Covered Call Writing barely economic as originally conceived.

To overcome low premiums, retail brokers simply write calls against higher volatility stocks; go longer term; or, write calls closer to parity with the strike price to overcome burdensome commissions. So begins Covered Call Writing abuses.

Covered Call Writing in the Conservative Sense.

Covered Call Writing relies on the 95%+ expiration rate of out-of-the money options written against low volatility stocks. High expiration rates occur principally with options that are near expiration (less than 30 days), the period when the time value runs out the quickest. For institutions, which can negotiate for nominal trading commissions, 1/16th of a percent of a billion dollars every month can offset a lot of costs. Unfortunately for the retail investor paying retail commissions, the strategy is just not economic.

With Covered Call Writing Only Three Things Can Happen, And None Of Them Are Particularly Attractive

- **The Market is Rising:** Of course, in a rising market, call option premiums are highest, but so are commissions and the probability of losing your stock. If you lose the stock even once, the game's over, which makes the strategy senseless in up markets. After all, it's not called a "Write Call-Lose Stock" strategy.

- **The Market is Falling:** Falling stocks result in low call premiums and selling out-of-the-money calls against a falling stock only prevents you from selling the stock without first closing out your option at the Ask price. This gets pretty ugly as stock prices decline more quickly than the option premium and the repurchase is effected at the Ask price.
- **The Market is Stagnant:** This market gives the highest probability of expiration. But low volatility stocks trading within a narrow range result in very low premiums, albeit with a higher proportion of expiration. Costs as always reduce returns but, since expirations do not generate commissions, this is the goal. Investors still miss the upside if the market breaks out, meaning that when the market run-ups occur, covered call writers are effectively “out of the market”.

Abuse, Do You Know It When You See It ?

1. **Count Expirations:** With Covered Call Writing, the first analysis you need to do is calculate the percentage of opening “Sell” transactions that expire worthless. You should set a very high bar of at least 95% and no lower than 90%. Expiration is the measure of success and less than 95% expiration signals failure of the strategy.
2. **Assignments:** If the Call doesn’t expire worthless, the option will either be assigned or the Call will have to be repurchased to close out the position. You must analyze the account to determine if closing transactions are primarily Assignments or Purchases. Assignments should occur only rarely with Covered Call Writing and principally as an exit strategy for the stock.
3. **Purchases to Close:** You must analyze the number of Closing Purchases. Hopefully you’ll never see any in a Covered Call Writing account. That signals failure. Closing purchases occur

because the calls are in-the-money and must be repurchased lest the stock be lost. Remember you need the stock to re-write the calls! Unfortunately re-writing calls is often necessary to generate sufficient cash flow to repurchase the in-the-money calls and avoid assignment. If that’s the case, you’re likely to find a cascade of opening and closing transaction monthly that should be picked up by the supervising Registered Options Principal (ROP)

4. **Average Premiums Received (APR):** You must analyze the APR because it speaks volumes about risk and adherence to strategy. Normally you should expect the APR to be less than a dollar and probably in the ¼ to ½ range. Low premiums reflect positions that are well out-of-the-money, expire in less than 30 days and are “covered” by low volatility stocks, all of which translates into a high probability of expiration. Once the APR exceeds \$1.00, it’s likely: (a) that the underlying stock is too volatile; (b) that the calls are written at or close to parity (increasing the chance of assignment); or, (c) that expiration is longer than 30 days (increasing exposure to market gyrations).
5. **Average Premiums Paid (APP):** A properly implemented Covered Call Writing strategy should have relatively few Purchase-to-Close transactions. APPs greater than \$1.00 raise serious question about the volatility of the stocks that cover the calls as well as the strategy’s management. If APPs exceed \$3.00, you also need to analyze the account for the likelihood that the broker is actually writing deeper in-the-money calls to generate the premiums needed to offset those repurchases, a vicious circle that gives the customer the illusion of profitability, generates very high commissions but masks losses in the underlying stock.

6. **Days to Expiration:** Average days to expiration must also be measured. This isn't necessarily the Holding Period. Ideally, a call will expire in less than 30 days. This is the opposite of typical churning analyses on stock portfolios. If there are multiple repurchases, you're likely to find premiums well above \$1.00 and Days to Expiration exceeding 60 days. These are both signs that the strategy is being applied erroneously if not negligently.
7. **Monthly Premiums Received:** Analyze the account to determine the ratio of the premiums received to the market value of the underlying stocks. If the monthly premiums received exceed 1% of the market value of the "covering" stocks, you can likely conclude that the strategy is being violated. Logic should tell you that no conservative strategy generates 1% per month (12% annually) without carrying substantial risk. Covered Call Writing is approved as a conservative options strategy, a hyperbolic industry myth. Twelve percent returns are *not* conservative. To approve a strategy as conservative that utilizes covered calls on high volatility stocks deceives the investor and enables abuse.
8. **Commissions:** Since trading costs are so significant, you must analyze the options transactions on a position-by-position basis to determine the ratio of commissions to profit. This ratio will be influenced directly by the Expiration Percentage. This analysis is different from the traditional "hurdle rate" analyses that are used in churning cases. Where there are substantial closing purchases you're likely to find that average commissions exceed average profit, raising the question of who's the real beneficiary of the strategy - the broker or the investor.
9. **Volatility of Stocks:** Option premiums are directly correlated to the volatility of the underlying stock. Not only should you

argue that the average premiums are indicators of volatility (risk), but that the standard deviation of the collateral stocks establishes that Covered Call Writing strategies were misapplied.

