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TalkingPoints

Tracking Covered Calls in the Australian Stock Market

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The term covered call refers to an option strategy in which the investor selling call options owns an equivalent amount of the underlying security. To execute a covered call, the investor holds an underlying position on individual stock(s) or an index-like position. In addition, the investor seeks to supplement their return by systematically selling calls against their long position(s) and collecting option premium.

A covered call strategy essentially is intended to transform a "growth" position (i.e., a long stock) to a "growth and income" play. The potential for larger gains longer term is in effect swapped out for immediate income. A systematic covered call strategy may contribute to consistent income generation especially during low volatility periods.

1. What is the S&P/ASX Buywrite Index?

The S&P/ASX Buywrite Index is designed to measure the performance of a theoretical covered call strategy that is rebalanced quarterly and comprises a short position in the at-the-money (ATM) call option on the S&P/ASX 200 and a long position on the S&P/ASX 200.

2. What is a covered call strategy, and how does it work?

A covered call (or buy-write) strategy aims to generate income and mitigate loss, particularly in bear market conditions. Specifically, this strategy involves selling a call option against an underlying asset that is already owned by the option writer. If the asset's market price exceeds the contract's strike price at expiration, the call writer would be obligated to sell the underlying asset at the option strike price to the option buyer. If the strike price is not met, the option writer maintains control of the asset. Either way, the option writer generates income from selling the call contract — this is known as the "option premium."

3. What are the potential advantages of this type of strategy?

The main potential benefit of this strategy is the income generation from accumulating call option premiums. One factor that affects these premiums is the “option moneyness” — that is whether the option contract is “in the money” (ITM), “out of the money” (OTM) or “at the money” (ATM). An OTM call has a strike price that is above the current market price. An ATM call has a strike price that is equal to the current market price of the asset — this generates a higher premium, as there is a greater chance that the option will be exercised at this price. These premiums offer supplemental income to traditional sources like dividends and fixed income. This income can be distributed or reinvested into the underlying asset to mitigate against losses in a bear market.

4. What are the potential disadvantages of this strategy?

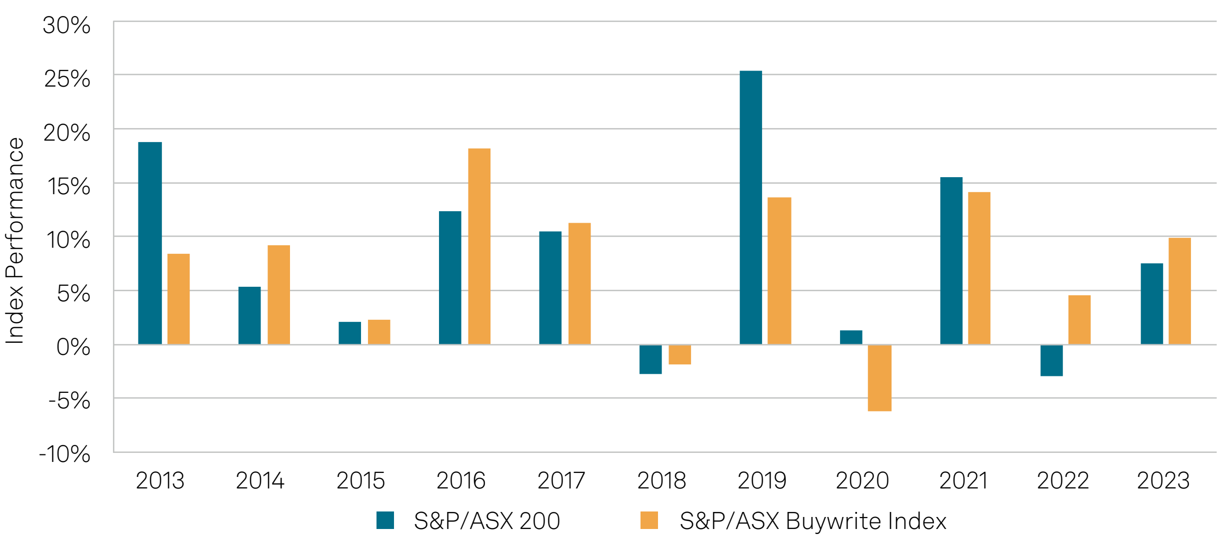
A drawback of the covered call strategy occurs if a call option is ITM, in which case the option writer would miss out on any gains that the asset may achieve beyond the strike. The option seller would be forced to sell the asset at this lower price, therefore capping the asset’s growth potential. This often occurs during bull markets, as the market price of the underlying asset increases above the option strike price. A long-term covered call strategy may help make up for this by offering income that can be used to reinvest into the asset.

5. How has the S&P/ASX Buywrite Index performed historically?

The S&P/ASX Buywrite Index was launched in 2004. The index employs a covered call methodology in which the index holds a theoretical long position in the underlying S&P/ASX 200 while “selling” theoretical quarterly ATM calls on this position. Any premiums and dividends that would result from those positions are reinvested into the long equity position of the index. This aspect of the methodology is intended to enable the buy-write index to outperform the underlying equity index historically in down, neutral and moderately up markets. On the other hand, the capped upside potential of the index methodology has led to historically underperforming the underlying equity index during bullish market conditions. Over the course of its 19-year history — through which it experienced variable market environments — the S&P/ASX Buywrite Index performed competitively with the S&P/ASX 200, posting an annualized return of 8.53%, compared with 8.71% for the equity index.

Exhibit 1 compares annual index performance between the S&P/ASX Buywrite Index and S&P/ASX 200. The results show that during periods of market decline or moderate upside, the S&P/ASX Buywrite Index outperformed the S&P/ASX 200. This is primarily caused by a higher likelihood that the call option position expires OTM during those market scenarios.

Exhibit 1: Historical Annual Index Performance Comparison



Source: S&P Dow Jones Indices LLC. Data as of July 31, 2023. Index performance based on total return in AUD. Chart is provided for illustrative purposes.

6. How much theoretical potential income has the S&P/ASX Buywrite Index generated historically?

Since launching in 2004, the S&P/ASX Buywrite Index has achieved an average quarterly option premium yield of approximately 3.00% — translating to a yearly premium yield of nearly 12.5%. Historically, yields peaked under bear market conditions, such as during the Global Financial Crisis of 2008 and the onset of COVID-19 starting in March 2020. As stipulated by the index methodology, both the theoretical premiums and dividends generated by the index are reinvested into the underlying S&P/ASX 200.

For more information about the S&P/ASX Buywrite Index, please see the methodology.

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