Kurvature Perspective

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June 17, 2024

Finding the Right Remix for your Covered Call Strategy

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When new pop songs hit the top of the music charts, electronic music fans know that a wave of remixes of those top hits will ultimately follow — the modern version of theme and variations, if you will. DJs create these remixes by using a controller board, which contains many dials to adjust the music's tempo, volume, and pitch. When a DJ is able to turn a set of dials just right and find the perfect balance between all the components, a remix may even become better than the original.

Since the pandemic, a dizzying number of covered call ETFs (the variations) have been launched to help investors generate alternative income. Covered call strategies are used by ultra-high-net-worth investors to generate additional income in their portfolios. The basic strategy (the theme) is for the investor or their advisors to write or sell out-of-the-money call options on a stock position with low price appreciation potential in the portfolio. In exchange for writing the call option, the buyer of the call option pays the investor an amount (or premium) that is a form of alternative income and is accretive to portfolio returns if the call option expires out-of-the-money.

Most covered call ETFs remix this basic strategy, largely with three dials to adjust. However, adjusting these dials requires certain tradeoffs. Investors in covered call strategies should be aware of these tradeoffs and find the best strategy for their portfolio.

The three key adjustments for a covered call strategy are:

1. **Option expiry and contract rolling**
2. **Option out-of-moneyness**
3. **Option notional**

Dial #1: Option expiry

Unlike stocks, option contracts have an expiry date. Managers can dial the expiry from 1-day to 1-week to 1-month or even longer to beyond 1-year. The shorter tenure allows the manager to write more calls to generate option premiums within a period. Similarly, longer tenure reduces the number of options that can be written in the same period. For example, weekly options can be written 52 times a year. Monthly options can be sold 12 times a year.

However, being able to write more call options does not necessarily mean the strategy will generate more option income. Recall that the call options need to expire out-of-the-money in order to harvest the option premium fully. Writing more options contracts may actually statistically reduce the yield of the overall strategy. We can demonstrate this with a simple example. Writing a call option that is about 5-7% out-of-the-money on a monthly basis (or 2-3% on a weekly basis) has an 80% chance of expiring out of the money. Below is the table probability of having every option contract expiring out-of-the money:

Expiry	Distribution Yield	Probability to be 100% right	Trading cost
Weekly	19.8%	0.0%	5.2%
Monthly	9.3%	6.9%	1.2%
Annually	2.5%	80.0%	0.1%

Based on 0.2 Delta strikes, 25% implied volatility and 5 bps cost.

Source: Kurv

Additionally, short option contracts require more trading, which also increases trading costs.

Trade-off:

Writing Frequency	Yield	Probability of success	Trading cost
More frequent	Higher	Lower	Higher
Less frequent	Lower	Higher	Lower

Source: Kurv

Kurv currently writes 5-6 weeks options contracts and rolling them monthly. We feel this offers a good balance between successful income generation and trading costs.

Dial #2: Option out-of-moneyness

The second dial is how close or far to set the strike price of the call options to the current price of the underlying stock (spot price). The closer the strike is to the spot typically the higher the premium, hence higher option income. However, the trade-off is that the ability for the ETF to appreciate in price is also lower. Oppositely, the further away the strike price is from spot, the less premium, but there is more room for the stock to appreciate in price.

Moneyness	Yield/value	Price appreciation
Closer to Stock Price	Higher	Lower
Farther to Stock Price	Lower	Higher

Source: Kurv

Kurv believes the current sweet spot for option strike is between 5-15% away from the spot. This allows a good balance between income generation and price appreciation.

Dial #3: Notional of Option Positions

The last dial is the notional amount of covered calls a manager can write against the underlying position. A manager can maximize income generation for a $100 stock position by writing $100 of covered calls. 100% of the upside price appreciation for the stock is capped. If the manager only wrote $50 worth of covered calls (less premium or alternate income generated), only 50% of the upside is capped, leaving the remaining 50% with unlimited upside potential.

For Kurv, we aim to balance income generation with price appreciation. We look to write call options that are slightly out-of-the-money to allow for some price appreciation while rolling options on a monthly basis to generate good quality option income without incurring unnecessary trading costs. By optimizing these trade-offs, our strategies might just be the right remix for your investment portfolio.

For any questions or comments, please reach out to us at **info@kurvinvest.com**

Definitions:

Covered-Call: The term covered call refers to a financial transaction in which the investor selling call options owns an equivalent amount of the underlying security. To execute this, an investor who holds a long position in an asset then writes (sells) call options on that same asset to generate an income stream. The investor’s long position in the asset is the cover because it means the seller can deliver the shares if the buyer of the call option chooses to exercise.

Ultra-high-net-worth: people with investable assets of at least $30 million

Expiry date: The last day that an options or futures contract is valid

Out-of-moneyness: The state where an options contract does not have any intrinsic value; only extrinsic, or time value.

Strike price: A fixed price at which the owner of the option can buy or sell the underlying asset; also referred to as exercise price

Spot price: The current price at which an asset can be bought or sold for immediate delivery

Notional Amount: Notional value is the total value controlled by a position or obligation

Rolling: An options trading strategy in which the investor closes an existing position while simultaneously opening a new position at a different strike price / expiry date.

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