

Geared Investments Covered Call Case Study

What is a covered call?

A covered call is an Exchange-Traded Options strategy that can be used to generate additional income from securities you already hold, including those held through an investment loan. The strategy involves selling (writing) a call option, which gives another party the right to purchase those shares at a fixed price (the strike price) within a specified timeframe (up to the expiry date).

If the share price of the underlying security rises above the strike price, the options become 'in the money', increasing the buyer's likelihood of exercise. Should this occur, the investor sells the share at the strike price, retains the premium, but does not benefit from any gains above the strike price.



Why do investors use this strategy?

Covered calls can enhance returns and improve cash flow without requiring additional capital. When combined with a Geared Investments Loan the benefits can include:

Earn additional income

The premium received for writing the call option provides cash flow, which can boost overall portfolio returns.

Offset borrowing costs

Premium income can help cover interest charges on a Geared Investments Loan or even reduce the outstanding loan balance.

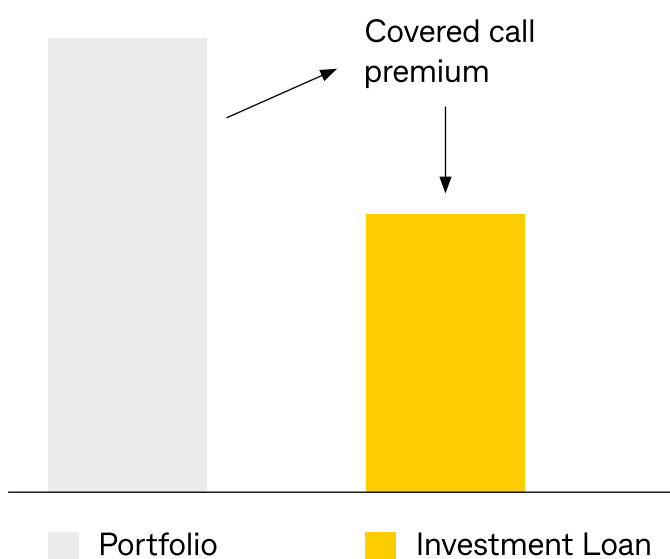
Retain share entitlements

While the Call Option position is open and the shares remain in your name, you continue to receive dividends and franking credits, provided you hold the shares through the record date.

Set a target exit price

Writing a call effectively pre-defines a sale price (the strike price), which can help investors plan and manage their portfolio more strategically.

Receive covered call premium into the investment loan



When might it suit?

Covered calls can be effective when:

- You expect the share price to remain flat or rise modestly.
- You are comfortable selling at the strike price if the option is exercised.
- You want to generate income now rather than speculate on large future gains.
- You are looking for a way to potentially reduce the cost of borrowing from a Geared Investments Loan.

When may it not suit:

- If you expect significant upside and don't want to cap gains.
- If you need full liquidity and cannot risk early assignment.
- If you are uncomfortable with options mechanics or margin obligations.

How it works

Step-by-step instructions on how you may be able to implement a Covered Call strategy over shares held in a Geared Investments Loan:

1. Own the shares: Either you already hold the shares, or you purchase the shares via a Geared Investments Loan.
2. Choose strike price and expiry:
 - Strike price: The price at which you agree to sell the shares if exercised.
 - Expiry date: The last day the option can be exercised.
3. Write the call option: You sell the option contract to a buyer.
4. Receive the premium: This is credited to your Geared Investments Loan.

5. Know the break-even price: Purchase price of the shares – premium received.
6. At expiry (or earlier):
 - If the *share price is below the strike price*, the option usually expires. You keep the shares and the premium.
 - If the *share price is above the strike price*, the buyer will likely exercise. You sell the shares at the strike price and keep the premium.

Key terms explained

- Contract size: Typically, 1 option contract = 100 shares.
- Premium: The income you receive for writing the option.
- Assignment: Your obligation to deliver shares if the buyer exercises.

