Corporate and Investment Banking

Covered Calls

Standard Bank

Content

Introduction

Covered Calls are one of the most commonly used option strategies and are used by a wide range of investors and traders to enhance the returns of their portfolios. A Covered Call strategy entails an investor writing (selling) a Call Option over shares they already own. The investor earns a premium (a sum of money) for the sold option.

Covered Call practitioners will often look for moderate dividend yielding, high volatility shares over which to apply the strategy. The moderate dividend yield plus the higher premium which can be earned can boost a portfolio's cash flow and ultimate performance.

Who should trade Covered Calls?

Covered Calls are best suited to investors who hold shares in a company and:

- would like to generate additional yield or cash flow into their portfolio
- have a neutral to mildly bullish view on the share
- are willing to sell their shares **at** or **give up any upside above** a **predetermined** share price.

In return for foregoing potential upside in their shares, investors will receive cash in the form of **option premium**.

What is a Call Option?

A Call Option is a financial contract between two parties, a buyer and seller. The buyer of the call pays a fee called **"option premium"** to receive the right but not the obligation to buy:

- a specific quantity of shares (the underlying)
- at a predetermined price (strike price)
- on or before a specified date (expiration date).

The seller (writer) earns the **"option premium"** and is then obligated to sell the underlying shares of the Call Option at the strike price if the buyer decides to **"call his stock."**

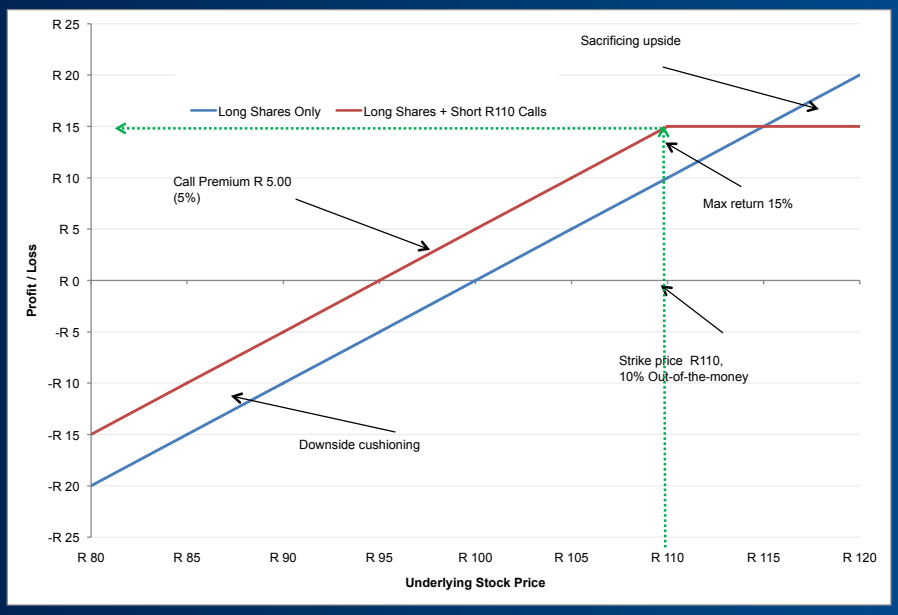
With all other factors remaining constant, an increase in the underlying share price will result in an increase of the Call Option's value (premium)[1].

[1] Refer to Appendix 1 for more information on option pricing.

What is a Covered Call?

A Covered Call is a strategy whereby an investor writes (sells/ shorts) a call option over shares they already own to a buyer (in this case The Standard Bank of South Africa Limited). The call options are considered **"covered"** because the underlying shares fully collateralise (cover) the obligation created from writing the calls. The investor in return receives an option premium for selling the calls which is immediately credited to their Online Share Trading (OST) account.

Diagram 1: Payoff diagram comparing Holding Stock versus writing Covered Calls and Holding Stock.



What happens at Expiry Date?

The underlying share price closes above the strike price (predetermined price):

- The options are exercised/taken-up by the Standard Bank of South Africa Limited.
- The investor (seller) delivers their shares to the bank and is paid the strike price in return.
- The shares will be transferred out of the investors OST account as a consequence of the bank exercising its right.
- The cash from the sale of the shares (number of shares multiplied by the strike price), are credited to the investors OST account.
- An investor selling Covered Calls is essentially agreeing to forego any upside in the underlying share above the Covered Calls strike price in return for the premium that they are paid.

The underlying shares price closes below or at the strike price (predetermined price):

- The investor keeps their shares **and** the option premium they have received.
- The investor can choose to repeat the process and write more Calls out to the next expiration date and receive a premium again.

To ensure that investors can meet their potential obligation to deliver their shares to the bank (in return for being paid the strike price), they are **pledged/reserved** in their OST account. The shares **cannot** be sold until the Covered Calls expire or are unwound[2].

