RESEARCH MEMO

Writing for Income

Options let a portfolio be paid for an obligation it was willing to take anyway, and the decisions that set the payment are the same ones that set the obligation

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One of a set of companion pieces to Options in a Portfolio, which establishes the framework this memo assumes. Illustrative throughout; no client facts are described. Nothing here is tax, legal, or investment advice. Options carry risk and are not suitable for every investor.

1 · SUMMARY OF CONCLUSIONS

A portfolio holding assets can be paid for agreeing in advance to transact in them. That is the whole of it. Selling a call against shares already held collects cash for agreeing to sell at a stated price. Selling a put against cash already set aside collects cash for agreeing to buy at a stated price. In both cases the money arrives immediately and the obligation lasts until expiration.

This is one of the few sources of portfolio cash flow that does not require owning a different asset. A client who wants more income from a bond sleeve has to accept more credit or duration risk. A client who wants more income from an equity sleeve has to tilt toward higher-yielding names and accept whatever that tilt does to the portfolio. Writing options produces cash flow from positions already held, in their existing weights, without changing what the portfolio owns.

> What the program costs is not the premium — the premium is received. It is the obligation, and the obligation is real whether or not it is ever called upon. The seller has agreed to transact at a price. The decision to transact belongs to the buyer.

Findings

1 · Two structures, one idea. A covered call obligates the holder to sell at the strike; a cash-secured put obligates them to buy at it. Both are paid up front for accepting an outcome they do not control, and both are collateralized by something the portfolio already has — shares in the first case, cash in the second. (§2)

2 · Writing on an index and writing on a single name are different trades. They differ in liquidity, in how they settle, in whether early assignment is possible, and in how the premium is taxed. The difference between an index option and an option on an index fund is larger than the names suggest. (§3)

3 · The chain determines whether the strategy exists. Premium quoted on a screen is only available if the contract trades. Open interest, daily volume, and the width of the bid-ask spread decide whether a position can be opened at a fair price and closed at one later. Thin chains quietly consume most of the premium they appear to offer. (§4)

4 · Strike selection is a decision about price, not about premium. Strikes nearer the current price pay more and are more likely to be transacted — those are the same statement. The only workable rule is to write at a strike where the resulting transaction is acceptable on its own terms. (§5)

5 · Coverage is a dial, not a switch. Each contract covers 100 shares. A 10,000-share position does not require 100 contracts; it can carry 25 or 50 or any number up to the full holding. Partial coverage is the normal case and is how the program is sized to the client rather than to the position. (§6)

Three standing rules

1. **Write only at a strike where the transaction itself is acceptable.** If no available strike produces a sale price worth making, or a purchase price worth making, the position should not be written at any premium.
2. **Read the chain before committing to the program.** Open interest and spread width determine whether the quoted premium is real and whether the position can be exited.
3. **Treat assignment as the buyer's decision.** The intention to close before expiration is a plan, not a protection. The right to exercise belongs to the other side of the contract.

What would change these conclusions

- **A sustained compression of the volatility risk premium.** The premium available to sellers exists because implied volatility has tended to exceed subsequently realized volatility often enough to compensate for the risk taken. If that relationship narrowed persistently, the compensation would narrow with it and the case for a standing program would weaken.
- **A tax-deferred or tax-exempt account.** Most of §7 disappears. Premium character, holding period effects, and dividend treatment all stop mattering, which makes a writing program materially simpler to run and easier to justify.
- **A position the client cannot sell.** Restricted stock, an insider window, or an existing trading plan can make assignment impossible to satisfy. Where that is the case, calls should not be written against the position regardless of the premium.
- **A packaged alternative.** Buy-write and covered-call funds run the same program at scale with no approval, no chain to read, and no assignment to manage. Where the client wants the exposure rather than the control, that trade is often the right one.

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2 · WHAT IS BEING SOLD

2.1 The covered call

The portfolio owns shares. It sells a call at a strike above the current price and receives premium. If the shares finish below the strike, the option expires and the premium is kept. If they finish above it, the shares are sold at the strike.

The word covered means the obligation is backed by the shares themselves. Nothing has to be purchased to satisfy assignment, which is why this is the lowest approval level at most custodians and the usual entry point for a practice that has not written options before.

2.2 The cash-secured put

The portfolio holds cash. It sells a put at a strike below the current price and receives premium. If the shares finish above the strike, the option expires and the premium is kept. If they finish below it, the shares are purchased at the strike.

Secured means the cash to complete the purchase is set aside — strike price multiplied by 100, per contract — and is not available for anything else while the position is open. That reservation is the real cost of the position and it does not appear as a cost anywhere.

