RESEARCH AND COMMENTARY

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Insights for Investors

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Should you use a covered call strategy for income in retirement?

These days retirees and or would be retirees are doing a lot of planning and strategizing on their income and expenses. As the world economy is always changing people need and want to have a plan for the longevity of their health and for their wealth.

Retirement income can come from a variety of sources. Social Security, while never intended to be a pension or

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the sole source of income in retirement is something many have grown to depend upon. Many also worry about the longevity or reliability of Social Security.

We are of the belief that congress will act, as they have in the past to take steps toward those ends. The last real change came about in 1983, when the full retirement age (FRA) was changed from 65 to 67 years old. In short, if you were born in 19860 or later, full Social Security benefits would not be available (you qualify for reduced benefits at 62) until age 67. That in and of itself extended the viability of Social Security for decades.

We now stand at familiar crossroads so congress and the next administration will be faced with one, or a combination of, choices. What is out there now is 1) extended FRA to age 70 2) raising the annual wages ceiling beyond the current (approximate) of $168,000 (Social Security taxes do not apply once someone's income goes beyond $168,000) in any given year, 3) potential reducing benefits.

Pensions are also something that some retirees might be able to rely upon. Those might be military, public service, teaching, hospitals, the clergy and still a few private companies.

Then we come down to one's own resources: Their savings. Those can be in the form of 401ks, 403bs, IRAs or other work-related retirement savings plans. If someone has had the opportunity and of course the discipline to maximize contributing to these plans, over the course of their working life, this could be a substantial source of core or supplemental retirement income. The question is, how to make it into a supplemental source. We list several here for your consideration however this is not an exhaustive list.

1) Systematic Withdrawal Plans (also known as SWPs or swips). That is taking the amount you want and withdrawing it from your account (however it is invested) proportionately each month or year. This approach is often used but the word of caution would be to account for market declines as well as unforeseen changes that come from emergencies or opportunities. There is also something known as the sequence of returns that should be considered (potentially accelerating the depletion of the account due to the unforeseen or planned for events).
2) Dividends and interest from investments and savings. Stocks pay dividends (as do many mutual funds) and are also a source of supplemental if not core income for retirees. Interest would come from bonds primarily but in recent history savings rates been competitive with bonds. Bonds are where you do not live off the principal (you keep that invested), just the interest. In both cases statement value is important because stocks and bonds do fluctuate in value.
3) Annuities are also a source of retirement income Those can be from what is known as immediate annuities where you invest an amount now for a predictable stream of income over a certain period or for life. Some people have been saving (in addition to their workplace or IRA savings) with annuities to build those for income in retirement. Annuities have added complexity mainly because there are so many choices, and the investor needs to be a position to understand the benefits and any limitations.

Now we come down to the focus of this article, and that is on the so-called covered call strategy. Retirees have been looking more at these as a source of income in retirement. Simply put, covered calls (considered the most conservative option strategy) are owning stocks (or equities) and selling, for a premium/income the right for someone to buy the stock from you at a predetermined price. That is a bit different from buying options. When you buy options, you are risking 100% of that investment. When you sell (or write) covered calls, your risk is the stock being called away from you (that buyer exercises their right to buy your stock (and pay you) from you. They would only do so if they had bought the right to buy the stock for a price that is lower than where it is currently trading.

The income generated from this strategy can often exceed that of the alternatives mentioned above. The income comes from two sources: The premiums received plus any dividends that the underlying stocks might pay).

The risk is that this is still a stock portfolio and while the risk relative the overall market is considered lower the portfolio can fluctuate with market activity. Also, this strategy can limit the upside potential of the portfolio because if the underlying stocks go up and value, they are likely to be called away from that buyer that paid you that income for that right.

This strategy's growth is seen in the number of choices that are out there now to utilize it:

1) There are mutual funds that use the strategy, and you take (or reinvest) the income.
2) Exchange Traded Funds (ETFs) there are a multitude of these.
3) Separately managed accounts (SMAs) – many investment firms offer a choice of these where a specialty firm (which maintains the assets on your investment firm's platform) execute the strategy for you.
4) Do it yourself (DIY). That would mean building your own stock portfolio and writing or selling the calls on your stocks. That takes time and interest. Some stockbrokers and financial advisors might specialize in this as well.

In cases we encourage our readers to understand the risks along with the potential and the costs in line with the big three: Investment objective (IO), Time Frame (TF) and Risk Tolerance (RT).

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