Below is a simplified example of the mechanics of a Covered Call trade:

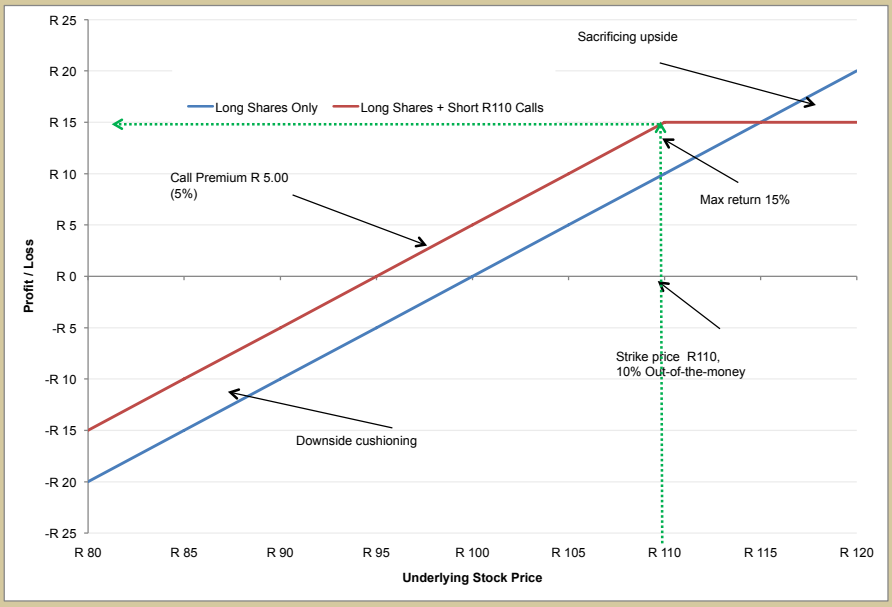
Example 1[3]

- An investor holds 1 000 XYZ shares currently trading at R100.00.
- The investor has a neutral to slightly bullish view on the shares and is of the opinion that the share price will have little movement within the next three months.
- The investor decides to write Covered Calls over XYZ.
- The investor decides to sell 10% Out-of-the-money (OTM) Covered Calls[4] at a strike price of R110.00
- The investor sells 1 000 XYZ Covered Calls with the following terms :
  - Strike price of R110.00
  - Expiry date – 92 days
  - Investor receives option premium of R5 000.00 or R5.00 per option (R5.00 x 1 000) into their OST account on trade date (not expiry date).
- The investor holds 1 000 XYZ shares and now holds a short position in 1 000 XYZ Covered Calls.
- The Investor is effectively agreeing, in return for the option premium they have received, to forego any upside above the strike price of R110.00 if XYZ shares move higher than R110.00 by the expiry date.

[2] Covered Calls would need to be purchased back from the bank, crossing a bid/offer spread to close or unwind a Covered Call position.

[3] For these examples we assume zero trading costs.

[4] For a Call, when an option's strike price is higher than the market price of the share.



Scenario 1

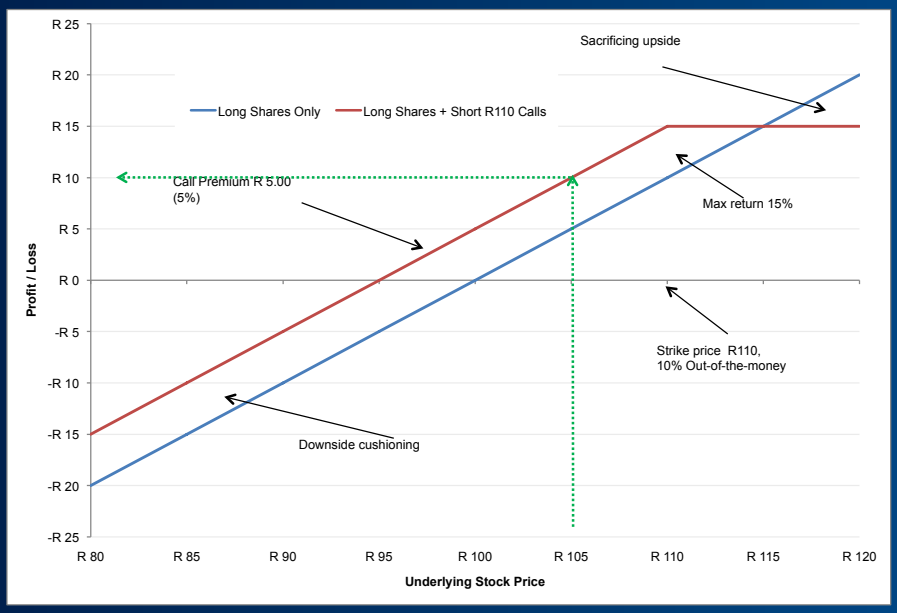
Possible scenarios at expiration date:

1. Share price closes at the strike price of R110.00

- In 92 days time, XYZ shares close at R110.00.
- The Calls have expired "at-the-money"[5] and the investor retains ownership of the underlying shares and has banked the full option premium.
- The investor could write more Covered Calls to the next maturity if they wish.
- The return made on capital appreciation of XYZ shares is R10.00 per share or R10 000.00 in total ([R110.00 – R100.00] multiplied by 1 000 shares).
- The return made on Covered Calls R5.00 or R5 000.00 in total (options expired worthless).
- The total return on shares plus Covered Call premium: R15 000.00 (R10 000.00 + R5 000.00).

This scenario demonstrates the maximum potential return for a Covered Call trade because anything above a R110.00 close in XYZ would result in the investor's shares getting called away at R110.00. Maximum profit = (Strike – underlying price) + premium received.

[5] An option is considered at-the-money (ATM) if the option's strike price is equal to the underlying share price.

