ReadySetCrypto
Income Through Options
Masterclass

Module Six: Income Through Covered Calls

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By Doc Severson

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Earning Income Through Selling Calls

This is one of the simplest, most powerful Options strategies out there, yet few investors understand it. Not only does Warren Buffett understand the power of compounding, but he also uses the Covered Call strategy to help him generate 20% annual returns through Berkshire Hathaway. Perhaps you can do the same if you learn to generate monthly income through this strategy, and others.

Before you are intimidated by the name of this strategy, let's use a simple analogy through an imaginary discussion between "Jim" and me to help us understand what's going on here:

Jim: Hey Craig, I just took a fabulous Dean Grazipelosi seminar and I am going to earn income off of Real Estate! In fact, I just bought my first property!

Me: That's great! What did you buy?

Jim: I just bought an apartment building!

Me: Sounds great....how many tenants are there, what is the occupancy rate, and what is the monthly rent? What kind of monthly income do you earn?

Jim: Huh? <*blank stare*> What do you mean? I just bought the building and I'm hoping that it goes up in value over time so that I can sell it for a gain.

I realize that this conversation is ridiculous and that no one named "Jim" would be so dense as to buy an apartment building without expecting to benefit from monthly rent as part of the equation.

Then why aren't you doing this with the crypto assets that you hold?

Yes, you can "rent out" the crypto assets that you hold in your current portfolio! (assuming that they have Options that you can write against them with) Let's see how we can do this by selling a Call Option...

Selling a Call Option - Reminders

Recall the "Call Options" chapter where we defined the following characteristics about Selling Call Options:

- Instead of *buying* a Call Option to open a position, we can *sell* a Call Option to open a new position.
- When we sell a Call Option to open a position, we will be paid the selling price of that Option and the cash will be deposited into our account.
- Selling a Call Option creates an obligation that we agree to fulfill if called to do so, which is called "being exercised;" as part of the Option contract we agree to sell the other party the underlying asset at the agreed-upon Strike Price.
- We might have to sell our spot crypto to the exercising buyer if we already own it (covered), or we might have a short spot crypto position created in our account if the short Call was naked (uncovered or unsecured).
- The Time Value component of the Call Option erodes in an exponential fashion as Expiration Day approaches. An Option's "Time Value" component will become equal to zero as expiration day comes to a close; this is an enormous benefit to selling Call Options.
- Short Options that have Intrinsic Value will become automatically exercised if you hold them past Expiration day; in other words, if you have a short Call Option that is In the Money (ITM) and you hold it past "closing time" on that Expiration Friday, you can expect to be assigned a short position on the underlying spot currency, or be "called out" on the spot crypto of the underlying that you already own.

Before we get into Covered Calls, let's see what's wrong with selling "Uncovered" or "Naked" Calls. Let's use Bitcoin for this example; let's see what happens if we sell front month Call Options "Naked."

Selling Naked Calls

As we saw in the bullet points above, we can create income by selling Call Options against a spot crypto like ETH or BTC; let's use Bitcoin. With the current price of BTC at $11800 as I write this, any strike price on the Options chain at $12,000 or above is considered "out of the money," or OTM. Any strike price at $11,500 or below is considered "in the money" or ITM. We also know from our previous studies on Call Options that if the price is ITM at expiration, then we are liable for assignment of that Option; that means that we are obligated to sell the other party spot crypto at the strike price that we sold regardless of what the actual spot price is at that time.

In the Option chain in Figure 1 below, with BTC at $11,800, we are going to sell an OTM Call Option with about 22 calendar days left to expiration. The 30AUG $14000 Call Option is selling for about a midpoint of .047BTC. This is a per-contract value which means that we would receive .047BTC credit per Option sold. For the purposes of this example, we will sell 1 contract of 30AUG $14000 Call Options, bringing in a credit of .047BTC This cash goes directly into our account once the trade executes.

