COVERED CALL STRATEGIES

EAGLE | Asset Management

August 2024

How opportunistic call-writing strives for better outcomes

Income-oriented investors have long looked for creative ways to generate equity-like returns while also focusing on income, leading to the use of covered call strategies. In these strategies, investors own a dividend-paying stock and sell call options on the shares to generate income – though this takes place at the expense of the option being called away if the shares reach a market price determined when the option was sold. The common implementation of this strategy involves managers targeting a specific yield for investors. At face value, this is a reasonable goal as investors seek to receive a reliable income stream from the options while also receiving dividends from the stock.

We believe, however, that this practice doesn't consider the characteristics of both the options and the stocks. That oversight could prevent investors from fully participating in the upside of the stock while they receive lower levels of income when the options aren't priced attractively. As an alternative, we believe that if these metrics are considered and managers are allowed to be opportunistic with call option writing, it is possible to participate more in the stock's upside when the shares should be expected to perform well while generating higher levels of income with attractively priced options.

Pricing of options

Options are priced based on several factors, including the current stock price, the strike price (the price at which the option can be exercised), the time until expiration, the volatility of the stock, and the risk-free interest rate. Generally, in periods of high estimated volatility, options are priced higher. In periods of low volatility, options are priced lower, with the investor receiving less income from the options as a result.

If an investor is targeting a specific yield requirement during a period of low volatility for a specific stock, this usually requires accepting a lower strike price. This tradeoff raises the likelihood of a stock being called away and removes the upside potential from owning the stock.

While the investor receives a higher yield, they participate in less of the upside potential. While yield-seeking investors may accept this, it is important to note that you won't be participating in the potential upside of owning a stock while having no protection on the downside. A quick, sizeable negative return can wipe out multiple years of income generated from writing at-the-money call options in low-volatility

What is a covered call?

A covered call strategy consists of two components:

1. Owning a stock

2. Selling call options on the stock

Income is generated from selling the call option on the stock.

Potential upside on long equity positions is capped if the buyer of the option exercises the ability to buy the stock at a pre-determined price, known as a strike price.

What is a call option?

A call option gives the buyer of the call option to buy a specific stock at an agreed-upon price (the strike price), before a certain date, called the expiration date.

The buyer of the call option pays a fee, called the option premium, for the option contract.

The seller of the call option collects the option premium as income but may be forced to deliver the stock at the strike price if the price on the underlying stock meets or exceeds the strike price prior to expiration.

The seller of the call option keeps the premium whether the call option is exercised or not.

Not FDIC Insured | May Lose Value | No Bank Guarantee

environments. However, periods of high volatility can create the potential for the investor to generate income at high levels with strike prices similar to those seen in low-volatility environments.

Dividend-paying stocks, volatility, and options

Historically, dividend-paying stocks often perform well during periods of low volatility due to several factors. First, these stocks tend to be from established companies with reliable cash flows and strong balance sheets, making them less susceptible to market fluctuations. Historical data supports this, showing that during low-volatility periods such as the early 2000s or recoveries following financial crises, dividend-paying stocks outperformed non-dividend-paying stocks.

Additionally, dividend-paying stocks are attractive to investors seeking income consistency, especially when interest rates are low or falling, as they provide a steady stream of income regardless of market conditions.

The chart below illustrates calendar-year returns for the S&P Dividend Aristocrat Index, with years when the S&P 500 Index was above its historical volatility shown in gray and years when it was below its historical volatility shown in blue. Periods of low volatility generally indicate strong return potential relative to periods of high volatility.