10. **Implied volatility:** Since options are derivative investments, they derive their risk characteristics from the underlying security. Given the impact of leverage, the days to expiration, and general market fervor, the volatility of an option is implied from its pricing. The best way to assess this "Implied Volatility" is to download the free "Options Toolbox" off the CBOE website. The toolbox includes a "Black Scholes" calculator that will compute the Implied Volatility of an option by plugging in the stock price, expiration date and premium paid.

But Options prices are influenced not simply by fundamental factors in the underlying stock, but also by the Market's speed and the expected volatility. The higher the Implied Volatility, the greater the premium and the higher the risk. If market conditions suggest periods of higher volatility, the price of an option will rise regardless of the movement of the underlying stock (and vice versa).

Options writers must have at least a basic understanding of Implied Volatility. Institutional traders and sophisticated speculators control the options markets. These traders utilize all types of financial modeling to determine the Fair Value of the option. Without an understanding of Implied Volatility, an investor has no idea whether they are receiving less than fair value and taking on too much risk. If you play around with the Black-Scholes calculator, you can observe the impact on an option's "Fair Value" by manually changing the Implied Volatility in the calculator. It's worth doing.

11. **The Vix:** To properly assess volatility, you should also compare the option's Implied Volatility with the Vix Index, which

analyzes a basket of out-of, at-the and in-the-money S & P options to calculate volatility. At the height of the tech-wreck, the Vix (basically analogous to the Standard Deviation) was at or near 40, while in 2003 it fell below 15. The higher the Vix during the trading period, the greater the volatility in the market. Understanding the impact of volatility on options pricing is essential, otherwise the client will likely be selling calls well below fair value.

12. Match Stocks With Calls: Your analysis must also include an aggregated matching trade analysis for each underlying security and the options written against it. Often in-the-money calls will be profitable in collapsing markets and without aggregating those gains with the losses in the underlying stock; the trade-off is undetectable and the analysis becomes misleading.

It Ain't Covered Call Writing

Covered Call Writing utilizes a high-risk derivative instrument under very controlled conditions, e.g. deep out-of-the-money, expirations within 30 days, low volatility stocks. Writing calls under these conditions is an acceptable risk due to the extraordinarily high probability of expiration. Just use common sense in your arguments, does anyone with a brain believe an investor can enhance returns by 1%-2% monthly, 12% to 24% annually simply by writing calls on growth stocks without substantial risk?

"Covered Call Writing" is simply not economic at the retail level. Unfortunately, Brokerage Firms categorize Covered Call Writing as "conservative" without ever drawing distinctions between legitimate Covered Call Writing that seeks to enhance returns marginally and the abusive high-risk, high commission strategies recommended by their brokers. Owning the stock does not lower risk to the investor, it only means that the brokerage firms need not worry about

collecting from the client in the event of disaster.

If it Ain't Covered Call Writing - What do you call it, hedging?

Hedging is taking a counter-position in investments that are negatively correlated to portfolio positions. Like an insurance policy, hedging typically involves paying out a sum to buy "Protection". But selling calls against a stock position is at most a speculation in which an investor is willing to forego short-term upside in return for the premium. Unfortunately, growth stocks are volatile, meaning they typically move up or down in chunks.

Capping upside by writing calls against Growth Stocks thoroughly undermines the justification for owning them and converts long-term strategies into short-term strategies without reducing downside exposure. There are far easier and less risky ways to generate 4% - 6% annual returns. Sure, even with aggressive "Writes" the investor may be rewarded 9 out of 10 times, but when the underlying stock spikes up by 20% in a month, (a real possibility), the call writer's returns plummet below owning the stock alone with all the risk of a volatile portfolio.

There is simply no rationale for an investor's holding onto a portfolio of volatile growth stocks that can go to zero, simply to capture a premium. The short-term benefits of the premium are not justified by the limitations on the upside.

Profits in Perpetuity

There is a relatively high probability that investors can engage in Covered Call Writing over protracted periods using very low volatility stocks and deep out-of-the-money calls near to expiration. But the premiums generated will be fractional at best.

Conversely, the rationale for engaging in protracted Covered Call Writing utilizing higher volatility of growth stocks (standard

deviation of 16% -18%) is far more problematic. The rationale behind growth investing is that “Time” smoothes out returns. This is known as “Regression to the Mean”. Long-term investors expect short-term volatility, but by holding onto their growth stocks over the long-term there will be a higher certitude of profitability.