Figure 1

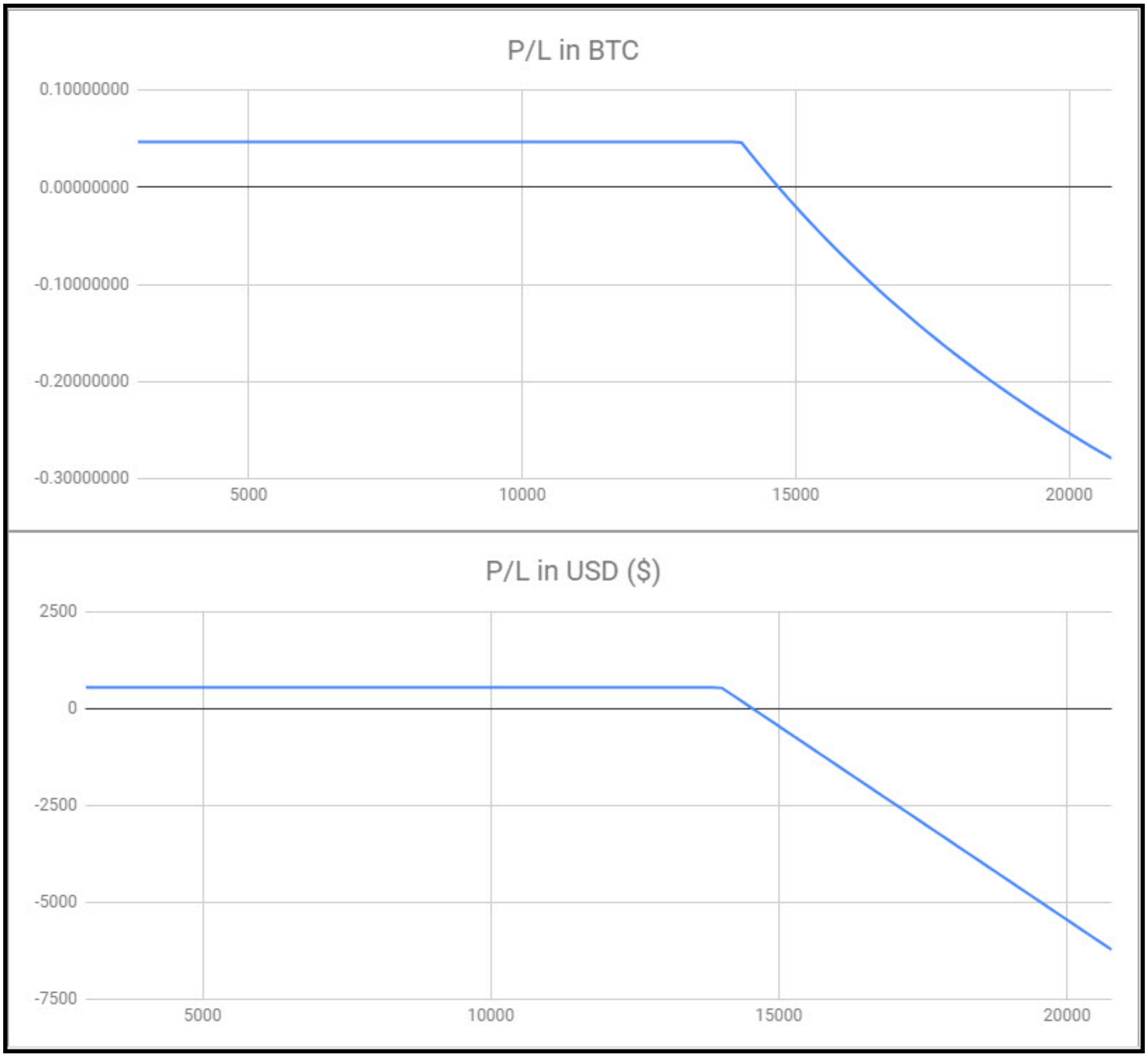
Calls **Expiration = 22 days** Underlying: SYN.BTC-30AUG19($11990.98) **30 Aug 2019**