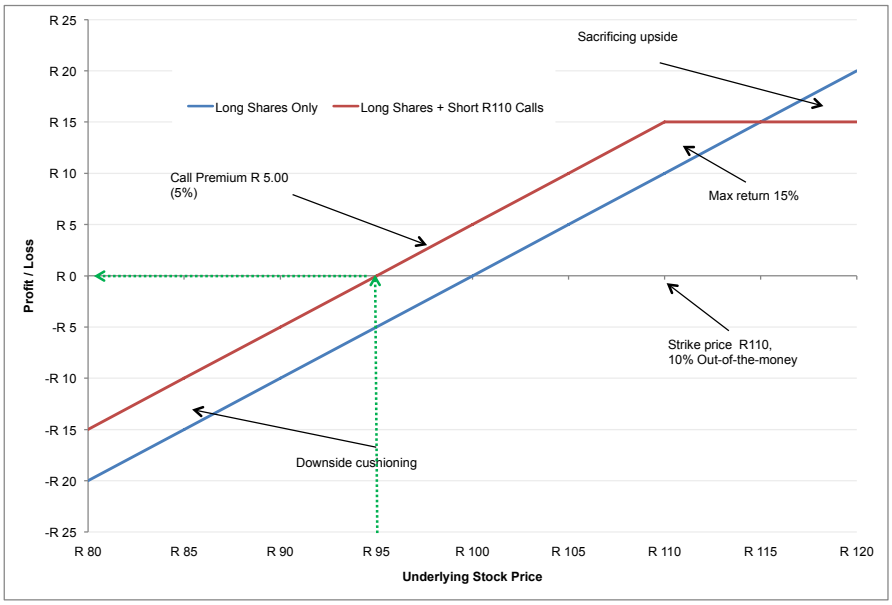


Scenario 2

2. Share price closes below the strike price of R110.00 but above starting price of R100.00

- In 92 days time, XYZ shares close at R105.00.
- The Calls have expired "out-of-the-money" and the investor retains ownership of the underlying shares and has banked the full option premium.
- The investor could write more Covered Calls to the next maturity if they wish.
- **The return** made on capital appreciation of XYZ shares is R5.00 per share or R5 000.00 in total ([R105.00 – R100.00] multiplied by 1 000 shares).
- The return made on Covered Calls is R5.00 or R5 000.00 in total.
- Total return on shares plus Covered Call premium: R10 000.00 (R5 000.00 + R5 000.00).

This scenario demonstrates an enhanced potential return for a Covered Call trade compared to an outright share purchase.



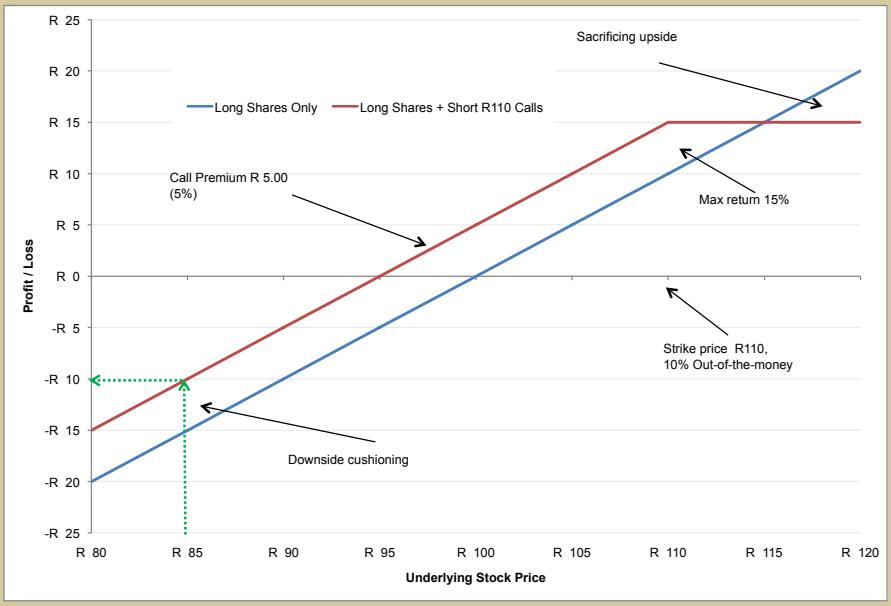
Scenario 3

3. Share price closes **below** the strikeprice of R110.00 and below the starting price of R100.00

- In 92 days time, XYZ shares close at R95.00.
- The Calls have expired "out-of-the-money"[6] and the investor retains ownership of the underlying shares and has banked the full option premium.
- The investor could write more Covered Calls to the next maturity if they wish.
- **The negative return** made on capital depreciation of XYZ shares is R5.00 per share or R5 000.00 in total ([R95.00 – R100.00] multiplied by 1 000 shares).
- The return made on Covered Calls is R5.00 or R5 000.00 in total.
- Total return on shares plus Covered Call premium is: R0.00 (-R5 000.00 + R5 000.00).

This scenario demonstrates the **break-even** potential return for a Covered Call trade when a long-only strategy would have resulted in a loss.

[6] A Call Option is considered out-of-the-money (OTM) if the option's strike price is higher than the underlying share price.

