



May 29, 2020

*“School’s out for summer...”*

— Alice Cooper, 1972

There it is: the inevitable sign that summer is upon us. According to legend (and Wikipedia), Cooper was inspired to write that song after being asked to relate “...the greatest three minutes of your life.” One of his responses was *the last three minutes of the last day of school*.

So here we are. School is about to be out and we can probably all agree it has an atypical meaning this year. School 2020 was different. This school-year end isn’t leading kids (or adults) into the conventional summer activities, and we are finding we each have our own story of what it all means in this new world. The more we connect with you, the more we understand everyone has a different, very personal story.

And like everyone’s unique circumstances, your individual portfolios are managed in a way unique to your own situation. As we temporarily reach out in this new format in our attempt to relay topical, educational, and informational pieces, we recognize not all topics will speak to each of you. We will do our best regardless. Though they will not all make it into one of our widely distributed communications, we do appreciate the ideas we get from you as we work through issues and address your good questions. Keep ’em coming.

### **Dark Science: Covered Calls 101**

At some point over the past few weeks it occurred to us that we had a captive audience. And an audience that is devoting more time than usual to their computers. Here was our chance to do a not-too-deep dive into an arcane topic, the dark science of selling call options against shares of stock you own. So, if you are not into Dark Science, hit delete. We promise not to hold it against you.

- 1.) *What is a call option?* Calls are instruments that give the buyer the right to purchase shares of a stock at a specified price for a specified period of time. Calls are traded in a “contract,” and one contract represents 100 shares of stock. Obviously, for every buyer, there must be a seller. An option seller, in exchange for payment, agrees to sell their shares to the option buyer at the specified price for said same period of time. Think of this concept as being a little bit like owning a house that you rent for six months but you receive full rental payment up front.
- 2.) *What is meant by the term covered call and how long do they last?* The term “covered” simply means the seller of the option owns outright the shares upon which they are selling the call. In terms of duration, most of the calls we sell range from two to five months.
- 3.) *What does the term “exercise price” mean (also known as “strike price”)?* The exercise price is the price at which the option seller agrees to sell their shares to the option buyer. The exchange on which the option trades sets the exercise prices and dates for the options they trade. We choose among them.
- 4.) *How do we determine when it is an opportune time to sell a call?* Let’s use a real time example to address this question. Last March 16, Gilead traded at \$65 a share. Two days later with the stock up over 10 points on good news re: Remdesivir, we sold the May 75 calls for nearly *11 points* on a

portion of shares you held. If the option was exercised, your sales price would be \$75 plus the 11 points produced by the call option for a total of \$86 a share, a price at which we were willing to sell. On May 15, the expiration date for the call, Gilead closed at just over \$76 a share and your stock was “called away” aka... sold. Your price? \$86. Now, to be fair the “news-worthiness” and volatility of Gilead combined with the highest price the stock had traded at since early 2018 made this opportunity to sell calls as attractive as any we have seen in recent years. This transaction is not easy to replicate.

- 5.) *We often sell calls when a stock is approaching a price where we would otherwise sell it.* Gilead was very much the “it” stock of March and April. And remember the option the call buyer acquired from you was for a very limited period of time. Not only did the price of Gilead have to go up, but it had to do so quickly. In other words, the passage of time is the ally of option sellers and the foe of option buyers. In that sense, a call option is a wasting asset to the buyer and a form of “income” to the seller.
- 6.) *Who gets the dividends and how are the options treated for taxes?* Short answer(s): You keep the dividends, and the gains from the option are taxed as short-term capital gains if they expire or are repurchased. If the stock is called away and we are long term on the underlying stock, the option premiums (as they are called) are taxed as long-term capital gains.
- 7.) *How well does owning a stock with a call written against it fare when a stock goes down?* Less bad but not well. In less spectacular circumstances than Gilead, let’s take a look at a steady stock like Intel. When Intel was trading at \$68 in January, we might have gotten 3 points for selling a 90-day option striking at \$70 a share. In mid-March Intel was trading in the mid-to-upper 40s, a decline of over \$20 a share in less than 60 days. Was the hypothetical \$3 a share collected a panacea? Clearly not. Did it help a little bit? Of course. But the basics of investing over the long haul still requires owning good companies with more money coming in the door than going out, and paying a fair price for that attribute never changes.

And on a closing note — as it relates to new experiences — here at Team Spence we have lived the new meaning of *School’s Out* with our own Shana and her family. Shana’s son is a senior in high school and the family has had to navigate the disappointment of no spring sports (Shana is the ultimate sports mom), no prom, no typical graduation and the cancelation of a celebratory family vacation. Shana has managed the disappointment with grace and worked to make the end of school meaningful for her son. Like Shana, we are all in the midst of struggling through something unique. Let’s hope our choices in navigating these days allows us to smile and feel a sense of pride on look-back. Way to go, Shana. School’s out... .

If you’d like to share a few of the best three minutes of your life, we’d enjoy receiving them ....and we might include a few (anonymously, of course) in our next note.

Stay well,

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