

Using Covered Calls in Portfolio Construction

A Practical Look at Options for Income, Risk Management, and Tax-Efficiency

In today's uncertain market environment, investors are increasingly seeking ways to generate consistent income while managing downside risk. In recent years, investment products featuring derivatives such as options have become increasingly popular as tools that, when used thoughtfully, can enhance portfolio outcomes. While some options strategies remain highly sophisticated and unsuitable for many, certain approaches utilizing options, particularly covered calls, stand out as a potentially effective tool, especially in portfolios seeking more consistent cash flow without excessive exposure to downside volatility.

Covered call writing is no longer just for seasoned traders. Long-term investors can now use it to enhance the cash flow from equity portfolios, potentially boosting returns in flat or mildly rising markets without incurring additional downside risk. While not without trade-offs, covered calls can be an effective and accessible tool for those seeking more than traditional buy-and-hold exposure.

The key is understanding how covered calls work, when they make the most sense, and why they deserve a place in more investors' portfolios.

Understanding Calls and Puts

To understand the value of covered calls in a portfolio, it's important to first grasp the fundamentals of options themselves. Options come in two basic types: calls and puts.

- **Buying a call option** gives the holder the right, but not the obligation, to buy a security at a specified price ("strike price") before or upon a specific expiration date.
- **Buying a put option** gives the buyer the right to sell a security at a strike price before or upon a specific expiration date.

Conversely, selling (or writing) an option creates an obligation. Selling a call obligates the seller to deliver the underlying security if exercised, while selling a put obligates the seller to purchase the underlying security if exercised.

Options contracts typically represent 100 shares of the underlying stock. Most options expire monthly, on the third Friday. A call is considered "in-the-money" when the stock price exceeds the strike price, while a put is "in-the-money" when the stock price is below strike price. Option maturities can range from as short as one month to more than 12 months, offering flexibility depending on the strategy being used.

Here is a quick reference summarizing basic option positions:

TYPE	RIGHT/OBLIGATION	MARKET VIEW
Buy Call	Right to buy	Bullish
Sell Call	Obligation to sell	Bearish/Neutral
Buy Put	Right to sell	Bearish
Sell Put	Obligation to buy	Bullish/Neutral

FIGURE 1

Common Option Strategies:

STRATEGY	DESCRIPTION	PRIMARY USE	RISK
Long Calls	Owns a position in a call option, offering a leveraged participation in the upside price movement of the equity.	Speculative bullish play	Total loss of investment is possible.
Long Puts	Owns a position in a put option, offering a leveraged participation in the downside price movement of the equity.	Downside hedge	Total loss of investment is possible.
Covered Calls	Owns a long position in a security while also selling a call option on the same security. This generates option premium (cash).	Income generation, modest upside cap	Caps the upside potential on the underlying equity.
Protective Puts	Owns a long position in a security while also buying a put option (long put) on the same asset.	Downside protection	Requires a cash outlay.
Uncovered Puts	A short position (sell the put option) while not owning the equity, offers the opportunity for cash flow from the put option proceeds.	Income generation with potential to buy the stock at a lower price	Obligates the investor to buy the underlying equity if the price declines below the strike price.

At this point, we should highlight that some strategies may use synthetic securities designed to replicate the performance of a long equity position and a call option. While these securities, sometimes called equity-linked notes or structured notes, may produce similar performance characteristics, the tax treatment of their cash flows can be different from the tax treatment of call options on single stocks. Investors should be aware of that to avoid any unwelcome tax surprises.

The Case for Covered Calls in a Portfolio



A covered call strategy involves selling a call option on a stock the investor owns (a long position). The call gives the buyer the right, but not the obligation, to purchase the stock from the seller at a predetermined strike price before or at a set expiration date. The goal is to generate additional income from the option premium, while potentially still benefiting from modest appreciation in the stock price.

Potential Benefits and Tax Considerations:

1. **Controllable Income Stream** - Covered calls generate premium income when sold by the investor, enhancing cash flow alongside dividends or interest.
2. **Boosts Returns in Flat Markets** - Writing covered calls provides the potential for investors to outperform in flat or moderately rising markets.
3. **Encourages Disciplined Selling** - Strike prices act as preset exit points, promoting systematic portfolio management.
4. **Tax Efficiency** - May offer favorable long-term capital gains treatment versus ordinary income from other strategies if used on stocks held longer than a year.
5. **Simple and Flexible** - Easily accessible to individual investors and adaptable to various goals and risk levels.