Size	Bid	Ask	Size	Δ|Delta	Strike
6.0	0.4450 $5332.95	0.5395 $6465.45	3.0	0.99	**6000**
3.0	0.3665 $4393.56	0.4520 $5418.53	3.0	0.98	**7000**
3.0	0.2895 $3469.41	0.3675 $4404.18	3.0	0.95	**8000**
3.0	0.2195 $2626.54	0.2705 $3236.81	5.0	0.90	**9000**
3.0	0.1550 $1858.28	0.2045 $2451.73	5.0	0.80	**10000**
14.4	0.1410 $1690.44	0.1495 $1792.34	3.0	0.68	**11000**
14.4	0.0985 $1180.91	0.1030 $1234.86	10.0	0.55	**12000**
14.4	0.0670 $803.26	0.0715 $857.21	10.0	0.43	**13000**
19.3	0.0445 $533.51	**.047** 0.0495 $593.45	10.0	0.32	**14000**
19.3	0.0295 $353.67	0.0335 $401.63	10.0	0.23	**15000**
19.3	0.0195 $233.73	0.0225 $269.69	10.0	0.17	**16000**

We just made a .047BTC profit for selling Call Options, right? Not quite; we have pulled in the credit but that does not turn into a profit until our obligation is released. The obligation is not released on this position until either: 1) the Option expires OTM after Expiration with the Spot Currency price settling at $13,999 or lower, or 2) by closing down the position prior to expiration by "buying to close" the short Call Option position.

Let's put a visual aid to use to help us understand the risks and rewards of this position. Figure 2 below is a "risk profile" graph and the blue line is showing the profits and losses that we'd incur when the Options expire, depending on where price is on the horizontal scale.

Figure 2



Note that if the price is anywhere below roughly $14,000 on Expiration day, the potential profit would be that .047BTC figure that we discussed**. This means that if the price of Bitcoin is less than $14000 on Expiration day closing, we are released of our Option obligation and we get to keep that .047BTC credit that we received on day one!** Not a bad payday if Bitcoin stays where it is today, or drops....over the next 22 days

OK, that's the good news....if the price drops or stays steady, we make a profit by doing absolutely nothing. Now what would happen if the price actually went UP on Bitcoin over the next 22 days? Unfortunately, this is where the term "unlimited risk" comes into play. Note that the higher the price goes, the more that we lose. This is because we have obligated ourselves to sell Bitcoin for the $14,000 price, no matter how high the price goes by Expiration. You can see that if BTC ripped higher to the upside over the next 22 days and closed at the $20,000 level on Expiration day, we would have to sell someone 1 BTC at $14,000 and take on a loss of over $5,000. We have to buy BTC at $20,000 and then sell it to someone else at $14,000, eating the difference. OUCH.

It is extremely important that you understand the mechanics of what selling a Call Option obligates you to do.

So if that doesn't sound like a very good trade.....risking potentially unlimited upside funds in order to make a small credit of 047BTC…..I agree. **This is why we never ever sell Naked Call Options. Ever.**

Some professionals will trade them but only if they understand how to mitigate their risk should the price move against their position. This is not something that we will cover in this program as 99.9% of traders have no business using an unlimited risk position. Only those who truly understand how to implement Risk Management can.