Written against cash the client intends to deploy into that security anyway, this is also an entry technique, and the entry-and-exit memo treats that use. Written repeatedly against cash with no particular desire to own the shares, it is an income program and belongs here.

2.3 The obligation runs one way

Worth stating plainly because it is the most common misunderstanding among people new to writing. The buyer of the option holds a right. The seller holds an obligation. Those are not symmetric, and the seller does not get a vote.

A position can be closed by buying the same contract back, and most programs intend to do exactly that rather than carry positions to expiration. But closing is a transaction at whatever the contract costs at that moment, which is highest precisely when the writer most wants out. And it has to happen before the holder exercises. For American-style equity options the holder may exercise at any time, which means a plan to close next week is not protection against being assigned tomorrow.

This is the sentence that belongs in every client conversation about a covered call: whatever strike is chosen, however far from the current price, whatever the intention, these shares can be called away.

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3 · WHERE TO WRITE IT

3.1 Single names

Writing against an individual holding is the most direct version. The obligation attaches to shares the client already owns, so assignment simply sells a position they hold.

Three characteristics follow. Equity options are American-style, so early assignment is possible at any time. They settle in shares, so assignment produces an actual sale with an actual tax consequence. And early assignment clusters in a predictable place: in-the-money calls on dividend-paying stocks tend to be exercised just before the ex-dividend date, when the holder wants the dividend more than the

remaining time value. A writer who does not track ex-dividend dates will be surprised by this, and will be surprised in the cases where the position has moved in their favor.

Premium on single names is generally larger in absolute terms, because individual stocks move more than indices do. Whether it is larger relative to the risk taken is a different question and the covered call memo takes it up.

3.2 Index options and options on index funds

These sound like the same thing and behave differently, and the distinction is worth carrying into practice.

Options on a broad-based index are typically European-style, which means they cannot be exercised before expiration — early assignment is simply not available to the holder. They settle in cash rather than shares, so assignment produces a payment rather than a sale. And they generally receive §1256 treatment, which marks positions to market at year end and splits gains 60% long-term and 40% short-term regardless of holding period.

Options on an exchange-traded fund that tracks the same index are equity options. They are American-style, so early assignment is possible. They settle in fund shares, so assignment delivers or removes an actual position. And they are taxed as ordinary equity options, with no §1256 treatment.

For a writing program the practical consequences are substantial. Index options remove early assignment as a category of risk and remove the possibility of unintentionally selling a holding. Fund options keep both, but they allow writing against shares the portfolio already owns rather than requiring a separate cash-settled obligation. Neither is better; they answer different questions, and the choice should be made deliberately rather than by whichever ticker came to mind.

3.3 Index-level writing against a diversified book

Where the portfolio holds many positions rather than one large one, writing against each holding individually is impractical. The alternative is writing at the index level against the portfolio's overall equity exposure.

The tradeoff is the mirror image of the one in the hedging memo. An index obligation does not attach to any specific holding, so no individual position is at risk of being called away. But the payoff is driven by the index rather than by the portfolio, and a book that behaves differently from the index will see the two diverge. For a portfolio closely tracking a broad index that gap is small. For a concentrated or heavily tilted book it is not.

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4 · READING THE CHAIN

Before any of the above is a strategy, the contracts have to be tradable. This is the step most often skipped, and it is the one that quietly determines whether the premium on the screen is the premium that gets collected.

Open interest is the number of contracts currently outstanding at that strike and expiration. It is a measure of how much of a market already exists. A strike with open interest in the thousands has participants on both sides. A strike showing single digits has essentially none, and the quote there is theoretical.

Volume is how many contracts traded that day, and it answers a different question: whether the market is active now rather than whether a market exists. Both matter, and a strike with high open interest but no recent volume may be harder to transact than the first number suggests.

The bid-ask spread is the direct cost. A contract quoted at 2.40 bid and 2.50 ask can reasonably be sold near the middle. The same contract quoted 2.10 bid and 2.80 ask cannot, and the gap is paid twice if the position is opened and later closed. On thin single-name chains the round-trip spread can consume a meaningful share of the premium the trade was entered to collect.

Liquidity concentrates predictably: in the front standard monthly expirations, near the current price, and in widely held underlyings. It thins with distance from the money, with longer tenors, and in anything unusual. A program designed around far-dated, far-out-of-the-money contracts on a mid-cap name is designed around the thinnest part of the chain, and the execution cost will reflect that regardless of how the strategy looks on paper.

The practical test before committing to a program: look at the strikes and expirations the program would actually use, over several weeks, and confirm they consistently show real open interest and a spread worth crossing. If they do not, the strategy is unavailable at the price that made it attractive.

