

Comparing the Risk of a Covered Call versus Selling a Naked Put

Example 5.2a³

- E. Covered Call – buy the Stock for \$25 and sell the May 2001 \$30 (Strike) Call for \$0.75.
- F. Naked Put – Sell the \$20 (Strike) May 2001 Put for \$0.75.

	Covered Call (E) (Strike \$30)	Naked Put (F) (Strike \$20)
You Pay / Receive	Stock Price - Call Premium \$25 - \$0.75 = \$24.25 (you pay)	Put Premium received \$0.75 (you receive)
Risk	Stock Price – Call Premium received \$25 - \$0.75 = \$24.25 Risk of \$24.25 is 100% of your total cost	Put Exercise Price less Put Premium received \$20 - \$0.75 = \$19.25 Risk of \$19.25 is more than 25 times what you received for the Put Premium
Maximum Reward	Limited to the Call Premium received, plus the Call Strike Price less the Stock Price paid \$0.75 + \$30 - \$25 = \$5.75 You only receive this maximum reward if the stock price appreciates to \$30 or more at expiration. This represents a maximum return on maximum risk of 23.7% but the stock must reach \$30 at expiration for this to happen.	Limited to the Put Premium received \$0.75 Provided the stock remains above \$20, you will receive \$0.75 as your maximum reward. You didn't have to put any money down for this trade, but you did have to provide liquid funds in your account as margin for the trade. Your return on maximum risk is only 3.9% but the stock has to plummet to below \$19.25 for you to start lose money.
Breakeven	Stock Price – Call Premium received \$25 - \$0.75 = \$24.25	Put Strike - Put Premium received \$20 - \$0.75 = \$19.25
Comment	As you can see, a straightforward comparison can be a little misleading and although these two strategies share the same <i>shape</i> of risk profile, they actually require totally different risk perspectives from the trader. A Covered Call trader will not necessarily fancy Naked Puts and vice versa. The danger with both these strategies is if the stock plummets. For this reason you should never trade them before a major news item is due out on the stock (e.g. earnings). Furthermore, these strategies should only really be played in up-trending markets.	

³ Using real prices for Dell on 6 April 2001