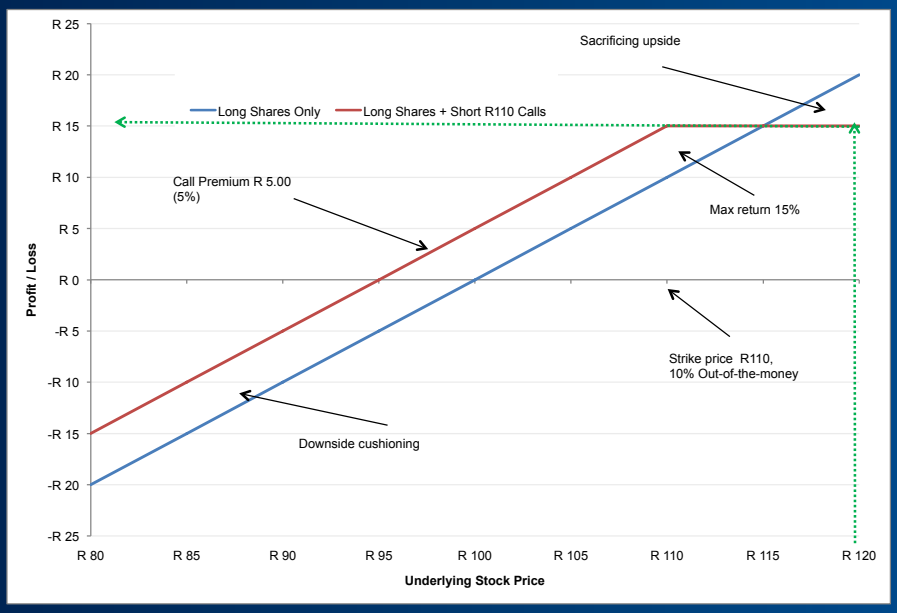


Scenario 4

4. Share price closes well-below the strike price of R110.00 and below the starting price of R100.00

- In 92 days time, XYZ shares close at R85.00
- The Calls have expired "out-of-the-money" and the investor retains ownership of the underlying shares and has banked the full option premium.
- The investor could write more Covered Calls to the next maturity if they wish.
- **The negative return** made on capital depreciation of XYZ shares is R15.00 per share or R15 000.00 in total ([R85.00 – R100.00] multiplied by 1 000 shares).
- The positive return made on Covered Calls is R5.00 or R5 000.00 in total
- The negative return on shares plus Covered Call premium is: –R10 000.00 (–R15 000.00 + R5 000.00).

This scenario demonstrates the **reduced-loss** negative return for a Covered Call trade when compared to a long-only strategy.



Scenario 5

5. Share price closes above the strike price R110.00

- In 92 days time XYZ shares close at R120.00.
- The Covered Calls have expired "In-the-money"[7].
- The investor's options will now be exercised and the 1 000 XYZ will be delivered automatically to the bank at **R110.00** (the strike price).
- The return made on capital appreciation of XYZ shares is R10.00 per share or R10 000.00 in total ([R110.00 – R100.00] multiplied by 1 000 shares).
- The return made on Covered Calls R5.00 or R5 000.00 in total.
- Total return on shares plus Covered Call premium is: R15 000 (R10 000 + R5 000).

This scenario demonstrates the **opportunity-cost** for a Covered Call trade when compared to a long-only strategy. In a long-only scenario the investor would be up R20 000.00 but in the Covered Call scenario the upside from R110.00 to R120.00 is forgone and the return is R15 000.00.

[7] A call is considered In-the-money (ITM) if the option's strike price is lower than the underlying share price.

6. Investor unwinds (closes out) his Covered Calls before expiration

- On or before the expiration date of the investor's Covered Calls, the investor would have the option to unwind (close out) the Covered Call position. They would have to buy back the Covered Calls with the same strike price and expiry date. The investor will have a short position in Covered Calls and therefore would need to buy them back to unwind.

  Please note: Covered Calls should be transacted as a medium-term strategy (that is, held until expiry of the option) and should not be viewed as trading instruments. Whilst you will be able to unwind the position prior to expiry it is likely that you will cross a large bid/offer spread, which could result in losses. The potential benefits of this strategy will be heavily impacted by early unwinds.
- Remember that over the life of a call option, a Call Option's value will increase as the underlying share price increases (everything else being equal and vice versa) and therefore, the premium (Covered Call price) of the Covered Call that the unwind purchase transaction will take place at may be different from the premium originally received from selling the Covered Calls. Refer to Appendix 1 for more information on option pricing.
- Continuing with our examples let's assume that before expiry date, XYZ is trading at R120.00.
- The investor decides that they don't want their stock called away at R110.00 and would like to keep their shares.
- To ensure the investor's shares are not called away, the investor would place an order (in the same way he originally sold the Covered Calls) to buy back 1 000 XYZ Covered Calls with a strike price of R110.00 and the same expiry date.
- **The investor will now have to pay R11 000.00 or R11.00[8] per option to unwind his Covered Call position (R11.00 x 1 000 options). In this instance the investor is making a loss of R6 000.00 as they received R5 000.00 in premium on writing the Covered Call – but are paying R11 000.00 to unwind it.**
- Once the Covered Call position has been closed out the investor can carry on holding their shares and/or could write more Covered Calls with a new strike price and longer dated expiry.

[8] The Premium of R11.00 is a round number used for illustration purposes and will vary across different shares, strike prices, expiry dates and will also be depend on how much time is left to the expiry date of the Covered Call. In this example we have assumed that the investor is unwinding a month before expiry so that the option has R1.00 in time value and R10.00 in intrinsic value.