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5 · CHOOSING THE STRIKE

The relationship is mechanical. A call written closer to the current price collects more premium and is more likely to be assigned. A call written far above it collects less and is less likely to be assigned. These are not two facts to be weighed against each other — they are the same fact stated twice, because the premium is compensation for the probability of being transacted.

Which means strike selection cannot be optimized by looking at premium. Every strike offers the market's assessment of its own risk, and a strike that looks generously priced relative to its distance from the money is usually pricing something the writer has not noticed — an earnings date inside the window, a pending announcement, an unusually wide expected move.

The question that does resolve it is a price question. For a covered call: at what price would the client be content to sell these shares? For a cash-secured put: at what price would they be content to buy? Write there. If no listed strike produces an acceptable answer, the position should not be written, and no premium changes that.

This matters more than it sounds because of §2.3. The intention to manage the position before expiration — rolling it out, buying it back if the stock runs — is a plan that depends on the writer getting to act first. Assignment does not wait for the plan. A strike chosen on the assumption that it will never be reached is a strike chosen without answering the question.

The strike also carries tax consequences that depend on where it sits relative to the current price and on how long the underlying has been held. Writing a call that is sufficiently deep in the money against an appreciated position can suspend the holding period on those shares, convert what would have been a long-term gain into a short-term one, create a straddle, and disqualify dividends from preferential treatment for as long as the position is open. Those effects turn on specific thresholds, and §7 points at where they are developed.

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6 · HOW MUCH TO WRITE

Each standard equity option contract covers 100 shares. That number is the unit of the entire program, and it is where the sizing conversation starts.

A 10,000-share position supports up to 100 contracts. It does not require them. Writing 25 contracts covers 2,500 shares and leaves 7,500 fully exposed to the upside. Writing 50 covers half. The coverage ratio is a continuous choice, and treating it as all-or-nothing is the most common sizing error in the category.

The ratio should be set by how much of the position the client is prepared to see transacted, not by how much premium a given level generates. A client who would be content selling a quarter of a holding at a particular price should write against a quarter of it. The remaining three quarters keep their full upside, and the program produces exactly the obligation the client agreed to.

Partial coverage also changes how a surprise feels. A position fully written and then called away in a sharp rally removes the entire holding at a price set months earlier. The same rally against a quarter-covered position sells a quarter and leaves the rest participating. Both outcomes were disclosed in advance; only one of them is likely to be the subject of a difficult conversation afterward.

One mechanical point that constrains the arithmetic: coverage moves in 100-share increments, so odd lots cannot be written against. A 4,350-share position supports at most 43 contracts, and the residual 50 shares sit outside the program entirely.

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7 · WHAT ELSE IS GOING ON

Writing options generates income. It also does several other things at the same time, and a program run without accounting for them will produce results its sponsor did not expect.

Upside is capped while the position is open. This is the economic cost, and it appears on no statement. The premium shows as a credit; the gain that was given up when the stock ran past the strike shows as nothing at all.

The tax treatment does not follow the underlying. Premium, exercise, assignment, and expiration are each treated differently. Writing against an appreciated position can affect holding periods, convert gain character, create a straddle, and disqualify dividends. For a taxable client this is frequently the largest cost in the program and the least visible.

The return pattern is asymmetric over time. A writing program collects small amounts regularly and gives back larger amounts occasionally. That is the shape of the trade rather than a flaw in it, but it means a program evaluated over a stretch containing only the collecting is being evaluated on an incomplete sample.

Each of these is developed properly elsewhere. The covered call memo treats the economics of an overlay program in full, including where the premium comes from and why it behaves differently on an index than on a single name. The collar memo treats the tax consequences of writing against an appreciated position. The purpose of naming them here is to make clear that income is what the program produces, not all of what it does.

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8 · HOW THE COMPANION MEMOS FIT

This memo covers writing for income as a purpose. The framework it assumes is in the hub, and the adjacent purposes are treated separately.

- **Options in a Portfolio** — the framework memo: what the instrument set does, what the complexity consists of, and why it goes unused.
- **The Covered Call Overlay** — overlay economics in depth: the source of the premium, and why it is substantially richer at the index level than on individual names.
- **Buying Protection** — the other side of the same contracts, where premium is paid rather than received.
- **Entry and exit** — the same two structures used to acquire or dispose of a position on terms set in advance, where the transaction is the objective rather than the risk.

Framework memo prepared for illustrative purposes. Not tax, legal, or investment advice. Options carry risk and are not suitable for every investor; the standardized options disclosure document describes those risks in full. Qualified covered call status, straddle treatment, holding period consequences, and §1256 eligibility are legal determinations that depend on specific facts and should be confirmed with qualified counsel.