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ARTICLES

Behavioral Aspects of Covered Call Writing: An Empirical Investigation

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Abstract

Various explanations for the popularity of covered call option strategies have been explored in the literature. According to Shefrin and Statman [1993], framing and risk aversion can help justify its attractiveness to investors. Applying prospect theory and hedonic framing, these authors predict that in a world of frame dependence an investor that is sufficiently risk averse in the domain of gains will prefer a covered call position over a stock only position and that certain covered call designs will be preferred despite identical ... and covered ... vidence to complet... ence for a pron... h equal net cash ... evidence for a rela... ence for covered ... ion and covered call writing, investors with above average risk aversion seem to be required.

Keywords: Behavioral finance Covered call writing Risk aversion Framing Options

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Notes

1. The term covered call generally refers to overwrites, i.e. to short a call option on a stock that one already owns, as well as buy-writes, that is, to first buy a stock and then to short a call option on this stock (Figlewski, Silber and Subrahmanyam [1990]).

2. For more information about these products, see www.cboe.com or www.euronext.com.

3. The BMX is a hypothetical buy-write strategy that entails the simultaneous purchase of the S&P 500 and the shorting of an at-the-money S&P 500 Index call option (ww.cboe.com).

4. While the Sharpe ratio measures return relative to upside and downside variability, the Sortino ratio measures return only relative to its downside variability. It is used as a measure of risk-adjusted return (Sortino and Forsey [1996]).

5. The Upside Potential Ratio is defined as the upside potential over the downside risk measure. As such, it is used to identify strategies with stable growth for a given minimur

6. We th e value function 2]) may also drive oncur, but an in

7. DRCs ular bonds with a sh

8. We thank an anonymous reviewer for noting that in case probabilities are small, not 50–50 as in Shefrin and Statman [1993] and here, investors may exhibit risk seeking in the domain of gains, even with concave utility.

9. We thank an anonymous reviewer for noting that our graphical display of the binominal case used by Shefrin and Statman [1993] may mask the true payoff pattern of covered calls (e.g., Figure 2). Future research should employ more realistic examples that also include intermediate payoffs.