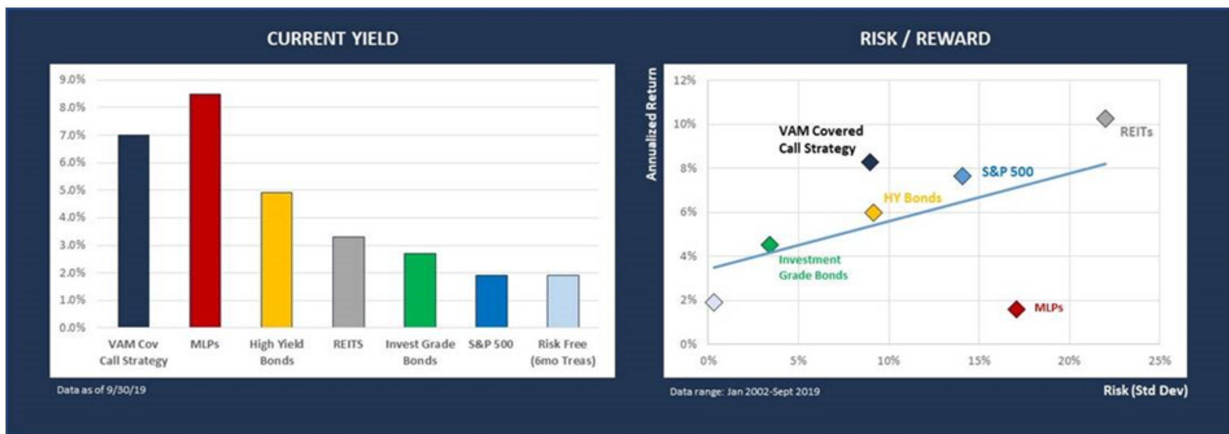
INVESTMENT COMMENTARY: Q3 2019

October| 2019

The Quest For Yield

The recent collapse in interest rates has put income investors in a tough spot. Where do you turn for a decent yield without exposing yourself to too much risk? Not only are bond yields near all-time lows, but stock dividends aren't much better. Other income alternatives include REITs and MLPs, but REITS have run so far that they are now only yielding about 3.3%. And MLPs, while offering very attractive yields, present all sorts of other risks (they got destroyed in 2015 and still haven't recovered). Covered calls are one of the few categories that offers an attractive yield (typically 6-8%) with below-average risk.



VAM covered call returns are gross of management fees; MLP performance represented by the Alerian MLP index; High Yield Bonds represented by the IBOXX High Yield index; REITs represented by the Dow Jones Real Estate Index; Investment Grade bonds represented by the Barclay's US Aggregate Bond Index. Source: Bloomberg. Each of these asset classes has its own set of investment characteristics and risks and investors should consider these risks carefully prior to making any investments. Past performance may not be indicative of future results. The referenced indices are presented for general market comparisons and may not be available for direct investment.

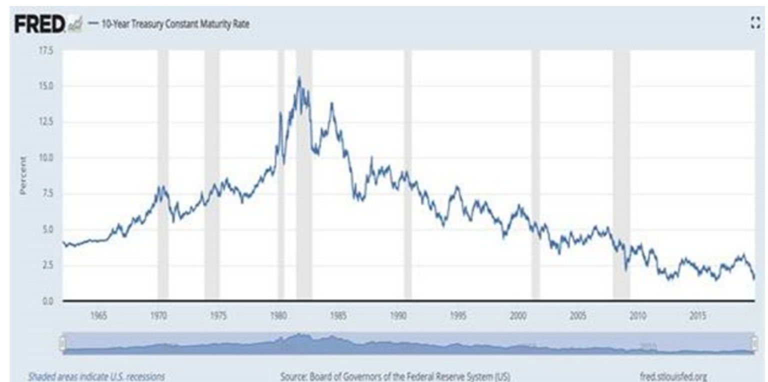
An Unprecedented Low-Yield Environment

Today's low yield environment has made it incredibly hard to find reliable sources of income without sacrificing quality. Treasury rates have been on a downward trend for 36 years, which has fueled an impressive bull market for bonds. Although the Fed seems committed to its low rate policy in the near term, most economists believe current levels are unsustainable over the long run. This certainly seems true based on the charts below. Regardless of near-term direction, it's clear that positioning your portfolio to mitigate interest rate risks will be more important than ever going forward.