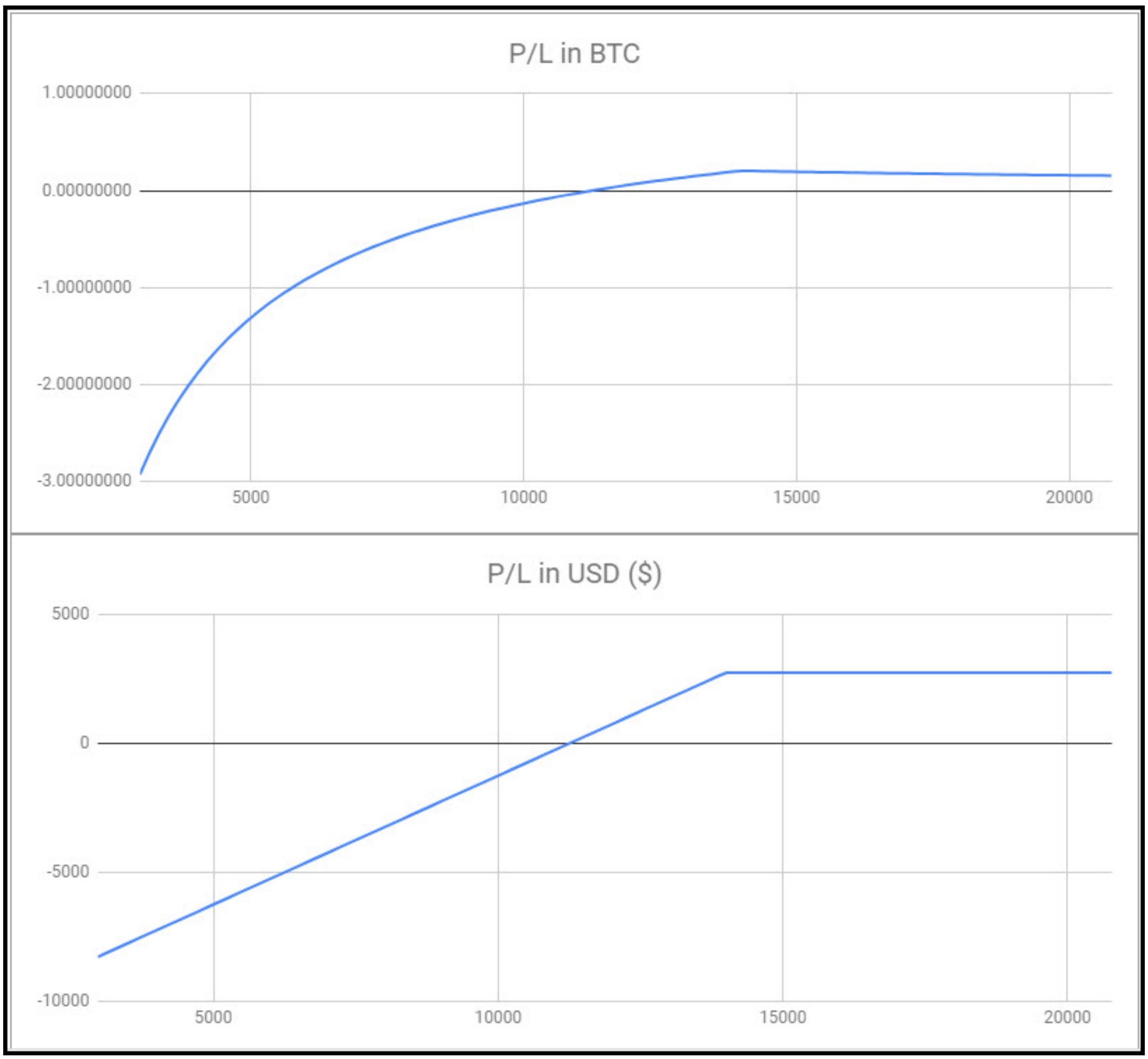
So in this case, it's not the fault of the Call Option, rather it's how we used it. Let's see how we can combine this position with some underlying spot currency to turn it into a much more conservative, yet much different position.

Owning Spot Crypto with Short Calls = Covered Calls

Let's use the same example as before with BTC Spot, but instead of selling those $14,000 Call Options naked, let's combine them with the required 1 BTC Spot position to "cover" the Call position. (one contract controls 1 BTC in this example, so in this case we need 1 full BTC of spot currency to cover)

It does not really matter for this example what price we bought the BTC Spot at (cost basis) although for this example we'll assume that we bought it at today's price of $11,800. You can see the completely different risk profile in Figure 3, showing how the risk has been flipped to the downside:

Figure 3



Let's do the math and see what happens on Expiration day depending on what the price does:

- **Price stays at $11800:** in this case, you would keep the original .047BTC (about $555) credit from selling the Calls, and since the Spot price has not changed, that would be your total return. This amounts to a return of .047BTC divided by the capital invested into the spot currency, or ($555/$11,800) = 4.7% return on capital.

- **Price goes to $10000:** in this case, you would still keep that .047BTC credit from selling the Calls, but the price of the spot currency drops by $1800. In this case the entire position would be slightly less than break-even, with a net return of ($555 - $1800) = -$1245 return. Note how the short calls have helped to "hedge" the loss on the spot currency somewhat. It's very likely that these calls will expire worthless and allow you to release the obligation, writing against the spot again in the next cycle.

- **Price expires at $14000 or higher:** if the Calls are even one penny ITM at Expiration, the Option will be exercised automatically, or "called away" from you. You will make the same return on the credit received from the calls (.047BTC or $555) plus the capital appreciation of the spot currency ($14,000 - $11,800) = $2200. The net profit will be $2755, for a $2755/$11,800 = 23.3% return on capital.