Advantages of trading Covered Calls vs. Holding Only shares

We have compiled a study where we compare the performance of two different portfolios, in the first portfolio an investor starts off by investing R100.00 into a single share and all dividends received are reinvested back into the same share.

In the second portfolio we simulate a passive Covered Call strategy where an investor also starts off by investing R100.00 into the same share with dividends reinvested but at the same time sells 10% Out-of-the-money Covered Calls over the share and repeats the process of writing calls every quarter. Every quarter (expiry of the Covered Calls) the following happens:

- If the Covered Calls do not expire In-the-money (share price closes below the option's strike price):
  - The investor keeps the underlying shares.
  - All cash received during the quarter is used to buy more of the underlying shares (Dividends received on the underlying share plus Covered Call premium received previously).
  - The investor then sells 10% Out-of-the-money covered Calls which expire at the next quarter (90 days away).
- If the Covered Calls expire In-the-money (share price closes above the option's strike price):
  - The investor's shares are called away and delivered to the bank at the option's strike price.
  - The cash proceeds from the shares being called away plus all cash received during the quarter is used to buy the underlying shares again (Dividends received on the underlying share plus Covered Call premium received previously).
  - The investor then sells more 10% Out-of-the-money Covered Calls which expire at the next quarter (90 days away).

We have completed our study looking back over a period of 11 years (beginning of 2001 to the end of 2011) on two shares Anglo American PLC (AGL) and MTN Group LTD (MTN). The Covered Call strategy tends to outperform an equity only strategy in a range bound or bear markets, however, there was an under performance of the Covered Call strategy during the bull market (2004 to 2008) and then started to outperform post the 2008 financial crisis when markets were in a bear market. The Covered Call strategy collected an average premium of roughly 4.7% on both shares (Covered Call premium as a percentage of the underlying price) and out of 44 option expiries the AGL scenario saw the investor's stock being called away 14 times and 15 times for the MTN.

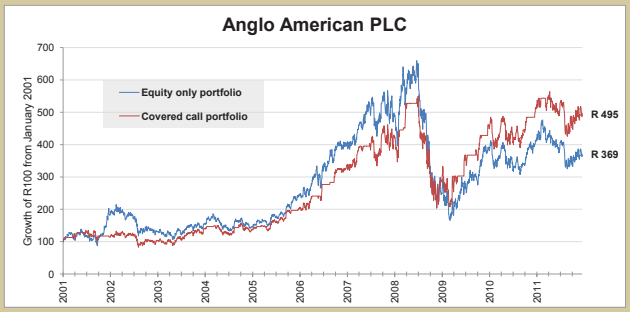


Diagram 1: Anglo American PLC

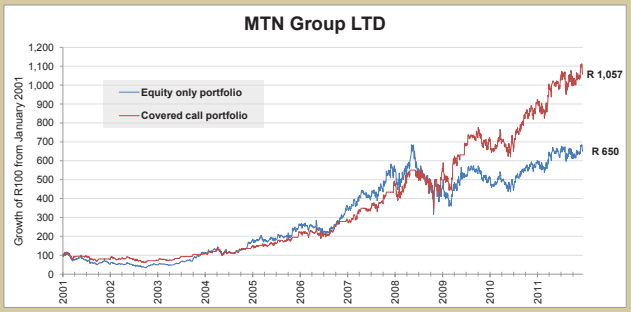


Diagram 2: MTN Group LTD

Benefits of trading Covered Calls

- ## Generating income

  Writing Covered Calls generates income in the form of option premium. If the underlying share does not close above the Covered Call's strike price at expiry then the Covered Calls expire out-of-the-money. The investor then keeps their shares and the premium they received from selling the Covered Calls and is kept as profit.

- ## Limited downside protection

  If the underlying share falls, the option premium received effectively cushions the Covered Call writer from part of the loss incurred from holding the shares. For example, if the investor received a R5.00 premium per Covered Call sold, they are effectively "protected" from a R5.00 fall in the underlying share because the value lost from the price of the shares falling by R5.00 will be offset by the Covered Call premium received, however anything more than a R5.00 fall would be a loss for the investor.

- ## Shareholder benefits

  An investor that writes Covered Calls will have the same benefits as an ordinary share holder as they are still the holder of the underlying shares. The investor will receive all dividends that are paid by the underlying and still keep their voting rights. **Keep in mind that if the investor's shares are called away at expiry then the investor would no longer hold the shares and receive these benefits.**

Risks in trading Covered Calls

- ## Market risk

  Whilst the premium received provides partial protection from the underlying share falling, you are only cushioned by the amount of premium received, you still have full exposure to the underlying share **(for example, if the investor received a R5.00 premium per Covered Call, you are effectively covered for a R5.00 fall in the underlying, anything more than that would be a loss to the investor).**

- ## Limited profit

  The maximum profit from a Covered Call strategy will be **limited**, by writing calls the investor is **capping** their upside at the strike price of the Covered Call plus the premium received, so the investor will miss out on any of the upside if the share moves higher than the strike price. So there is a potential opportunity cost to writing Covered Calls.

