



What is a buy-write option strategy?

John Coker

A buy-write option is a strategy that involves an investor buying a stock and at the same time selling a call option on it. This strategy is the same as a covered call with the only difference being that both the long stock position and the short call option are opened at the same time. The long stock position acts as a form of collateral in case the call option is ever assigned [that is, exercised or there is an obligation to sell] against the seller before the expiration date.

Buy-writes require a moderate level of risk tolerance. This is because the maximum potential loss is the entire value of the stock purchase *less* the premium received from the option sale. If the stock price declines after entering a buy-write, the sale of the call option provides limited downside protection to offset any capital depreciation.

Investors whose investment objective is to generate income may utilise a buy-write option strategy to collect premiums from the sale of call options.

While buy-writes can produce returns that outperform a buy-and-hold stock strategy, they also cap the upside profit potential of the stock throughout the duration of the option. This is due to the obligation of the option seller, who must sell shares of the stock if it reaches the strike price by the expiration date. Investors who utilise a buy-write option strategy would ideally have a slightly bullish-to-neutral outlook with a price target below the call option's strike price.

A buy-write in action

An investor anticipates that the stock price of ZAH will go up in the short term but not beyond a certain price. They simultaneously purchase 100 shares of ZAH at \$9 in addition to selling a call option of ZAH at the \$13 strike price with two months until the expiration for a premium of \$1.

The investor now holds the following positions:

- Long 100 shares of ZAH stock bought at \$9
- Short 1 ZAH call option at the \$13 strike price with 2 months until expiration date for a premium of \$1

The maximum profit per option is the difference between the strike price of the option and the purchase price of the stock plus the premium collected from the option sale multiplied by 100 shares.

Maximum profit = (strike price of option – stock purchase price + premium) x 100 shares

$\$500 = (\$13 - \$9 + \$1) \times 100 \text{ shares}$

The maximum loss is the stock purchase value less the premium received multiplied by 100 shares.

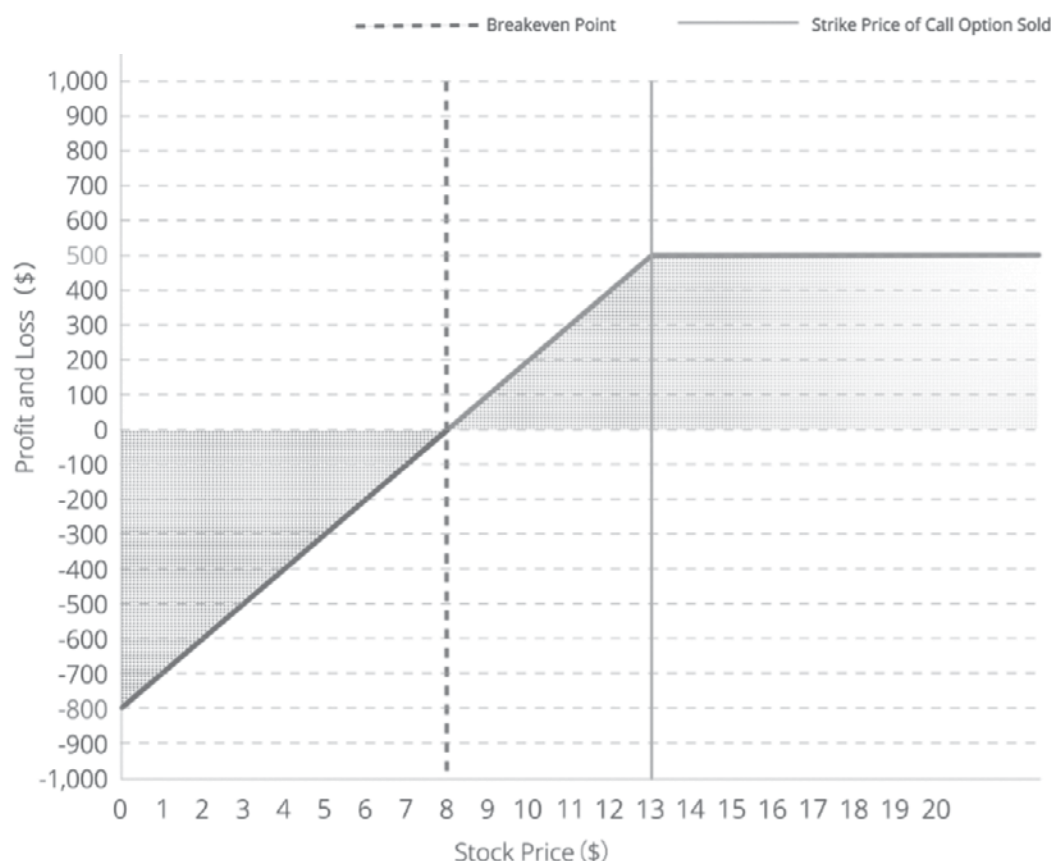
Maximum loss = (stock purchase price – premium) x 100 shares
 $\$800 = (\$9 - \$1) \times 100 \text{ shares}$

The breakeven point is the stock price less the premium received, multiplied by 100 shares.

Breakeven price = (stock purchase price – premium)
 $\$8 = \$9 - \$1$

The profit and loss of the buy-write option strategy at expiration date is depicted in Figure 1 on the next page.