- **Break-even Point** - if the price drops, where is your break-even point? Since you are receiving a .047BTC/$555 credit, the Spot Currency can lose this amount of value and your loss is still covered by the Options credit. We would find this point by performing this calculation: ($11,800 - $555) = $11245. This means that as long as the price drops below our starting point of $11800,….but not below $11245, then our loss is covered by the income brought in by selling the Calls.

Covered Call Characteristics

Let's summarize the characteristics of what we've learned so far about Covered Calls:

- **Price Sideways:** If the price goes sideways between when we sell the Calls....and Expiration....then we keep the Spot Currency and keep the Call Option credits, assuming that the short Call Option was OTM to begin with.

- **Price Higher:** If the price goes higher, but below the Call Option strike by Expiration, then we still keep the Call Option credits and we enjoy a modest gain on the Spot Currency value, which we still keep.

- **Price Much Higher:** If the price goes much higher, then we keep the Call Option credits, but we will have to surrender our Spot Currency unless we buy back the Call Option by the end of Expiration Day to release our obligation. Buying back the short Call can be relatively expensive because they will have gained a lot of intrinsic value by then, which is offset by the Spot Currency price gain.

- **Price Lower to Break-even:** If the price goes lower by Expiration, we are protected against downside losses on the Spot Currency by the amount of the Call Option credit.

- **Price Much Lower:** If the price goes below the break-even point of the trade, you will still take "paper" losses on the value of the Spot Currency. There is no risk of assignment if the share price declines since the Call Options are now OTM. Although you still earned income on the asset through your short Calls, your Spot Currency value might be well below the ability of the short Call Option to protect it.

When Should We Use Covered Calls?

Covered Calls are not a good strategy for extremes; if the price bolts higher right after selling the Calls, you will lock in a profit but cap your potential gains. If the price drops, you will gain some measure of downside protection but usually not enough to make up for a big decline.....you will earn immediate income from the profit on the short Call but you will also lose more than that in the drop of the value of the underlying Spot Currency.

Covered Calls are best set up as a strategy for flat-to-somewhat bullish markets. They are NOT a strategy to play if the Crypto Market is in a primary Bear Market. Your long Spot Crypto position will be swimming against the tide. Your short Calls will benefit for the most part as the price continually runs away from them, however Bear Market rallies can be very sharp and severe. There's no question that Bear Markets are more difficult to trade in many different ways, so I would definitely look to lighten up your "long" exposure instead of using Call income to offset the price reversion.

My personal opinion is that this strategy is best used with Spot Currencies that you already own in a portfolio, you have no intent on selling them, and you would like to create an income stream by collecting "rent" against them.

I would advise against doing a "buy write" strategy where you simultaneously buy the Spot Currency and then write the Calls against them; there are more efficient trading strategies.

We've also shown how adding, or "covering" the short Call Options with underlying Spot Currency...has turned a bearish short Call Option trade (Naked Calls) into a neutral-to-bullish trade.

Let's put everything together by listing a suggested rule set.

Suggested Trading Rules for Covered Calls

If you have never traded Covered Calls before, then this is a perfect time to experiment with them using your broker's "sim" interface. (such as test.deribit.com) If you intend to use this strategy against some Spot Currency that you already own, then set up an equivalent simulated position with your broker and practice selling Calls against the position every month. Don't be in a rush to trade them live until you have demonstrated positive results through several iterations in your Strategy Development cycle.

Offensive Rules (establishing the position)

- Check to make sure that the Spot Currency is Optionable; not all of them are. At this time only Bitcoin and Ethereum have listed Options, and not on all exchanges.

- You will either sell Calls OTM or ATM; if you go too far OTM then it's unlikely that you'll be called out, but the credit for selling the Calls is negligible. Your largest equivalent credit will be found ATM, but selling ATM carries a higher risk of being exercised or "called away" from your Spot Currency.

- The further in time that you sell the position, the more credit that you will receive, yet the more risk that you will take of the Spot Currency moving strongly towards or against your position. A suggested timeframe is 4-6 weeks to start with.

