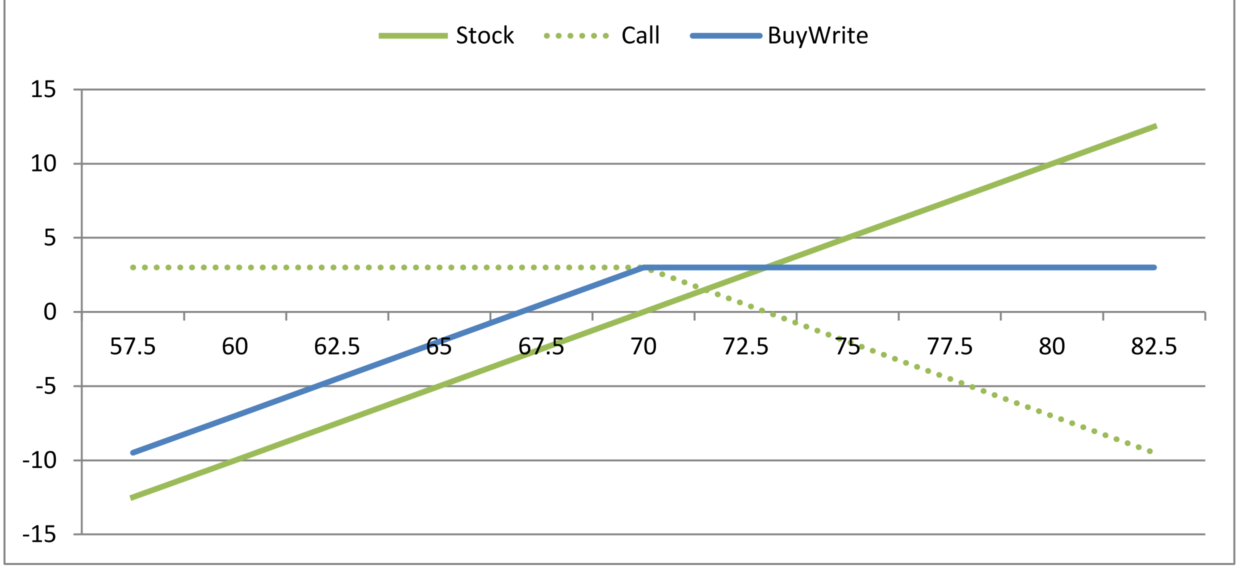
DENNING PRYCE

# Buy-write discussion

A buy-write, or covered call, is one of most common option strategies traded in the market today. The strategy involves buying a portfolio of stocks, and then writing call options against the holdings.

The written (or sold) call option generates premium that cushions losses and may boost income payout. However, as per Figure 1, this cash premium comes at the opportunity cost of forfeiting part of any potential gain - should the share price rally beyond the strike price of the option.

**Figure 1 - Buy-Write Payoff (3-Month covered at-the-money call at $70)**

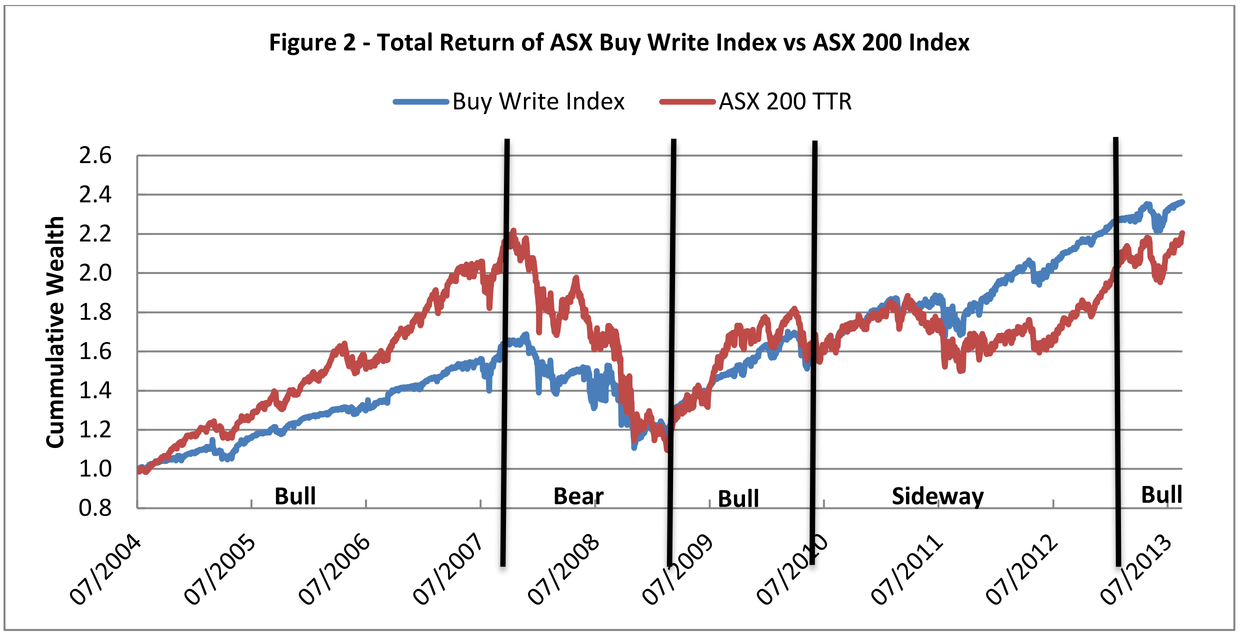



As the written call dampens both upside and downside outcomes, the buy-write strategy as a whole tends to be less volatile than a long-only portfolio.

