Manoeuvring difficult markets: How covered calls can boost fund performance

Many houses are gearing up to use the strategy that lets the fund manager pocket some extra returns in range-bound markets.

Outperforming the benchmark indices such as the Sensex TRI and Nifty 50 TRI has become extremely challenging for large-cap equity mutual fund schemes. Data from Valueresearch indicates that the category average return of large-cap funds over the past one year was -4.86 per cent compared to -3.99 per cent recorded by the Sensex TRI over the same period.

As fund houses search for ways to outperform, many are gearing up to use the 'covered call' strategy to deliver better returns than their benchmarks. This is allowed by the markets regulator Securities Exchange Board of India (SEBI). Fund houses such as Axis, Edelweiss, ICICI Pru and Tata have decided to take the covered call strategy route by amending their scheme information document. Here is what you as an investor must know about what your fund house does in pursuing the strategy.

Q: What is a covered call strategy?

A: The strategy involves having a stock and a call option. A call option is a contract that is traded in the derivatives segment of the stock exchanges. It gives the buyer the right but not the obligation to buy a security at a specific price on a given date.

For example, if let's say a HDFC Bank share is available at Rs 2259 today. A call option on HDFC Bank with a strike price (price at which the buyer has the right to buy) of Rs 2300 on September 26, 2019 trades at Rs 20. In simple words, this contract gives the buyer the right to buy HDFC Bank share at Rs 2300 on September 26. The option contract of HDFC Bank has a lot size of 250 shares, which means the transaction happens in multiples of 250 shares only.

If a fund manager does not expect the stock's price to go beyond Rs 2,320. He writes (sells) a call option. At the time of writing the call, he collects a premium, say Rs 20 as per the above example. If the stock's price does indeed remain within Rs 2,300, the option doesn't materialise and he gets to pocket the premium. The buyer of the option will not exercise the option (will not ask the seller of the option to deliver securities) if the share price remains below Rs 2320 as he will get the shares cheaper in the cash market.

On the other hand, if the share price moves beyond Rs 2300 and continues to go up, the buyer would like to exercise his option and get the shares at a 'cheaper rate' of Rs 2,300. In simple words, the buyer expects the stock to do better, while the seller (your fund manager or the writer of the contract) expects the stock price to be contained. Think of the seller (your fund manager) as an insurance company and the buyer to be a policy holder. Think of a call option as an insurance policy and the call premium as the insurance premium. If the event (stock crossing Rs 2300 mark) happens, the insurer pays the money. If the event doesn't happen, the buyer (just like the policyholder) foregoes the premium.

Q: When does the strategy work?

A: Here's when a covered call works. In this strategy, the fund manager goes with two options. In addition to the writing the call, she would already possess an equal amount of HDFC Bank shares or would buy a similar call option from a seller at a slightly cheaper premium. The covered call strategy works best when the fund manager expects some temporary blip in stock performance.

For example, if she expects poor quarterly results or some regulatory announcement to hit the stock price, she may choose to sell (or 'write' as is used by market participants) a call option. The idea is to make some money even if the stock price is falling, without selling the share in the cash market.

Q: Isn't the derivatives segment risky?

A: Derivative trading involves leverage and hence is seen by many as an inherently risky avenue. But the covered call strategy works smartly. If the stock price moves contrary to the fund manager's expectations, she does not lose money. Losses on the call option sold would be net off by the gain in price of the stock held.

Q: Are funds allowed to take such calls?

A: SEBI allows selling of call options against the constituent shares of the Nifty 50 and BSE Sensex held by the scheme. This strategy was allowed from January 2019. There are other quantitative restrictions also prescribed by the regulator for this strategy to ensure that mutual funds do not go overboard.

Q: Is it good option for investors?

A: The strategy aims to generate more returns from the existing portfolio. The fund manager will earn some extra returns on the stocks held, especially when they are not moving up. "Sebi's decision to allow the covered call strategy is an enabling provision and mutual funds need not necessarily use it. It gives more options to the active fund manager to generate excess returns over market returns," says Vishal Dhawan, founder and chief financial planner of Plan Ahead Wealth Managers. Only time will tell how efficiently fund managers use this strategy for the benefit of their investors.