Illustrative example

Ashley buys 5,000 XYZ shares at \$24.00 each, partly funded by a Geared Investments Loan.

Inputs	Value
Shares purchased	5,000 XYZ @ \$24.00
Total cost	\$120,000
Investment Loan LVR (Gearing ratio)	70%
Ashley borrows	\$84,000
Ashley contributes	\$36,000
Investment Loan interest	\$1,995 (3 months @ 9.5% p.a.)
Covered Call Strike Price	\$25.00
Expiry Date	1 February (3 months' time)
Premium	\$0.75 per share (\$3,750 total)
Breakeven price (XYZ price)	\$24.00 - \$0.75 = \$23.25

Risks to consider

Capped upside

If the share price rises significantly above the strike, you forgo any gains beyond that level.

Early assignment

The option buyer can exercise before expiry, particularly around ex-dividend dates or corporate actions – this is only applicable for Options with an American expiry style.

Market downside remains

If the share price falls, the premium provides only a partial buffer against losses.

Complexity and monitoring

Options trading requires a sound understanding of its structure as well as ongoing oversight to manage expiry dates, assignment risk, and market movements.

Let's look at the potential outcomes at expiry, including a scenario where Ashley had a Covered Call:

XYZ price @ 1 Feb	Covered Call	Option exercised?	Share sale proceeds	Premium received	Interest paid	Net result vs. contribution*	Summary
\$24.00	Yes	No	-	\$3,750	\$1,995	\$1,755	Premium offsets interest; small positive return despite flat price.
	No	-	\$120,000	-	\$1,995	-\$1,995	No premium; interest cost creates a negative return.
\$25.00 (Strike price)	Yes	Yes	\$125,000	\$3,750	\$1,995	\$6,755	Shares sold at strike; premium boosts return; upside capped.
	No	-	\$125,000	-	\$1,995	\$3,005	No premium; return is positive but lower than covered call outcome.
\$28.00	Yes	Yes	\$125,000	\$3,750	\$1,995	\$6,755	Significant rally, but capped upside.
	No	-	\$140,000	-	\$1,995	\$18,005	Full upside captured without call; no income protection if price falls.

*Net relative to the investor's initial \$36,000 contribution after repaying the \$84,000 loan and \$1,995 interest.

Example summary:

- *Covered Call* benefits most outcomes when the share price is flat or modestly higher (e.g., \$24.00 or \$25.00).
- *Premium income* (\$3,750) helps to offset interest and adds to returns, even if the share price does not rise.
- *Upside is capped* at the strike price (\$25.00) – if the share price rallies to \$28.00, the Covered Call return (\$6,755) is far lower than the no Covered Call scenario (\$18,005).

Key takeaways – Why Covered Calls and Geared Investments Loans can complement each other

Ideal in flat or mildly bullish markets

Covered calls are usually most effective when share prices are expected to remain stable or rise modestly. In these conditions, the premium income becomes a meaningful contributor to overall return.

Premium income offsets borrowing costs

When shares are purchased through a Geared Investments Loan, interest costs can erode investment returns. Writing covered calls generates additional cash flow that can:

- Reduce interest expenses.
- Lower the effective cost of holding the position.

Defined exit strategy with income

Writing a call sets a clear sale price (the strike price) while delivering additional income. This can be particularly useful for investors who:

- Want to create an income stream from their existing holdings without selling immediately.
- Are comfortable exiting at a pre-agreed price if the market rises.

Upside trade-off

Gains above the strike price are capped. If the share price rallies strongly, the covered call strategy will underperform simply holding the shares. This is the cost of gaining the premium income.