Low volatility characteristics may make buy-write strategies suitable for a conservative investor who seeks stability of asset base in order to sustain future income. For such an investor the need for capital preservation may well be as important as the given level of current income.

Certainly no strategy works in all environments. Buy-writing has the tendency to lag in bull markets – yield from written option premiums diminishes during bull markets due to subdued volatility and capital gain may be eroded by option loss.

As bull markets generally run more slowly but for longer periods than bear markets, at times buy-write investors may have to bear a significant period of relative underperformance. An example would be the period between Jan 2005 and Oct 2007 (Figure 2).

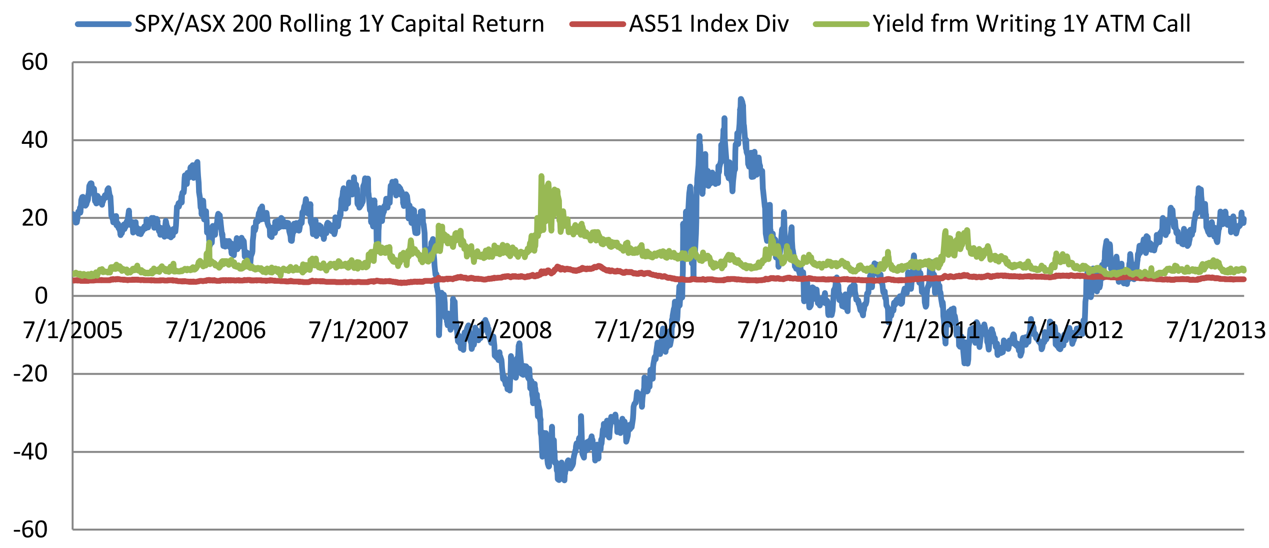



In the long run, however, empirical performance figures (again, Figure 2) suggest that from a risk-adjusted perspective buy-writing is superior to holding an index portfolio, as well as comparable in total-return terms over economic cycles.

Conventional income strategies based on dividends and coupons can expose investors to a high degree of interest rate risk. An increase in interest rate will lead to higher future yield but may result in capital erosion of existing income portfolio assets.

As Figure 3 shows, the anatomy of a buy-write strategy is such that its total return encompasses elements of capital return, option premium and dividend yield. It is of interest to note that the dividend yield is susceptible to rate movement risk, and that the call option premium exposes the portfolio to volatility as an alternative income source.

**Figure 3 - Buy-Write Return Decomposition**




Since equity volatility pricing tends to move in the opposite direction to equity market performance, large capital losses may often be offset by higher premium income harvested from the selling of higher volatility, smoothing the total return of the portfolio.

From an implementation point of view, buy-writing does not require leverage or the managing of alpha to deliver higher than average income returns.

Conceptual simplicity makes buy-write a viable strategy to be either applied stand-alone or blended with other approaches. In recent years markets have seen a proliferation of buy-write application under the “equity income” banner in both the active and enhanced-passive product space. Regardless of style, execution of a pure buy-write strategy may be too mechanical to deliver its full potential. The unique Australian option *liquidity* landscape can be challenging, and needs to be addressed at every stage of the investment process. In addition, the backdrop of Australia’s *dividend imputation* system and *tax regulations* warrant a tax-conscious investment approach. These aspects are often difficult to address through a mechanical buy-write only approach.

Denning Pryce operates a broad, diversified portfolio, with a flexible and active approach to option strategy selection.

Investors value different components of risk differently. By tailoring risk and reward strategies to specific client profiles, we can deliver return objectives with appropriate levels of risk.

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