- ## Exercise/Assignment

  If the investor's Covered Calls expire In-the-money the shares will automatically be delivered to the bank and they will be paid the strike price. If the investor believes there is a chance that the Covered Calls could expire in-the-money and does not want to give up their shares, they will need to unwind the covered call position by buying the Covered Calls back from the bank at the current market price. **Please note that the Covered Call could cost more than what the investor originally sold them for depending on a number of factors such as how much time has gone by and what the underlying share has done since entering the initial trade (please refer to Appendix 1 for more information on option pricing).**

- ## Taxation

  It is beyond the scope of this booklet to provide a detailed treatment of the taxation issues that are relevant to trading in Covered Calls. You should, however, take taxation into consideration when you are trading in Covered Calls, just as you would when trading in shares.

  We advise that you obtain specific tax advice from an independent tax advisor or SARS prior to trading in Covered Calls.

How does trading Covered Calls via the OST platform work?

Covered Calls traded through the Online Share Trading Platform (OST) are traded **over the counter (OTC)** and are **not exchange traded** as in the U.S. market where investors trade options on exchange.

When investor's trade Covered Calls via OST they will be entering into a contract between themselves and The Standard Bank of South Africa Limited (SBSA). Investors rely solely on SBSA making good on its obligations that is **(they have counterparty risk to SBSA).**

A call option's premium changes as the underlying share price moves up and down. SBSA as the buyer of the investors Covered Calls is at risk from these price movements. To hedge this risk out, SBSA would need to sell (short) a specific amount of shares (we call this delta) for a Covered Call order to be completed. An investor's Covered Call order will only be completed once the delta hedge for the underlying shares has been completed. If the order does not fully match, the investor will have sold a volume of Covered Calls in the same ratio as the delta hedge was matched in. At the time the investor places their Covered Call order, they will have the ability to choose the limit price for the delta hedge. The price of the delta hedge is important because it has a direct impact on the amount of option premium received. Keep in mind that if the investor sets their delta level too high then there is a chance that the order won't match and they won't execute their trade.

Covered Calls will expire at the close of the equities market (5 pm). The official JSE closing price of the underlying share will be used to determine whether an investor's Covered Calls expire in or out of the money.

How to register to trade Covered Calls

Registration is a simple process if you are already an Online Share Trading user.

Existing users

- Log on to OST.
- Select "My account → Product registration → Option Strategies" on the main menu items.
- Enable one of the existing trading accounts to trade Covered Calls or open a new trading account for Covered Call trading.

Additional accounts do not carry extra monthly subscription fees!

New Clients

- Open an account by logging on to **www.securities.co.za** and completing the necessary online registration process.
- Wait for your application to be processed and your FICA documents to be verified.
- Follow the same steps as detailed above for "Existing users".

Tips on trading Covered Calls

- ## Strike prices

  Investors should be writing Covered Calls over shares they are neutral to mildly bullish on; in other words the investor should believe that there will be little to minimal upside movement in the underlying share. Out-of-the-money options are options where the strike price is higher than the underlying share price, the higher the strike price the more upside potential you have (higher strike price also means less option premium received).

  If an investor is bearish on a share they are writing Covered Calls over, they could trade In-the-money calls rather (Covered Call strike price lower than where the underlying share is trading). In-the-money options have intrinsic value making them (on a like for like basis) more expensive than out-of-the-money options. The more premium received from a Covered Call sale the more downside protection a investor will have, however, it is important to note that you stand a greater chance of getting your shares called away at expiry due to the strike price being lower (lower than the current underlying share price) requiring the share to fall below the strike price for the investor not to have their stock called.

- ## Expiry dates

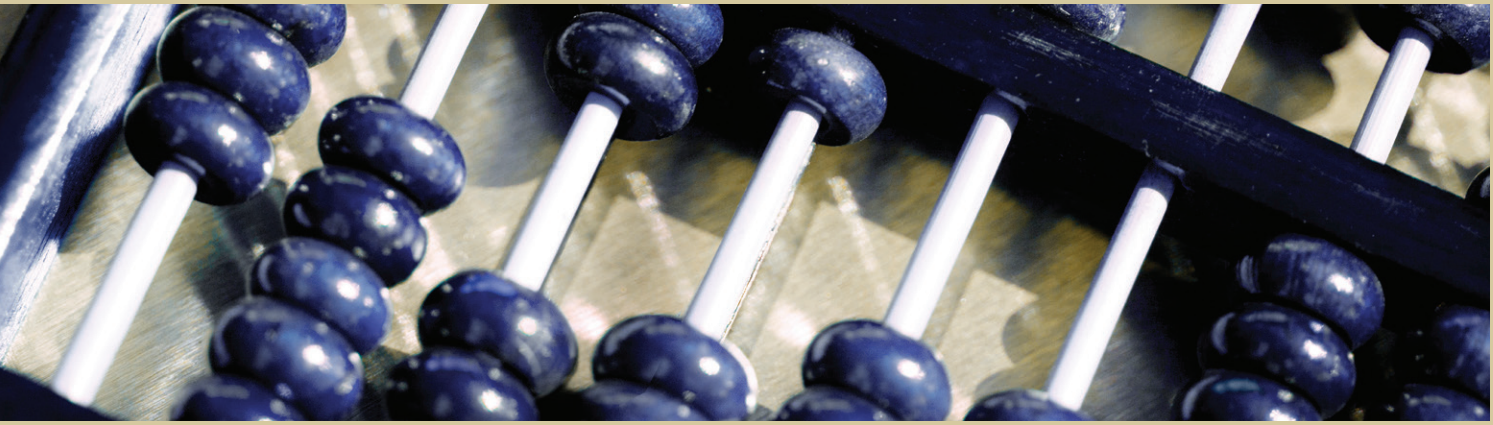
  An option's premium is not a linear function of time, on a relative basis (all else remaining equal that is: dividends, volatility, interest rates).

