# DRS vs. Covered Calls

## Seeking Portfolio Protection vs. Portfolio Cushioning

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All options-based strategies are not created equal. Many investors however tend to lump all strategies that utilize options together. This is an erroneous approach, as different strategies have very different objectives and different ways of utilizing options.

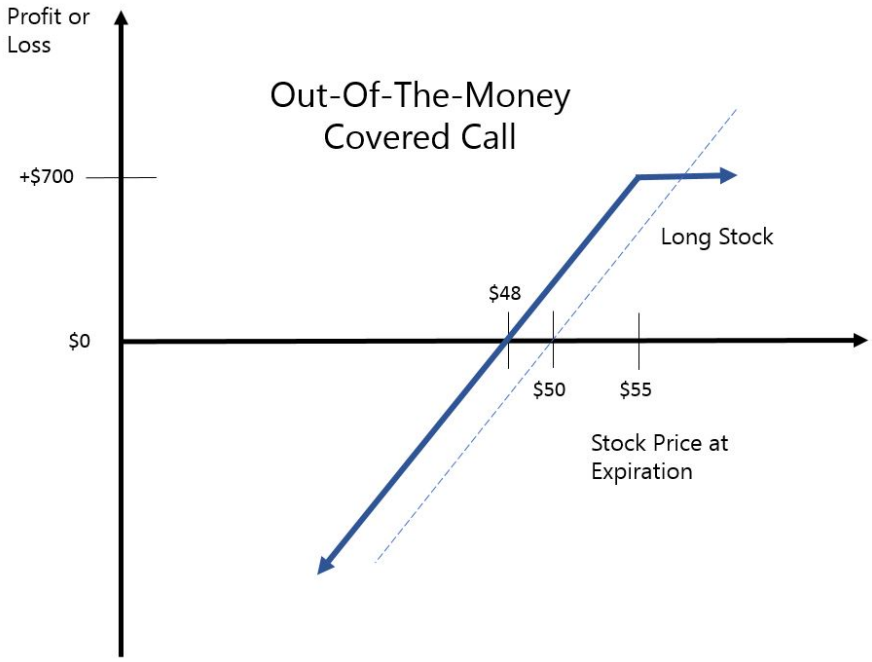
One of the most common option-based strategies is the covered call.

Swan Global Investments is producing a series of posts that answer the following questions regarding a number of alternative strategies:

1. What are the drivers of returns in each strategy?
2. What are the risks in each strategy?
3. What role does a given strategy play within a portfolio?
4. How does the given strategy compare to the Defined Risk Strategy?

## Covered Call Strategies are Not Hedges

With a covered call, the manager holds an underlying position on individual stocks or an index-like position. However, the manager seeks to supplement their return by systematically selling calls against their long positions and collecting that option premium. Below is a graph outlining the return profile of a covered call strategy, with the underlying stock as the dotted line and the combined equity-and-short-call return profile as the solid line.




*Source: www.theoptionsguide.com*

**Drivers of Returns:** With a covered call strategy the lion's share of the holdings are in a buy-and-hold position in a stock or index. While the collection of option premium might supplement the returns, the primary driver of a covered call strategy will most likely be simply the upward or downward movement in the stock price.

**Risks:** While the covered call strategy sounds like a clever way to supplement return with income, there are two major risks associated with it: one on the upside and one on the downside. The first risk is that the markets take off too quickly and the call option goes in-the-money. Under such circumstances the portfolio manager really only has a few options.

One, he could close out the trade and take a loss on the option trade. Second, the underlying asset could be called away and miss out on the gains. Finally, the portfolio manager could cross his fingers and pray that the stock reverses direction and dips back below the strike price before being called. Regardless, the covered call has effectively sold off its upside potential in a sharply rising market.

The other risk is on the downside. A covered call strategy offers no downside protection. The long position is unhedged and completely exposed to losses. The income from the sale of calls might offset a bit of the losses, but in a situation where the market sells off 20%, 30%, 40% or more, it is highly likely a covered call strategy would face similar losses.

**Role Within a Portfolio:** Using a dated but still useful nomenclature, a covered call strategy essentially transforms a "growth" position (i.e., a long stock) to a "growth and income" play. The potential for larger gains is in effect swapped out for immediate income. In a low-yield world where dividend-paying stocks are trading at a premium, this type of approach might boost income if it works out.

The ideal scenario for a covered call strategy is a slowly rising market, where the equity position gains but never moves past the strike price of the call option. In such a situation the portfolio can collect income from the sale of calls, but not worry about having its market gains being sold away. Sadly, this situation doesn't accurately describe much of what we've seen over the last decade or more. Either markets were selling off massively (2007-08) or rallying significantly (2009-10, 2012-2016). Neither situation is good for covered call strategies.

## How Do Covered Call strategies compare to the Defined Risk Strategy?

The Defined Risk Strategy shares a few similarities with covered calls, in the sense that it has a core, buy-and-hold, long position and does sell options on that underlying long position.

However, there are some key differences between the DRS and covered call strategies. The DRS is better described as a hedged equity approach, where there is explicit downside protection on the equity in the form of a long-term LEAPS put option. There is a premium collection component, but the income is generated via the simultaneous sale of both calls and puts in a market-neutral fashion. All this leads to a very different return and risk profile than covered call managers.

About the Author:

Marc Odo, CFA®, CAIA®, CIPM®, CFP®, Director of Investment Solutions, is responsible for helping clients and prospects gain a detailed understanding of Swan's Defined Risk Strategy, including how it fits into an overall investment strategy. Formerly Marc was the Director of Research for 11 years at Zephyr Associates.

**Important Notes and Disclosures:**