Balancing Risks & Returns

Low yielding investment grade bonds have pushed income-seeking investors out the risk curve in search of attractive yields. They inevitably end up in either high yield (junk) bonds with significant credit risk or in alternative income categories like REITs and MLPs, which carry full equity market exposure (or more) as well as interest rate exposure.

More and more investors are considering a high-quality covered call portfolio in order to diversify their risks. Covered call strategies can offer investors income of 6-8% without taking significant credit risk (for example, the average credit rating of our covered call portfolio holding is Single A, compared to Single B for most high yield bond funds).



This balanced combination of income and price appreciation is shown below, compared to the other major asset classes. Only the REIT category has out-performed our covered call strategy over the past 17 years, but this category has a standard deviation (risk) of more than 2x Over the last decade, as investors have sought opportunities to earn both consistent returns and income, covered calls have gained in popularity. Institutional investors and investment advisors alike are embracing the strategy as part of a diversified equity allocation. However, as the market becomes more familiar with covered call strategies, investors continue to gain an understanding of the nuances between approaches.

The Nuance of Covered Call Investing

Most simply defined, a covered call position is the ownership of equity shares of a corporation whereby the owner then offers to sell his shares to another investor at a higher price in the future. For this offer, the owner receives income from the call option buyer. At Van Hulzen, a covered call strategy is inherently an equity strategy (but with an advantaged risk profile) which by default should require a diligent investment manager to be proficient in fundamental analysis. It is for this reason that we designed the investment process around disciplined cash flow fundamentals. The first priority is to construct a high-quality equity portfolio. We then turn to the option market as the second step, in order to add incremental yield and potentially add downside protection.

This approach differs from most covered call strategies, which are designed to primarily focus on the collection of call option premiums and to derive their return solely from the implied volatility embedded in the option price. These types of strategies generally include theta capture (time decay capture), over-writing (writing more calls than underlying shares, beta-seeking (find high beta stocks), and leveraged players (the use of margin). As a result, the manager's core competency in these strategies tends to be in the modeling of implied volatility versus actual volatility, not in fundamental equity analysis. The inherent challenge we see in these strategies is that they seek to profit from a portfolio constructed on option-based inputs and generally fall apart in periods of distress and market declines. Index replication studies show the value of including covered calls in an equity allocation. Active managers who focus on a strong fundamental process can extend that value further and even improve it. But beware the option-based volatility strategies calling themselves covered calls: They might be better suited for more speculative investors.

Our covered call clients typically fall into two groups:

Equity investors: Because equities are the highest returning asset class, most investors see them as an important allocation. However, with the market at new highs, the outlook is more uncertain and volatile than ever. Covered calls are a nice way to stay invested in equities but to take a more cautious approach by focusing on income and downside risk management. The call premiums received in a covered call strategy supplement the dividend income, and increase total portfolio yield dramatically. These strategies are a good way to meet long term goals and sleep a little better at night during market pullbacks.

Fixed income investors: Today's low yield environment has made it incredibly hard to find reliable sources of income without sacrificing quality. And on top of that, interest rates stand poised to eventually rise, which will almost certainly increase the volatility and cut into the returns of this asset class. With treasury yields at all-time lows and investment grade corporate bonds yielding 2-3% compared to their historic range of 5-7%, income-seeking investors are having to move out the risk curve to find attractive yields. They inevitably end up in either high yield (junk) bonds with significant credit risk or in alternative income categories like REITs and MLPs, which carry fully equity market exposure as well as interest rate exposure. A high-quality covered call portfolio can offer investors income of 6-8% (or more) while also significantly reducing market exposure. Combining one of these strategies with a high-quality, short duration bond ladder (3-4yr duration, for example) can further reduce volatility and provide a weighted average portfolio yield of approximately 5-6%.