- ## Earning events

  It is important to take note of when a company reports its earnings, remember that by writing Covered Calls the investor is giving away all upside in the underlying share above the Covered Call's strike price. If the company reports earnings higher than what the market has anticipated, the share could rise sharply and the investor could potentially forego the upside past the Covered Call strike.

- ## High volatility shares

  Volatility is one of the most influential factors on an option's premium, with all else remaining equal, the higher the volatility, the higher an option's premium will be. By writing Covered Calls over shares with higher implied volatility an investor will maximize the option premium received. Keep in mind that the higher the underlying share's volatility, the more chance there is of extreme price movements which means there is a higher probability that the underlying share could reach the Covered Call's strike price.
  Refer to Appendix 1 for more information on option pricing.



- ### Dividends

  If the underlying share is expected to pay a dividend on or before the expiry date of a Covered Call then the Call Option premium will be discounted (if the ex-dividend date falls within the expiry, not the payment date), the higher the dividend, the cheaper the call option's premium will be. Most companies pay dividends semi-annually, so be aware of when a company pays its dividends because if there is a dividend expected before the expiry of a Covered Call, you will receive less premium. Remember that an investor will still receive all dividends that the underlying share pays only as long as they still hold the underlying shares.

  Refer to Appendix 1 for more information on option pricing.

Corporate events

An option buyer/seller has exposure to the underlying share over which the option is written. Occasionally a company will declare some form of corporate event which can have a material impact on the capital structure of the company and/or the value of its share price. These corporate events include activities such as special dividends, capital reductions, return of shareholders premium, splits, consolidations, mergers and acquisitions. Whenever such events occur, the option contracts written over the underlying company's shares need to have their terms adjusted accordingly so that both the buyer and seller of the option contract are not prejudiced. The adjustments will have the effect of putting the investor in the same financial position as they would have been prior to the corporate event.

Refer to the ISDA agreement for more details on the handling of the various corporate events.

Trading and other charges

Covered Call brokerage

OST charges a brokerage on all Covered Call trades entered into on a particular trading day. Multiple orders matched on the same day for the same Covered Calls (same underlying, strike, expiry date) in the same direction (selling or buying) will only be charged a single brokerage fee. Brokerage will be charged at the prevailing Covered Call brokerage rate.

Other fees to consider

Brokerage and other statutory fees will be incurred when trading in the underlying shares, in order to trade a Covered Call an investor would have to first hold the underlying shares. Purchasing the underlying shares will incur costs:

- Brokerage at the investor's prevailing brokerage rate.
- Securities Transfer Tax on purchases at the prevailing rate.
- Investor Protection Levy at the prevailing rate.
- Strate fees at the prevailing rate.

Appendix 1: Option pricing

Call and Put options

A Call option gives the holder the right but **not** the obligation to buy a specific quantity of shares (the underlying) at a predetermined price (strike/exercise price) on or before a specified date (expiration date). With all else being equal, a Call options value will increase if the underlying share price increases.

A Put option gives the holder the right but **not** the obligation to sell a specific quantity of shares (the underlying) at a predetermined price (strike % exercise price) on or before a specified date (expiration date). With all else being equal, a Put options value will increase if the underlying share price decreases.

Option terms

An option contract will have a number of terms that are determined at the time the investor trades. These terms are fixed and do not change, unless in the case of a corporate action.

- **Underlying**
  The underlying of an option contract is the underlying share that a holder has the right to buy (or sell for puts).
- **Expiry date**
  All options have an expiry date, an option trader would have until this day to exercise their options. At expiry an option may or may not have value, this depends on whether the option expires In or Out of the money.
- **Strike price**
  An option's strike price (exercise price) is the level that the underlying share needs to be above (for Calls) and below (for Puts) in order for the option to have a positive value at expiry. This strike price is set at the time the investor trades and cannot change (except in the case of a corporate event, for example a share split).
- **American and European style**
  Options come in two styles, American and European. American style options can be exercised at any time up to and including the expiry date. A European style option can be exercised only on the expiry date. Online share trading covered calls are all European style.

Option pricing and valuation

In addition to an option's terms, the option's price is dependent upon the following factors:

- **Underlying share price**
  The sensitivity of an option's price to a change in the underlying price is called the delta. It gives the relative change in the price of an option for a 1% change in the underlying. If the underlying share price increases, Call options will increase in value and Put options will decrease in value.
- **Time to expiry**
  Options lose value with the passage of time, this change is known as theta. Over the course of an option's life the theta increases and is highest in the last three months of an option's life. As a general rule of thumb, an at-the-money option will lose one third of its value in the first two thirds of its life and lose two thirds of its value in the last third of its life.
- **Volatility**
  By definition volatility is a statistical measure of the tendency of a market or security to rise or fall sharply within a short period of time. Volatility is typically calculated by using variance or annualized standard deviation of the price or return. In layman's terms volatility is a measure of the speed of a market. Slow moving markets have low volatility levels while fast moving markets have high volatility levels. In a low volatility market price movement is limited and options will be relatively cheap. While in a high volatility market, the chances for extreme price movement are greater and hence the options will be more expensive.
- **Interest rates**
  An increase in interest rates will make Call options more expensive and Put options cheaper, the reason for this can be explained by comparing an option position versus holding the underlying shares. It is much cheaper to buy a Call option than the underlying share, the Call option buyer should then be willing to pay more for a Call option when rates are relatively higher because the investor could then invest the difference in the total capital required and

earn interest. The sensitivity of an option's to short-term variations in interest rates is called the rho. For normal changes in interest rates the impact of rho on the pricing of the option is very small.

