

How to Use Options to Generate Massive Yields on Your Stocks

Description

While the Oracle of Omaha is the furthest thing from what you would call a trader, Warren Buffett has been known to include options as part of **Berkshire Hathaway's** overall strategy. In fact, Buffett has revealed that during the 2008 crisis, he wrote naked puts on a variety of stocks for a net premium of \$4.9 billion.

Now, although (unfortunately) we don't have Mr. Buffett's capital, nor would I recommend writing naked options to novice investors, the "covered call" strategy, highlighted below, is a great introduction to options with very little risk to your capital.

The covered call

The covered call is a popular strategy used by everyday investors as well as institutional money managers. In fact, there are several popular ETFs that replicate that strategy. Its mechanics are simple: for every 100 shares you own, you simply write one call option contract against them (as options are standardized to 100 share amounts). Unlike an option buyer, who pays what is known as a premium, as a seller, you will receive the proceeds from your short option.

Moreover, the premium the seller receives can be thought of as money that can go towards lowering your average cost basis for your position or extra yield.

For example, say I purchased 100 shares of **Suncor Energy Inc.** ([TSX:SU](#))([NYSE:SU](#)) at the January 13th closing price of \$42.62/share. Afterwards, I write the \$46 *strike* call, expiring on June 16, 2017; I'm assuming that Suncor will not go past \$46/share by then. For the written option, I receive a premium of \$1.00 per share which I can use to reduce my cost basis for Suncor to \$41.62 per share or, alternatively, as an extra source of dividends.

Now, say June 17 comes around and Suncor is below the strike of \$46/share. The option will expire worthless for the buyer on the other end, and I get to pocket the entire premium of \$1.00 for every share I own.

Of course, there is no free lunch in the options world. Should Suncor rally past \$46 per share by June, I will be "assigned" on my position, and the buyer on the other side will get to buy my shares at \$46 per share. If say, Suncor is \$50/share by June 17, the buyer on the other end has profited \$4 per share on this trade, while I miss out on all the gains from \$46 onwards.

Taking these factors into account, you can see how covered-call writing becomes a viable way to generate additional yield. If your call expires worthless, then you can write another one. If you are writing two calls per year, that's an additional \$2.00/share of premium you are receiving on top of your stock's usual dividend stream.

In Suncor's case, with an expected quarterly dividend of \$.29/share, your total dividends for the year

become \$3.16/share, or a yield of 7.4%!

The bottom line

The covered-call strategy is an easy and effective way to generate additional yield or to lower the cost basis of your share position. However, as I said, there is no free lunch in the options world; should your stock rally past the strike price of the option, you will miss out on all of the gains from the strike price onward. In case of assignment, you have effectively sold your shares, triggering possible capital gains; therefore, covered-call writing should generally be undertaken in your registered account.

CATEGORY

1. Dividend Stocks
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Date

2025/10/02

Date Created

2017/01/16

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