Income Strategies

Covered Calls & Cash-Secured Puts — Lesson Explainer

The Concept

A covered call means selling a call option against stock you already own, collecting the premium in exchange for agreeing to sell at the strike if exercised. It's 'covered' because you already hold the shares that would be delivered.

A cash-secured put means selling a put while setting aside enough cash to buy the shares at the strike if assigned. If the stock stays above the strike, the put expires worthless and you keep the premium.

Both strategies collect premium upfront in exchange for a trade-off: a covered call caps upside above the strike; a cash-secured put commits you to buying more shares if the stock falls. Neither eliminates stock risk - they reshape it, in exchange for income.

Illustrative Example: A Covered Call at Three Outcomes

100 shares owned at $100, a call sold at a $110 strike for a $3 premium.

Stock at Expiration	Call Outcome	Stock P&L	Premium	Total P&L
$95 (Below Strike)	Expires worthless	-$500	+$300	-$200
$108 (Below Strike)	Expires worthless	+$800	+$300	+$1,100
$120 (Above Strike)	**Called away at $110**	**+$1,000 (capped)**	**+$300**	**+$1,300 (capped)**

Even though the stock rallied to $120, total gain is capped at $1,300 - the shares are called away at $110, missing the additional $1,000 of upside a plain stockholder would have captured.

5 Things to Know About Income Strategies

1. A covered call caps upside, it doesn't remove downside - you still lose if the stock falls.

2. A cash-secured put commits capital, not just risk - cash must genuinely be set aside.

3. Both work best on stock you already have a view on - happy to sell, or happy to buy.

4. Assignment can happen before expiration - most common near expiration or dividend dates.

5. These are income-generation strategies, not risk-free ones - the premium compensates for a real trade-off.

4 Things to Check Before Selling a Covered Call or Cash-Secured Put

- Pick a strike you're genuinely fine with - happy to sell at, or happy to buy at.
- Confirm the cash or shares are truly set aside - don't count on capital needed elsewhere.
- Check for dividend and earnings dates - early assignment risk rises around ex-dividend dates.
- Compare the premium to the capped upside - weigh income against upside given away.

Worth knowing:
this explains covered calls and cash-secured puts using illustrative numbers - it isn't personalized financial advice, and no strategy here is a recommendation to trade. Both strategies involve real downside risk in the underlying stock, and past option premiums are not a guarantee of future income.

Quiz — Answer the questions, then check the key on the next page

1. What is a covered call?

A. Buying a call option with borrowed money
B. Selling a call option against stock you already own
C. Selling a call option with no underlying stock position
D. A guarantee that a stock will not fall

2. In the illustrative example, why was the total P&L capped at $1,300 even though the stock rose to $120?

A. Because the premium was refunded
B. Because the stock actually fell, not rose
C. Because the shares were called away at the $110 strike, missing further upside
D. Because covered calls always lose money above the strike

3. What must be true for a cash-secured put?

A. The seller must already own the underlying stock
B. No cash is required at all
C. The put must be sold at an out-of-the-money strike only
D. Enough cash must be set aside to buy the shares at the strike if assigned

4. Does a covered call eliminate downside risk in the stock?

A. No - you still own the stock and lose alongside it if it falls, cushioned only slightly by the premium
B. Yes, covered calls fully protect against any stock decline
C. Yes, but only for stocks that pay dividends
D. Covered calls cannot be sold on stocks that might decline

5. According to this lesson, what compensates the seller in both strategies?

A. A government subsidy for options sellers
B. Guaranteed profit regardless of outcome
C. The premium collected upfront, in exchange for capping upside or committing to a purchase
D. A refund from the options exchange

Answer Key

1. What is a covered call?

Correct answer: B. Selling a call option against stock you already own

A covered call means selling a call option against stock you already own.

2. In the illustrative example, why was the total P&L capped at $1,300 even though the stock rose to $120?

Correct answer: C. Because the shares were called away at the $110 strike, missing further upside

The shares are sold at the $110 strike once called away, capping the gain there.

3. What must be true for a cash-secured put?

Correct answer: D. Enough cash must be set aside to buy the shares at the strike if assigned

A cash-secured put requires setting aside enough cash to buy the shares at the strike if assigned.

4. Does a covered call eliminate downside risk in the stock?

Correct answer: A. No - you still own the stock and lose alongside it if it falls, cushioned only slightly by the premium

A covered call caps upside but does not remove downside risk in the underlying stock.

5. According to this lesson, what compensates the seller in both strategies?

Correct answer: C. The premium collected upfront, in exchange for capping upside or committing to a purchase

Both strategies collect premium income upfront in exchange for a real trade-off.