Figure 1. Profit and loss of buy-write option strategy at expiration date



Source: Webull Financial LLC

Figure 1 shows the potential profit and loss on the y-axis versus the corresponding stock price in the x-axis at expiration date.

If ZAH trades up to \$13 and beyond, the investor will make \$500, which is made up of \$400 from the stock price appreciation plus the \$100 from the sale of the call option. Conversely, the maximum potential downside risk is \$800. This comprises the \$900 loss if the stock price goes to \$0 less the \$100 premium made from selling the call.

At any point, if the stock trades above \$13, the investor may possibly be assigned, and obligated to sell the 100 shares of ZAH. If, however, the stock stays between \$8 and \$13, the investor earns a profit with a slightly higher return than if they had not sold the call option.

The same holds true that if the stock falls between \$8 and \$0, the premium received from the sale of the call option will offset the losses of the stock investment in ZAH by \$100.

Risk and return profile

Before diving into the benefits of the buy-write strategy, it is essential to understand its mechanics. Let us explore the risk and return profile in the following example.

Suppose a person has 100 shares of ABC stock in their portfolio currently trading at a price of \$50. They want to use a buy-write strategy on their 100 ABC shares to collect the premium. After some research, they decide to sell one \$55 21 October 2023 call for a premium of \$3.00. Table 1 on the next page shows how the portfolio is affected by this strategy at several different stock prices on the expiration date.

If the call is not exercised, they keep the stock and the premium collected, so the value of this position in their portfolio is calculated by adding the stock value and premium proceeds.

If the call is exercised, the person, as the call seller, will deliver shares at the strike price of \$55. The position's value would then be calculated using the strike price (the price they receive for the shares) plus the premium (the price they received for selling the contract) times 100 shares (the standard deliverable of an options contract). In this case, the strike of \$55 and the premium of \$3 add up to \$58 per share, meaning the total value of their position is \$5800.

From the data above, we now have a very clear picture of how the sold call works:



John Coker,
Webull
Financial LLC

John is a registered options and security futures principal in the Compliance department at Webull Financial LLC. With over a decade's worth of experience in the trading business, his aim is to empower investors through education, best-of-class tools, and low-cost trading.



The quote

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Table 1. Portfolio return profile

Stock price (\$)	Action on expiration	Option proceeds (\$)	Total portfolio value (\$)	Stock return	Covered call return	
44	Not called	300	4700	-12.00%	-6.00%	
46	Not called	300	4900	-8.00%	-2.00%	
47	Not called	300	5000	-6.00%	0.00%	← Breakeven point
50	Not called	300	5300	0.00%	6.00%	
53	Not called	300	5600	6.00%	12.00%	
55	Called	300	5800	10.00%	16.00%	
56	Called	300	5800	12.00%	16.00%	
58	Called	300	5800	16.00%	16.00%	
60	Called	300	5800	20.00%	16.00%	← Opportunity cost of \$200
62	Called	300	5800	24.00%	16.00%	← Opportunity cost of \$400

Source: Webull Financial LLC

Figure 2. Buy-write performance in different market conditions



Source: Webull Financial LLC

- If the stock price is below the strike price, the call will expire worthless, and the person keeps the entire premium. After that, they can repeat the buy-write process all over again to produce a *cash flow stream* as long as the call is not assigned (that is, there is no obligation to exercise or sell).
- When the stock price decreases slightly, the buy-write provides *limited downside protection*. Compared to just owning stocks, the premium received brings the breakeven point down, from \$50 to \$47, reducing risk. It will not effectively hedge against more significant downturns.
- A buy-write can *outperform the underlying security* as long as the stock price stays below the level of the strike price plus the premium through expiration.
- The buy-write strategy will help increase portfolio returns on stocks that have slight price increases. However, *upside potential is capped*. The seller of the

call cannot profit more than the amount of the premium received. If the stock price increases to exceed the strike price plus the premium, the opportunity to sell the shares at those higher prices is lost. The higher the stock price, the more *opportunity cost* incurred.

Performance in different markets

As mentioned, the buy-write strategy can be most effective under bullish-to-neutral market conditions but comes with its trade-offs. Figure 2 summarises how a buy-write strategy performs in various market conditions.

Bull market

A buy-write strategy can be helpful when the stock price is rising. The seller will keep the premium as income and profit from stock appreciation. If, however, the stock price increases beyond the strike price of the call option, the strategy begins to incur an opportunity cost of forgone profits.

Sideways market

When the stock price trades within a relatively small range, indicating no clear upward or downward trend, a buy-write strategy can be a powerful tool to benefit from the time decay effect [where the value falls over time]. The buy-write strategy will outperform the market since the seller earns an additional return from the sale of the call option.

Bear market

If a stock price decreases slightly, the buy-write strategy will provide limited downside protection to a portfolio due to the income generated from the sale of the call option. However, any significant downturn is likely to outweigh the received premium. If someone plans to hold the shares even in a bear market, the premium will only generate a small gain to offset the falling prices. Overall, the buy-write strategy is not optimal for those with a bearish outlook.

The bottom line

A buy-write strategy can make a difference to a portfolio, especially for a bullish-to-neutral-investors. **FS**

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