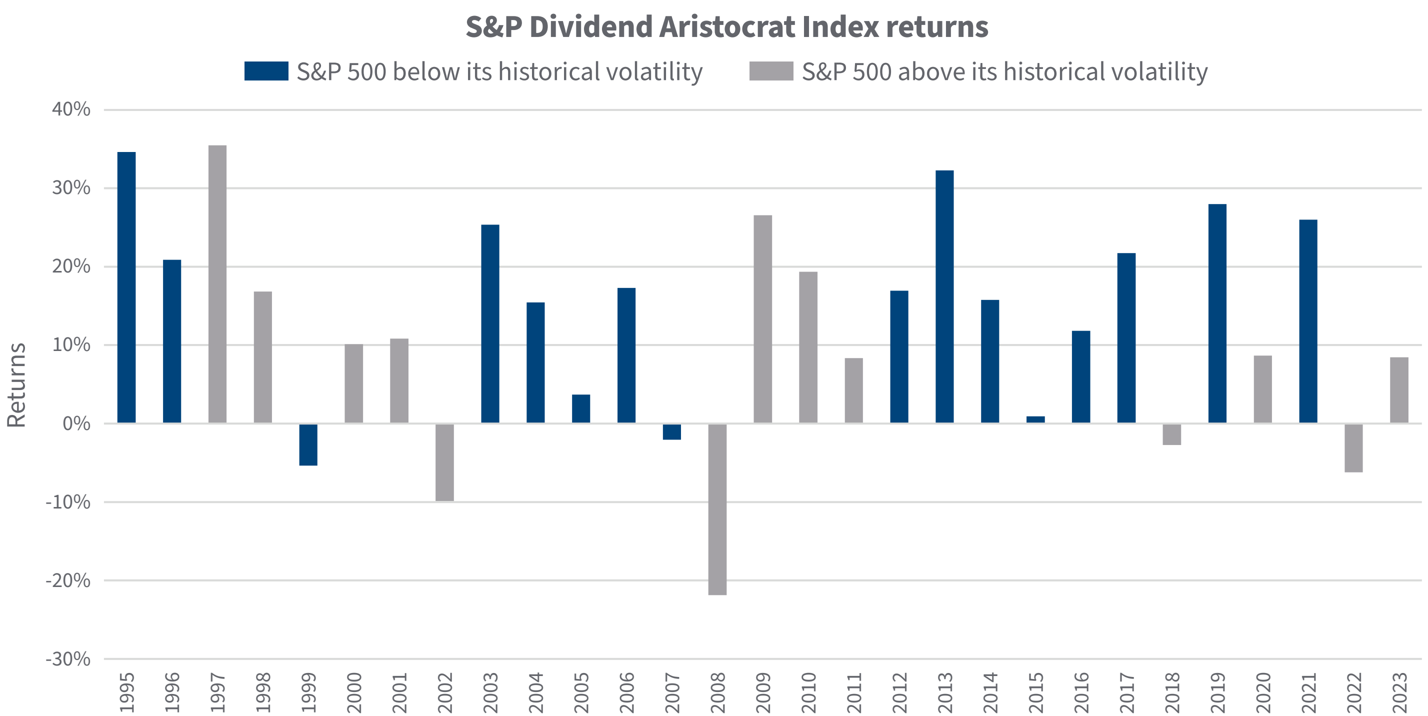
During these periods, investors would likely notice that the stated yield on their portfolio would decrease as limited options would be written because the pricing is less attractive. That said, it is important to note that a dollar of capital appreciation is the same as one earned from writing options. In this scenario, when the dividend-paying stocks have historically performed well, we believe investors should feel confident in withdrawing from capital to meet spending goals and still potentially result in a better outcome than they would have in strategies with high stated yields that are likely to underperform in these environments because of limited capital appreciation.

Why consider opportunistic covered call strategies?

We conclude that targeting yields may not be in an investor's best interest over the long term when you consider the combination of:

- upside potential in stocks during periods of low volatility while receiving limited compensation for writing options; or
- being required to limit upside during periods when the stocks would be expected to perform well.

If portfolio managers do not specifically target a yield by being forced to sell options when they aren't attractive or



Source: Bloomberg, as of 7/31/24.

by capping equity upside, they can be opportunistic and take advantage of option-writing environments during periods of high volatility. This strategy can allow them to generate similar levels of income to those that target yield over a full market cycle, while also participating in the upside of periods when the equities should be expected to perform well.

While targeting a yield may appear to be attractive for income-oriented investors at face value, it is not an efficient structure for maximizing long-term income and capital growth. We encourage investors to consider exploring strategies that can exploit opportunities for income when priced effectively or that can let their stocks run when they should be expected to do well. In the search for an implementation of these strategies, investors should be aware of the pitfalls of targeting a specific yield and instead look to take a more long-term, flexible approach that can result in better investment outcomes.

Learn more

eagleasset.com

Past performance does not guarantee or indicate future results. No inference should be drawn by present or prospective clients that managed accounts will achieve similar performance in the future. Investment in a portfolio, investment manager or security should not be based on past performance alone. Because accounts are individually managed, returns for separate accounts may be higher or lower than the average performance stated. Individual portfolio/performance results may vary due to market conditions, trading costs and certain other factors, which may be unique to each account. There is no guarantee that these investment strategies will work under all market conditions, and each investor should evaluate their ability to invest for the long term, especially during periods of downturn in the market.

Investing involves risk and you may incur a profit or a loss. Investment returns and principal value will fluctuate so that an investor's portfolio, when redeemed, may be worth more or less than their original cost. Diversification does not ensure a profit or guarantee against a loss.

Investing in Large Caps is based on the expectation of positive price performance due to continued earnings growth or anticipated changes in the market or within the company itself. However, if a company fails to meet that expectation or anticipated changes do not occur, its stock price may decline. Moreover, as with all equity investing, there is the risk that an unexpected change in the market or within the company itself may have an adverse effect on its stock. As with all equity investing, there is the risk that a company will not achieve its expected earnings results, or that an unexpected change in the market or within the company will occur, both of which may adversely affect investment results. The biggest risk of equity investing is that returns can fluctuate and investors can lose money. Not every investment opportunity will meet all of the stringent investment criteria mentioned to the same degree.