Covered Calls in Summary

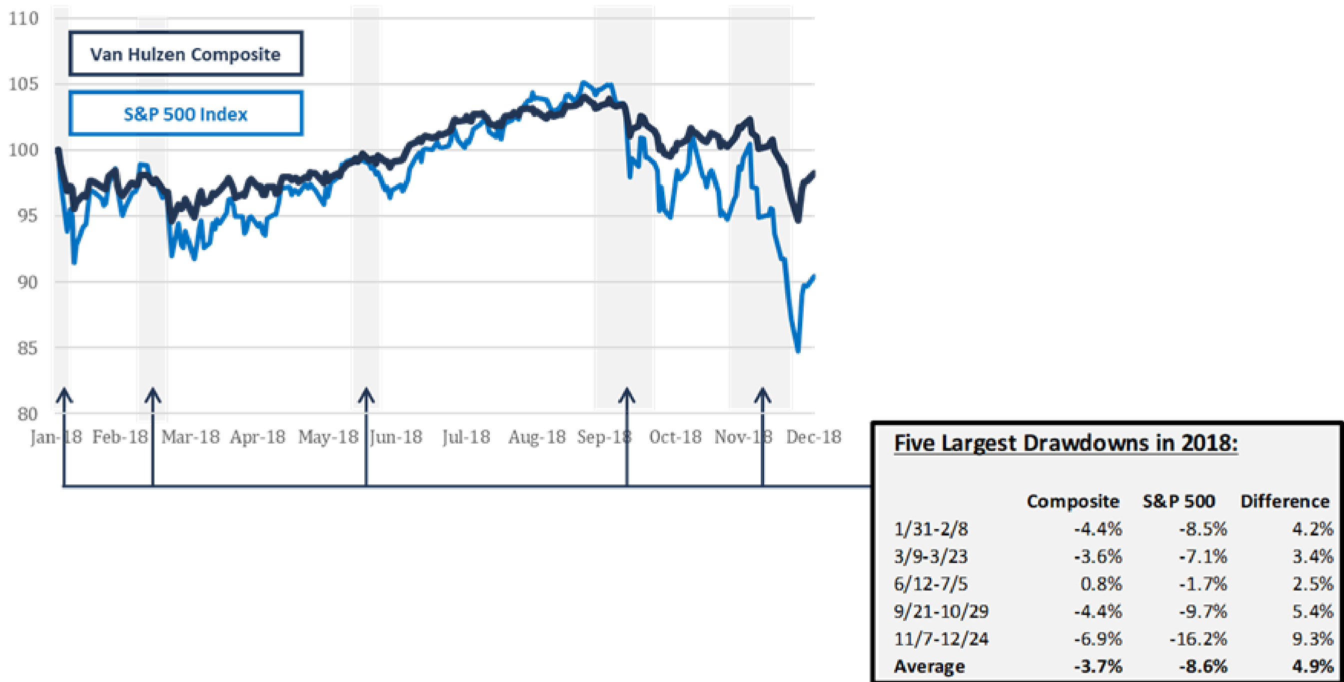
Wherever you stand as an investor, the consideration for a covered call strategy is both widely researched and supported. The current market environment has brought such strategies ever more into the spotlight as a potential solution for income seeking, risk conscious investors. Yes, rates are at all-time lows. But as the saying goes, "The pessimist complains about the wind; the optimist expects it to change; the realist adjusts the sails." How are you adjusting your sails?