- Sell one contract of Call Options (sell to open) for every "unit" of Spot Currency that you already own. Some brokers may allow you to sell fractional contracts against equivalent fractional spot units.

- The underlying Spot Currency must be in a primary long-term uptrend, or at the very least flat, for me to consider selling Calls against it. I will judge long-term trends by the Weekly trend price action, as well as whether the 50 day moving average is above the 200 day moving average. I do not want to be fighting the trend with this strategy and typically do not stay in long Spot Currencies if we are in a primary Bear Market.

- One challenge with selling Covered Calls against a set position of Spot Currency is that you cannot sell more than one month's worth of Calls against the same Spot Currency position. In other words, if you have 1 BTC, you cannot have both Calls sold against the Spot Currency in the June cycle and then overlap it with the July cycle. You have to wait until the June Options expire (or are closed) before selling the July Calls, and in lower-volatility conditions, four weeks of time value doesn't provide much of a credit. One way to alleviate this is to split the spot position into two positions and then overlap the months against half of the position; in other words, sell Calls against half the spot for June, and sell July Calls against the other half. When the June Calls expire OTM, then you can leapfrog to the next month and sell August Calls.

- I will typically look for the price to be up against resistance and showing weakness before I sell the Call Option. I can even wait for the price action to show a "lower high" indicating that the price is about to go into a consolidation zone for a period of time, or possibly even a trend reversal. In upcoming modules in this program we'll discuss how the charts and "energies" play a role.

Defensive Rules (maintaining the position)

- Your defensive rules depend on whether you want to keep the Spot Currency, or don't care if it's called away. Determine this ahead of time; the answer depends on your long-term interest in owning that specific Spot Currency as well as your original Cost Basis. (What you originally paid) If my cost basis is well above what I would receive for the trade should the Spot Currency be called away, then I will manage the trade so as to prevent that occurrence if possible.

- If the Spot Currency declines, then you should generally leave the position alone as Spot Currencies will fluctuate quite a bit during a 4-6 week period.

- If the Spot Currency climbs in price, then your action will depend on whether you can or cannot let it be called away. If you can NOT let it be called away, then you might consider buying back the short Call Options at a small loss and then establishing a new short Call Option at a higher strike price, further out in time. This is called "rolling out" the Options position.

- If your Call Option is deep ITM, then you run a higher risk of being exercised on your Spot Currency.

- In the event of a large decline in the Spot Currency price, causing you to think about closing the entire position, you may not sell the Spot Currency before first clearing your Options position by "buying to close" the Calls.

- If the short Call can be bought back for a very small debit with a week left before Expiration, you might consider buying back the short Call to release your obligation and sell the next cycle of Calls against the "back" month, especially if the price is fairly close to being "in the money."

Homework and Next Steps

Please complete the following tasks before moving to the next module:

- [ ] Watch the associated video for this module.
- [ ] Take the quiz for this module.
- [ ] In a virtual trading interface, set up at least two different “covered call” positions against simulated spot currency. How difficult is managing this position?

Final Thoughts on the Covered Call Strategy

What we've shown so far is that selling Naked Calls looks like a great strategy, but that whole "unlimited risk" concept is not something that you can get away with for a long time without some serious risk management skills. Everyone has heard about the group of traders in the pit...or the group of airline pilots....or the weekend investment group that did multiple months of consecutive profits selling Naked Options, until they had one bad month that wiped it all away. We're not going to go there.

So we brought up how we can "cover" this naked Call with some long Spot Currency. That created a much more conservative, risk-adjusted trade. It's just not very nimble, however. It truly is like owning an apartment building. You can collect monthly rent, but you are forever chained to maintaining that monstrosity. And managing a large Spot Currency position can feel much the same way through all of the ups and downs that the market challenges us with. And a long Spot Currency position is vulnerable to downside moves that the short Call Option can only help so much with.

As I mentioned before, the ONLY time that I will trade Covered Calls....is when I already own the Spot Currency. And one of the ways that I might own the Spot Currency is if I'm assigned the Spot Currency when I sell a Cash-Secured Put Option! This is the "ping-pong" strategy that uses Short Puts to sell until you are finally assigned (acquiring real estate) and then once you become a spot owner, you can then become a "landlord" by renting out your spot currency.