Investing in Mid-cap sized companies is based on the premise that relatively smaller companies will increase their earnings and grow into larger, more valuable companies. Historically, mid-cap stocks have experienced greater volatility than other equity asset classes, and they may be less liquid than larger cap stocks. Thus, relative to larger, more liquid stocks, investing in mid-cap stocks involves potentially greater volatility and risk. In addition, mid-cap stocks have experienced greater volatility than other classes of securities. Mid-cap stocks can also be less liquid than those of large companies, and illiquidity increases the potential for volatility.

Options involve unique risks, tax consequences and commission charges and are not suitable for all investors. When appropriate, options should comprise a modest portion of an investor's portfolio. No statement within this document should be construed as a recommendation to buy or sell a security or to provide investment advice.

When "writing" or selling calls, if the value of the underlying equity shares falls significantly, the loss from holding the stock will likely outweigh the gain from the option premium received. Also, as an equity holder and selling a covered call, the potential gain from owning the stock is limited to the gain realized if the share price reaches the strike price of the option. At some point after this occurs, the shares are "called away" and then sold for the strike price of the call option. Gains from expiring call options or buying back for less are considered short term for taxes.

Raymond James limits the use of options to hedging strategies in managed accounts (e.g., covered calls and put purchases with limited downside risk). Prior to accepting an account for options activity investors must be given the Option Disclosure Document titled "Characteristics and Risks of Standardized Options" and must complete and submit an Option Agreement and Suitability Form for Raymond James review and approval prior to transacting option trades. Clients may only employ those strategies that have been approved. These documents are available from your financial advisor.

There are risks associated with dividend investing, including that dividend-issuing companies may choose not to pay a dividend, may not have the ability to pay, or the dividend may be less than what is anticipated. Dividend-issuing companies are subject to interest rate risk and high dividends can sometimes signal that a company is in distress. Historically, dividend yields have been relatively constant and therefore have created a cushion for investors when stock prices have declined. However, as with all equity investing, there is the risk that a company will not achieve its expected earnings results, or that an unexpected change in the market or within the company will occur, both of which may adversely affect investment results. Dividends are not guaranteed and must be authorized by the company's board of directors.

Sector investments are companies engaged in business related to a specific sector. They are subject to fierce competition and their products and services may be subject to rapid obsolescence. There are additional risks associated with investing in an individual sector, including limited diversification.

Definitions

"At the money" refers to what happens when an option's strike price is identical to the current market price of the underlying security.

Call options are financial contracts that give the buyer of the option the right, but not the obligation, to buy a stock, bond, commodity, or other instrument – known as the underlying asset – at a specified price (the "strike price") within a specific time period (the expiration or time to maturity). The buyer profits when the underlying asset increases in price.

Dividend payers are the companies that distribute a portion of their profits to shareholders in the form of a dividend.

A long position refers to the purchase of a security with the expectation that it will rise in value, reflecting a bullish attitude.

A risk-free interest rate, also known as a risk-free rate of return, is a theoretical interest rate of an investment that carries no risk. Real risk-free rates are calculated by subtracting the rate of inflation from the yield of the Treasury bond matching the duration of the investment in question.

Indices

The S&P 500 Index measures change in stock market conditions based on the average performance of 500 widely held common stocks. It is a market-weighted index calculated on a total return basis with dividend reinvested. The S&P 500 represents approximately 80% of the investable U.S. equity market.

The S&P 500 Dividend Aristocrats® Index measures the performance of S&P 500 companies that have increased dividends every year for the last 25 consecutive years. The Index treats each constituent as a distinct investment opportunity without regard to its size by equally weighting each company.

Individuals cannot invest directly in any index, and index performance does not include transaction costs or other fees, which will affect actual investment performance. Individual investors' results will vary.

About Eagle Asset Management

Eagle Asset Management (Eagle) is a wholly-owned subsidiary of Raymond James Investment Management. Eagle was organized as the corporate successor to Raymond James Asset Management, at the time a division of Raymond James and Associates, Inc., member of the New York Stock Exchange. Eagle was formed in 1976 and began managing assets in 1984 primarily to manage individual and institutional accounts according to broadly defined objectives agreed upon with investors. Eagle is a registered investment adviser with the United States Securities and Exchange Commission in accordance with the Investment Advisers Act of 1940. Eagle manages a variety of equity, fixed-income, and balanced assets for separately managed, institutional, Taft-Hartley, and mutual fund platforms.

880 Carillon Parkway | St. Petersburg, FL 33716 | 1.800.235.3903 | eagleasset.com

© 2024 Eagle Asset Management, Inc. All rights reserved. | 594379 | 8/31/2025 | FL-EAM-CVRCLL