Hypothetical Example

Consider a portfolio holding 500 shares of ABC Corp purchased at \$100 on December 31, 2024. On September 30, 2025, with ABC trading at \$135, a call option expiring March 2026 with a \$145 strike price is sold for \$5 per share. Possible Outcomes:

	Scenario	Result
 \$145	The stock trades above \$145 in March 2026	100 shares sold at \$150 (\$145 strike + \$5 premium) for long-term capital gain of \$50 per share.
 \$145	The stock trades below \$145 in March 2026	Call expires, short-term capital gain of \$5 per share. Retain ownership of the underlying equity.

When Covered Calls Make the Most Sense

Covered calls are not a one-size-fits-all solution. They work best in certain market environments and investor situations. Understanding when or when not to use them can help maximize their benefit while avoiding common pitfalls.



Flat or Moderately Rising Markets - Covered calls are most effective when the underlying stock is not expected to move much or only rises slightly. In these conditions, the call option often expires without being exercised (worthless), allowing the investor to retain both the premium income and the stock. If the stock appreciates modestly, you still earn some upside (up to the strike price) while collecting the premium if selling out of the money calls.

Why it works: The investor earns extra income from the option and still benefits from modest stock gains, without giving up too much upside.



When Income Is a Priority - Covered calls can enhance portfolio income. This is particularly valuable for investors approaching or in retirement, or those seeking cash flow to supplement other investments. A Buy/Write strategy, in which the investor buys the stock and simultaneously writes a call, can lock in this income from the outset.

Note: While these strategies may offer attractive cash flow, they may potentially generate high levels of short-term capital gains. Total returns from these strategies may be limited as well given that the underlying equity upside is capped at the strike price.



On Stocks You're Willing to Sell at a Specific Price - Covered calls work well if an investor owns a stock they are willing to sell at a certain price. By selling a call at that strike price, the investor collects income now. If the stock exceeds the strike price, which coincides with the investor's target price, the stock gets sold via the exercise of the option and the premium is added to the strike price and is booked as a capital transaction.

Strategy Tip: This is particularly effective for investors looking to gradually sell a large position or exit a long-term holding.



During Periods of Elevated Volatility - Option premiums tend to rise with market volatility. During these periods, covered calls can generate higher income than usual, even when the market outlook is uncertain.

Caution: Elevated option premiums often signal higher market risk, so the underlying stock should be suitable for continued holding in volatile conditions.

When Covered Calls Don't Make Sense

- **Strong Bull Markets:** Covered calls can limit gains if the stock rises sharply and is called away.
- **High-Growth Stocks:** Fast-moving or volatile stocks may not suit this strategy, especially when full upside potential is important.
- **When You're Not Ready to Part with the Stock:** Covered calls can lead to an unexpected sale, which may cause tax issues or reduce exposure to a core holding.

Key Considerations

While covered calls can enhance income and provide structure, they are not risk-free. Key considerations include:

- **Opportunity Cost:** If the stock rallies well above the strike, gains are capped.
- **Downside Exposure:** The premium provides a small buffer, but losses in the stock itself are not prevented.
- **Tax Complexity:** Different tax treatment applies depending on how the option concludes (exercised, expired, closed out early).

Summary

Covered calls may offer a practical, income-focused strategy that can complement a wide range of portfolios, particularly in flat or moderately rising markets. By generating option premium income and encouraging disciplined exit points, they provide a structured way to enhance returns without taking on significantly more risk. While not without trade-offs, such as capped upside and continued exposure to downside, covered calls can be a valuable tool when used thoughtfully. For investors seeking consistent cash flow, tax-efficient income, or a way to make existing equity positions produce more cash, covered calls deserve serious consideration as part of a broader investment approach.

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Material prepared by:

Cantor Fitzgerald Value and Income Strategies Investment Team

John Bruce, CFA

Norman Darden, CFA

David Marshall, CFA

Scott Morrell, CFA



Contact Us

For more information on Cantor Fitzgerald Asset Management:

Email: cfsupport@cantor.com

Phone: (855) 9-CANTOR

Web: cantorassetmanagement.com