Investors sold³ on Covered Call Writing are typically assured that they’ll be able to write and rewrite calls against their growth stocks pretty much forever. But the mere fact that a covered short position is profitable once, twice or fivefold, is scant comfort that it can be repeated indefinitely without collapsing. What you’ll find with Covered Call Writing on growth stocks is not merely limited upside vis-à-vis risk, but a far greater probability that the stock will be called away. This accounts for high proportions of “Buy to Close” transactions in rising markets. If the stock is lost, you can’t write the call. In order to preserve the strategy, the calls have to be repurchased.

Repurchasing a call in a rising market on a volatile stock is a recipe for disaster. Options premiums on growth stocks are high due to volatility, but even those premiums skyrocket if market events suddenly lead speculators to anticipate a sharply rising market. Significantly, option repurchases will always be at the Ask price, which could be one-quarter point greater than the Bid price in volatile markets. If the stock is actually called away, it can only be repurchased at the appreciated price. Worst of all, as the collateral stock price rises, the decision to repurchase the option becomes a daily race against hope. On an entire portfolio, this problem is unmanageable.

Naked Puts/Covered Calls: A Story About Downside Risk.

Gwen and Glen are 50-year-old twins. Each owns 1,000 shares of XYZ Corp with a market price of \$100. XYZ is a growth stock

with a standard deviation of 20% and an average annual growth rate of 15% over the past 10 years, with no dividends.

Glen’s broker recommends holding onto the stock and selling covered XYZ calls out-of-the-money at a strike price of 105, for a premium of \$3.00 (lots of volatility). Glen agrees, sells the calls and receives \$3,000. As long as XYZ remains below \$105, Glen will keep the premium and the stock at expiration.

Gwen, on the other hand, decides to cash out and sells her XYZ stock, realizing \$100,000 in sale proceeds. Her broker recommends that she write “naked” out-of-the-money puts on XYZ at a \$95 strike price, also taking in a premium of \$3.00. She agrees, sells the puts and also receives \$3,000. So long as XYZ remains above \$95, she too will keep the premium and her cash at expiration.

Gwen and Glen then leave for a family reunion in Tibet, arriving in Lhasa three days later, having been out of touch with the financial news. Unbeknownst to either, XYZ was disclosed as a sham corporation and the stock became worthless overnight. When Glen checked his account on-line, he discovered to his dismay that his account had \$3,000 in cash and 1,000 worthless shares, for a total value of \$3,000.

Gwen, too, checked her account and discovered that XYZ had been “put” to her at \$95 a share, resulting in a \$95,000 loss. Her account value amounted to \$8,000 (\$3,000 in premiums plus the \$5,000 balance remaining after the put’s exercise at \$95). Had XYZ stock dropped to \$50 a share, Glen’s net loss would still exceed Gwen’s by \$5,000. In truth, Gwen’s naked puts were lower risk than Glen’s covered calls.

Why then do brokerage firms approve “covered calls” as a conservative strategy that demands only low levels of supervision, suitable even for relatively unsophisticated

³ No pun intended.

customers, while, at the same time, categorizing Naked Put writing as high risk, requiring customer sophistication and greater levels of supervision?

Hopefully you can see from this example that broker approvals are not based upon customer risk or sophistication, but on broker/dealer risk. With covered calls, the brokerage firm has no risk, but with Naked Puts the client could default, sticking the firm with the liability. Margin *requirements* ameliorate that risk to the broker, but margin *debts* are notoriously bad for protecting brokers during short-term market crashes. Clearly, the only one protected by covered calls is the broker who depends on the covering stock to protect its own interests, not the customer's. This is pure "Alice in Wonderland" logic; lower customer risk requires higher levels of approval, while higher levels of risk are treated as conservative.

But let's imagine that XYZ actually goes up.

- Glen's benefit ends when the stock reaches \$105.01 and his stock is called away. In that case, Glen's account value is \$105,000 plus the \$3,000 premium, for a total of \$108,000 tops.
- Gwen on the other hand retains her \$100,000 in XYZ proceeds plus the \$3,000 in premiums for a total of \$103,000. Assuming Gwen does not invest any of her \$100,000 over the same time period, she'll under-perform Glen by \$5,000 on a dollar basis but outperforms him on a percentage return basis, (Gwen puts up nothing). Had Gwen invested her \$100,000 in an aggressive index fund, for example, she could easily have ridden her profits well beyond the \$105 strike price of Glen's calls. Glen, unfortunately, has no stock at all.

Summary and Conclusion

At best, Covered Call Writing is an anecdotal strategy without any verifiable track record. It is heavily promoted by cracker-barrel brokers with a strong financial incentive to engage in this commission-rich strategy. But there is absolutely no reliable evidence, peer-reviewed studies or documentation that the Covered Call Writing actually results in improved returns or reduces risk as claimed.

In the recent past, there have been several mutual funds that actually were promoted as Covered Call funds, but each has badly underperformed its bogey or worse. In litigating Covered Call Cases, you must challenge the foundations of the Covered Call Writing mythology. All that exists out there are anecdotal stories, mostly in the popular financial press that are based on the specious logic that covered call writing is low risk way to enhance returns. It just isn't true. Hopefully, this article removed that myth from your perception.