Downside Protection is Key

We have a lower risk profile and higher yield than our equity benchmarks:

- For 2018, the composite returned -1.7% (versus -4.4% for the S&P 500)
- For Q4, the composite returned -5.1% (versus -13.5% for the S&P 500)
- We continue to be the leader in downside protection in the covered call category
- The current portfolio carries approximately 10% annualized income
- The equity portfolio has a credit rating of single "A"

Five Largest Drawdowns in 2018 (All below performance is Net)



Five Largest Drawdowns in 2018:

	Composite	S&P 500	Difference
1/31-2/8	-4.4%	-8.5%	4.2%
3/9-3/23	-3.6%	-7.1%	3.4%
6/12-7/5	0.8%	-1.7%	2.5%
9/21-10/29	-4.4%	-9.7%	5.4%
11/7-12/24	-6.9%	-16.2%	9.3%
Average	**-3.7%**	**-8.6%**	**4.9%**

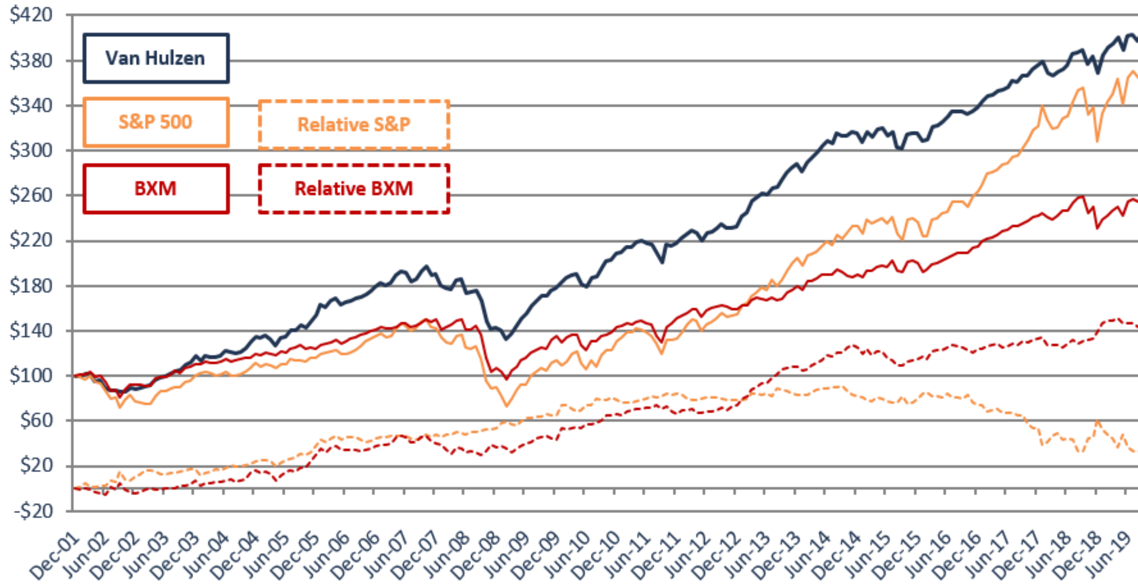
When You Lose Less, You Don't Have To Work As Hard To Break Even

Sept 2018 - March 2019

	Composite	S&P 500	Difference
Drawdown:			
9/30/18 - 12/24/18	-8.5%	-18.9%	10.5%
Since 9/30 Peak:			
9/30/18 - 3/29/19	1.8%	-1.7%	3.5%

Past performance may not be indicative of future results. All investing involves risk, including the potential for loss of principal. There is no guarantee that any strategy will be successful.

Covered Call Strategy Performance (gross as of 09/30/2019)



Returns (annualized)*	Sep 2019	3M	6M	YTD	1 Year	3 Years	5 Years	7 Years	10 Years	Inception
Van Hulzen (Gross)	1.8%	0.8%	2.5%	9.6%	4.0%	6.6%	5.3%	8.1%	9.0%	8.2%
Van Hulzen (Net)	1.8%	0.6%	2.2%	9.2%	3.4%	5.9%	4.7%	7.4%	8.2%	7.3%
BXM	0.6%	0.6%	3.9%	10.9%	-1.1%	7.0%	5.9%	6.6%	7.4%	5.4%
Difference (Gross-BXM)	1.1%	0.2%	-1.3%	-1.3%	5.1%	-0.4%	-0.6%	1.5%	1.6%	2.8%

*Inception date : 12/31/2001. Figures greater than one year are annualized. Van Hulzen returns represent actual returns from composite of accounts

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