- **Dividend expectations**

  Holders of options do not receive the dividends paid on the underlying shares. However; the dividend stream is priced into the options so that option holders aren't prejudiced in holding options over ex-dividend dates. Options do not carry voting rights, nor do they allow the holder of the options to participate in rights issues or bonus issues of the underlying share.

  Any changes in expected dividends generally have a small impact on the value of the option compared with other variables. Generally when a company declares its dividends different to what was estimated there will be a change in the price of an option. The higher the dividend, the lower the value of a Call and the higher the value of a Put.

  Ordinary dividends (Cash or Scrip) and Debenture interest payments are the only type of dividends that are priced into an option. All other types of distributions such as special dividends, capital reductions or return of share holder premium are **not** priced in to the option. In order for an option investor to not be prejudiced the option contracts will have their terms adjusted to place the investor in the same financial position as before the corporate event.

The table below above shows the direction (up or down) that the value of Call and Put options will move in response to a change in these market variables, subject to all the other variables being held constant.

Market variable	Change in variable	Call	Put
Underlying price	↑	↑	↓
Time to expiry	↓	↓	↓
Volatility	↑	↑	↑
Interest rates	↑	↑	↓
Dividend expectations	↑	↓	↑

Intrinsic value and Time value

An option's price (premium) is made up of Time value and Intrinsic value, Intrinsic value is simply the amount the option is In-the-money, for a Call option this means that the underlying share price is higher than option's strike price. Time value is the basically the value of the probability of the underlying share price reaching the option's strike price by expiry. Time value is the value that will be lost as theta.

Example:

- Let's assume we are dealing with a Call option that has a strike price of R100.00
- Assume that the Call option's premium is R15.00 per option.
- Assume the underlying share is trading at R110.00.
- Intrinsic value is R10.00 (R110.00 – R100.00).
- Time value is R5.00 (R15.00 – R10.00).

Appendix 2: Glossary of terms

Call Option

An option is a financial derivative contract between two parties, a buyer and seller. The buyer of the option pays a fee called option premium to receive the right but not the obligation to buy a specific quantity of shares (the underlying), at a predetermined price (strike price), on or before a specified date (expiration date).

Covered Call

A Covered Call is a strategy whereby an investor writes (sells/shorts) a Call option over shares they already own to a buyer (in this case The Standard Bank of South Africa Limited). The Call options are considered "covered" because the underlying shares fully collateralize (cover) the obligation created from writing the Calls.

Over the counter (OTC)

Trading in some context other than on a formal exchange such as the JSE Ltd. Also refers to instruments that trade via a dealer network or directly with a large corporate (like SBSA) as opposed to on a centralised exchange.

Spot price

The spot market is also called the "cash market" or "physical market", because prices are settled in cash on the spot at current market prices, as opposed to forward prices. In other words, the price at which an underlying share trades at on the JSE.

Option premium

The buyer of a Call option pays a cash amount called "option premium". In a covered calls strategy, the investor is selling a Call option and therefore receives option premium.

Strike/Exercise price

The strike (exercise) price is the price at which an option contract can be exercised. For Call options, this is the price at which the underlying share can be bought by the option holder (buyer) from the option writer (seller). The strike price is determined at the time the option contract is traded.

Expiry/Maturity date

The last day that an option contract is valid for, at the end of this day (JSE close) the option contract ceases to exist.

Underlying

For an option contract, the underlying is the share that is delivered when the option is exercised.

Exercise

Exercising an option is when an investor "converts" their options into shares. The option holder pays the option contract's strike price to the option writer (seller) and in turn receives the underlying shares.

Out-of-the-money (OTM)

A Call option will be considered out-of-the-money (OTM) when the underlying share price is below the option contract's strike price. An OTM option will be worthless at expiry.

At-the-money (ATM)

A Call option will be considered at-the-money (ATM) when the underlying share price is the same as the option contract's strike price. An ATM option will be worthless at expiry.

In-the-money (ITM)

A Call option will be considered in-the-money (ITM) when the underlying share price is higher than the option contract's strike price. An ITM option will be worth its intrinsic value at expiry (underlying share price less strike price).

Unwind

This is the process of closing out an option contract position, with a Covered Call strategy the investor has sold a call option to the bank, to unwind or close out the position, the investor would need to purchase the Call option back from the bank.

Volatility

Volatility is a statistical measure of the tendency of a market or security to rise or fall sharply within a short period of time. Volatility is typically calculated by using variance or annualised standard deviation of the price or return. In layman's terms volatility is a measure of the speed of a market. Slow moving markets have low volatility while fast moving markets have high volatility.