EQUITIES

Covered Calls Uncovered

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Many investors seek to protect their portfolios by purchasing equity index options. As a result, options tend to include a risk premium as a form of compensation to option sellers. Covered calls, which are short options, collect this volatility risk premium in addition to the equity risk premium earned from their long equity exposure. Because of option convexity, covered calls also embed active equity exposure that behaves like a reversal strategy.

The authors contend that covered calls are rarely considered in terms of their risk exposures. In this paper, they introduce a novel performance attribution methodology that decomposes the strategy's return into its passive and active equity and short volatility exposures. Not only does the performance attribution of their samples allow covered call investors to better understand the strategy's characteristics, but it also allows portfolio managers to assess the risk and return impact of portfolio construction decisions, such as the call option's strike and maturity, so that they may improve their strategy.

As an example, the paper proposes a risk-managed covered call to hedge away the uncompensated active equity exposure, which the authors say is a significant contributor to the covered call's risk. They contend that their proposed strategy has similar expected returns to the original covered call, but with lower risk, lower downside beta, and a higher Sharpe ratio. They added that while the motivation for covered calls is often confusing and muddled by a number of myths, the motivation for the risk-managed covered call is clear: earn the equity and volatility risk premium by constructing a portfolio with long equity and short volatility exposure.

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