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THE FALLACY IN THE STRATEGY OF WRITING CALLS ON STOCKS TO GENERATE INCOME

An Italian mathematician and economist by the name of Vilfredo Pareto (1848-1923) made the observation that it is in the nature of things that about 80% of an outcome is attributable to about 20% of its possible causes. This 80-20 relationship has become known as Pareto's Law and is found to exist in many aspects of life. As an example, about 80% of most firms' sales are produced by about 20% of their products.

If we examine common stock portfolios, we will discover that Pareto's Law, most assuredly, also describes their performances over time. In short, about 80% of a portfolio's returns will be generated by about 20% of its positions.

If we assume that common stocks, on average, return 10% over time, and that 80% of our returns come from 20% of our holdings, we can come up with the following simplified, but representative, five-stock portfolio for the typical common stock investor:

Stock Position	Expected Return
A	40.000%
B	8.000%
C	1.600%
D	0.320%
E	0.064%
Average	10.000%

(The "expected return" of the most profitable position is 80% of the 10% return of all five positions, or 40%. The "expected return" of the second most profitable position is 80% of the remaining 2.0%, or 8%, etc.).

By writing calls in the above example, we essentially deny ourselves the potential of enjoying most of the return in Position A. If, then, we are left with only the return from the remaining four positions, we are left with an average expected return on our portfolio of a mere 2½%.

The balance of 7½% must be generated by the income on the calls in order for us merely to break even on the call-writing strategy. This is a tall order for any writer of calls and, under current market conditions, is generally considered impossible.

The tax consequences of writing calls in a taxable account are particularly unfavorable. If we generate a 5% return on a portfolio by writing calls, we pay an income tax at ordinary rates on the whole 5% return. If, on the other hand, we generate the 5% by selling Stock A above, we will pay a tax on only 40% of what we withdraw and, in addition, we will pay at lower capital gains rates and not at ordinary income rates. If we generate the 5% by selling Stocks B, C, D, or E, the capital gains tax will be far less still.

Writing a call on a stock is not a free lunch. It involves selling the stock's potential for significant gain, in return for the income from the call. In a perfect world, this would be a zero-sum game and, in the aggregate, over time, the sum of all income returned on calls would be equal to the sum of all capital gains forgone on the same calls. In reality there is much friction in the system in the form of spreads and transaction costs. The end result is that, in the long run, the writer of calls receives a significantly lesser amount of income, and may pay a higher income tax on it as well.

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