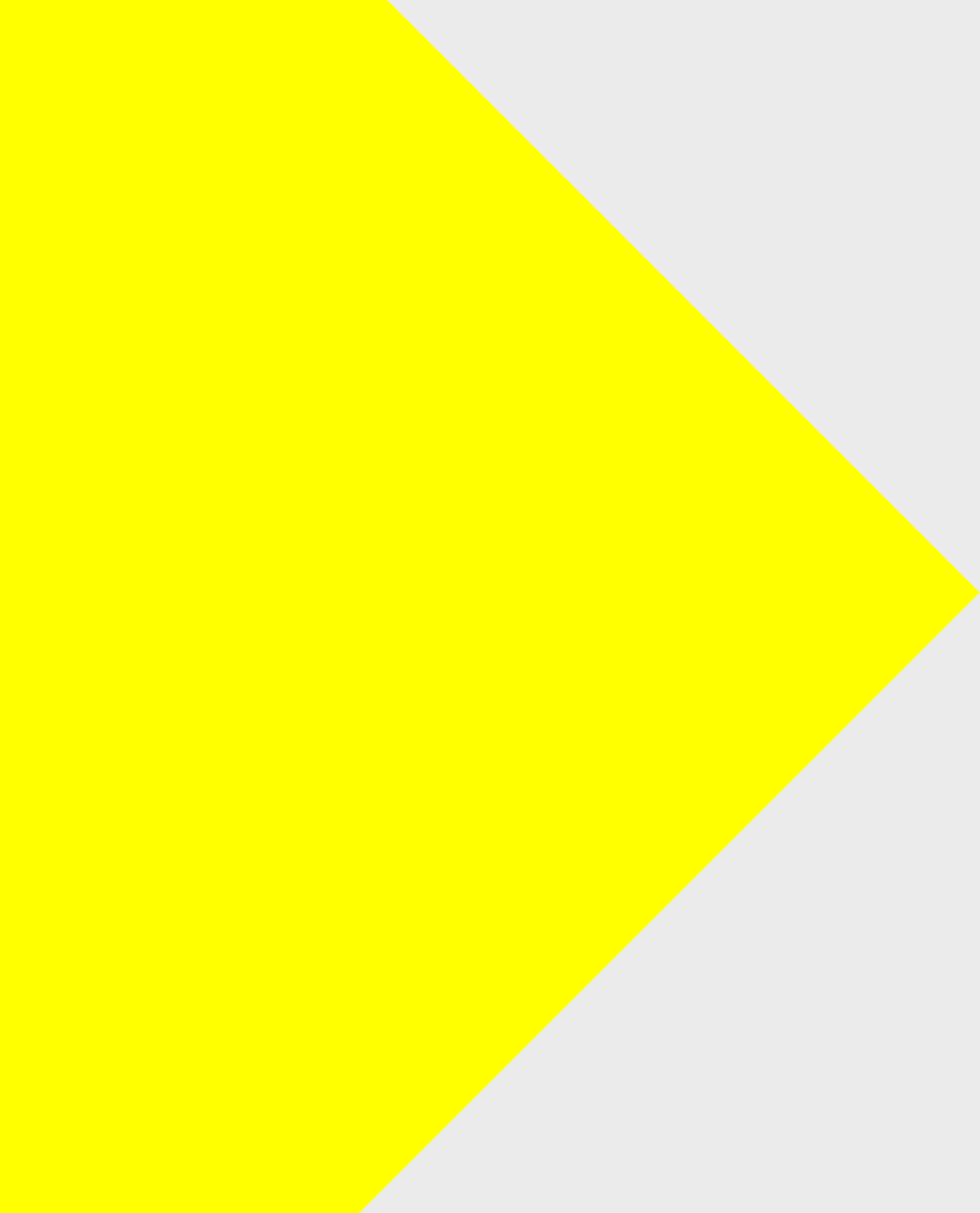
Leverage and income

Covered calls generate extra income that can offset borrowing costs, making investment loan strategies easier to manage in flat markets.

Active management required

Investors must monitor:

- Assignment risk, especially around ex-dividend dates.
- Market movements, which may require moving out or adjusting positions.
- Loan-to-value ratios, as margin calls remain a risk if prices fall.



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