

6.5 Six percent a month

On Saturday mornings in my local area, there is an AM radio program featuring a particular investment strategy that the hosts (sponsors) assert can and has earned six percent per month for clients. As best as I can tell from the description (the listener is advised to call in or attend periodic seminars for more information), the basic strategy is covered call writing. While there are many advocates and devotees of the covered call write strategy, six percent per month sounds extreme. Accumulated over the course of a year, this implies pre-tax returns of 100%. What is the likelihood that a covered call writing strategy can earn these returns? And if this likelihood is small, what is the justification for the claim?

Suppose the strategy is as follows (again, I'm not sure that this is exactly the strategy proposed by the radio hosts, I have not taken the seminar): at the start of every month we take our portfolio of stocks and for each stock seek to find a one month call option with premium equal to six percent of the current value. Since there are a variety of strikes for each stock, there probably will be a strike with premium fairly close to the six percent target. Naturally, for stocks that are not very volatile, the strike may have to be deep in the money. Even for volatile stocks, the strike is likely to be at least slightly in the money. Anyway, after identifying the strike, we short one call for each share we own. At the end of the month, if the stock price winds up above the strike, the calls will be exercised. In this case, we take the proceeds from the sale and reinvest in the same stock and write more calls at the start of the next month. The monthly return will be six percent less the percent discount of the strike to the initial price. If the stock price falls and the call is not exercised, then at the start of the next month we again seek to find a call with premium near six percent of the (now lower) stock price. Naturally, the strike for the second month's calls will be lower than it was for the first month's calls.

What is the likely return over time of this strategy? It is true that each month the strategy earns option premiums of approximately six percent of the value of the portfolio. But in the case of a falling stock price, the total return is less than six percent (including depreciation of the value of the stock) and the subsequent month's six percent will be on a lower balance. If the stock price rises and the calls are exercised, the total return for the month will depend on the strike. If it was at-the-money then the proceeds from the exercise and the call premiums do provide a six percent return. But this is a fairly unlikely scenario inasmuch as there are very few stocks that are so volatile that at-the-money or in-the-money one-month strikes are selling for a premium of six percent of the stock price. More likely is the case that proceeds from exercise combined with the option premium amount to less than six percent.

This strategy will most likely not deliver a total return of six percent per month. If you focus purely on the option premium earnings, the six percent a month claim may be reasonable. But

this is not total return. In order to evaluate the program it is important to evaluate its performance over a variety of stock price scenarios and keep track of the total value of the portfolio in each scenario. This analysis should be done but may not be provided by the product vendor. Investors must do it themselves or rely on a third party independent expert.

This lesson has broad applicability. Financial products are often quite complex and it is difficult to fully identify potential benefits and risks. The vendors generally have informational advantages and may choose to paint a rosy picture of the likely outcomes. It is important for consumers to learn to ask the proper questions or carry out the analysis to accurately assess the costs, benefits and risks of a particular product. Lacking sufficient expertise to do this, it would be desirable to have access to third party experts to provide independent assessments. Naturally, financial planners can fill this role. But you have to know enough to identify an appropriate advisor.

Another potential source of such information is regulatory consumer protection. For example, a stated goal of the new Consumer Financial Protection Bureau¹ (CFPB) is to promote simplicity and transparency in financial products (the primary focus of the CFPB appears to be credit and deposit products, not investment products). The plan to achieve simplicity and transparency includes restructuring mandatory disclosures to be shorter and easier to read and understand. Perhaps the CFPB mission will be expanded to include product testing. Stress testing products to assess their resilience under a range of economic scenarios is a way to improve transparency.

Ultimately, the best solution is for the consumer to develop a level of financial sophistication and expertise. Toward this end, the Dodd-Frank Wall Street Reform and Consumer Protection Act (DFWSRACPA) mandated creation of the Office of Financial Education (OFE). According to Ms. Warren, the OFE will develop and improve educational materials and create tools that “enable consumers to understand and assess the total costs and potential risks of different products.” It is not clear whether the OFE will cover investment products, or if that responsibility will remain with the SEC. Either way, the stated mission of the OFE seems a worthy one.

¹Testimony of Elizabeth Warren before the House Subcommittee on Financial Institutions, March 16, 2011.