INVESTMENT COMMENTARY: Q1 2020

March | 2020

Upside & Downside Capture

We talk a lot about upside and downside capture. These metrics represent how much the strategy participates in up and down markets, relative to the S&P 500, and can be compared across a peer group. According to the PSN database, the Van Hulzen Asset Management Covered Call strategy is in the middle of its peer group in upside capture (67.5% versus peer group median of 65.7%) but is **by far the market leader** in downside capture (51.8% versus peer group median of 72.8%).

The peer group average "score" is a net -7 (65% of the upside minus 72% of the downside). Our score is +16.

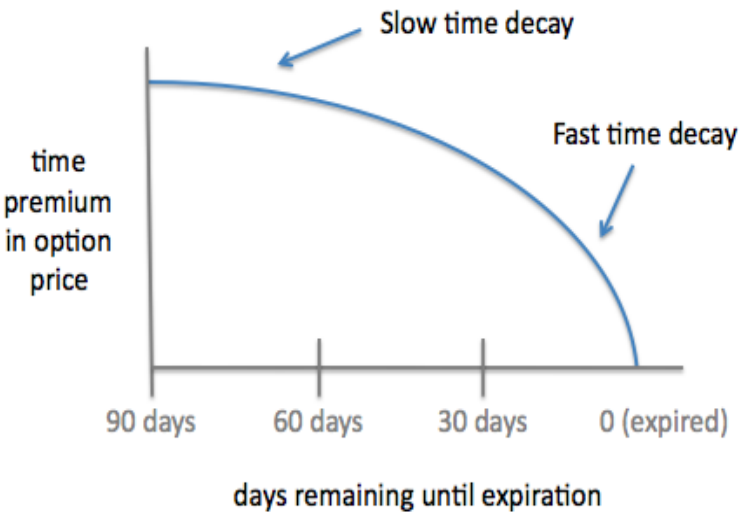
Keys To Downside Protection

We believe that protecting capital during declines is a powerful driver of long-term outperformance. Our strategy has three primary sources of downside protection:

1. Stock selection process. Quality is and has always been our primary focus. The companies in our portfolio have a much higher Cash Flow ROI than the overall market, pay a higher dividend, and hold less debt. They also tend to be industry leaders with slightly higher than average sales growth.

2. Portfolio construction. Much like our focus on upside & downside at the portfolio level, we calculate upside target prices for each holding (based on fundamental valuation) as well as downside price levels (based on a combination of fundamental and technical analysis). It is the ratio of these two readings (upside/downside) that determines which holdings have the largest weights in the portfolio.

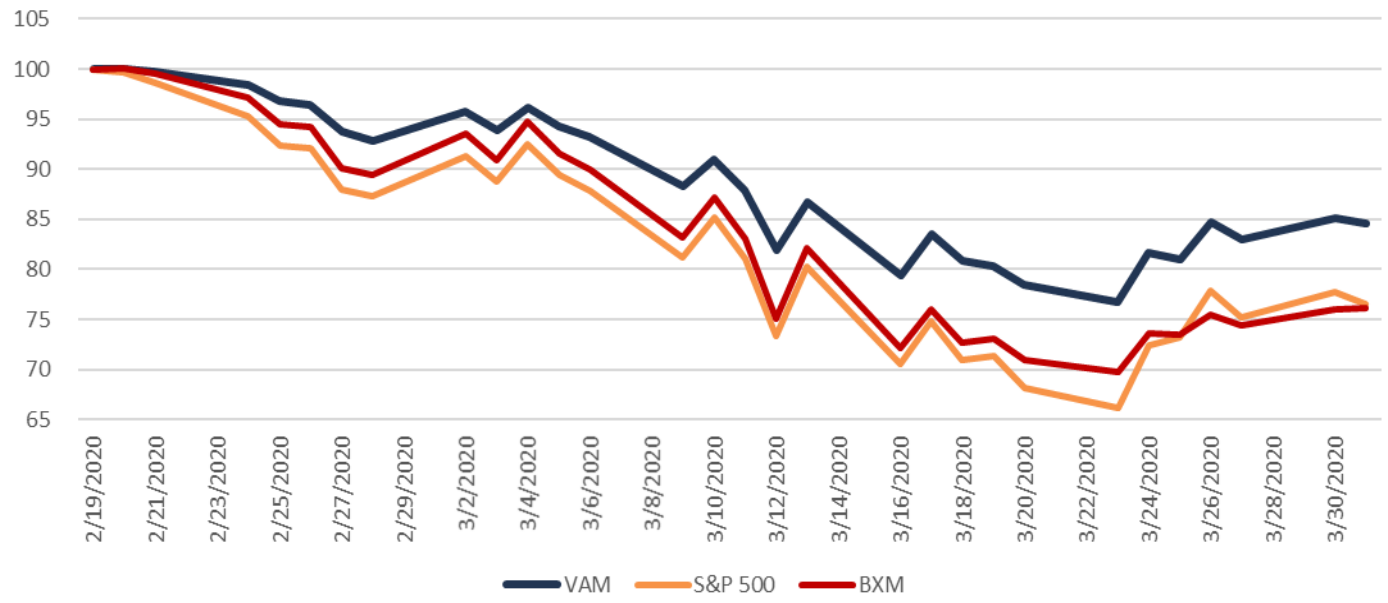
3. Actively managed options. The passive covered call benchmark (ticker BXM) holds the entire S&P 500 and systematically rolls the one-month call option contract based on a pre-set strike price methodology. This systematic rule can cause BXM to be exposed to index price movements ranging from 1% to 99% (of index risk) on any given day. In contrast, we have a dynamic process that allows us to customize the strike prices and duration of each contract based on the implied volatility of the options and our fundamental upside targets.. We then actively manage our options to maintain a range of net exposure to daily price movements, typically between 50% and 70% net long. Generally speaking, there is a trade-off between time decay (short term options) and total downside protection (longer term options), as demonstrated by the below graphic (from the website www.borntosell.com).



Unlike most options managers, who are short term traders, we generally choose to sell intermediate-term options on our positions (our duration is typically between 4-6 months), collecting far more total income dollars into the portfolio than short-term traders. We do this because we have conviction in our fundamental process and prefer to hold our stocks for total return and to protect against sudden declines.

Delivering on Expectations

During the 1st quarter ending March 31 2020, we protected clients from approx. one third of the market losses since the Feb 19 peak. See the relative performance chart and table below.



	VAM	SPX	BXM
Return	-15.4%	-23.5%	-23.9%
Std Dev	66.2%	97.6%	87.5%
Rel Risk	68%	100%	90%

One of the first things that pops out in this data is how poorly the BXM (the passive covered call index) performed during this period. The BXM actually underperformed the S&P 500! Many will wonder how this can be!? It's not necessarily a simple explanation, but we will do our best to lay it out.

The short answer is that option prices rocket higher when volatility spikes. So if you've collected premiums in a low volatility environment and then volatility suddenly spikes, chances are the options you sold will increase dramatically in value, and depending on how much time is left before expiration, the short term paper loss from this change in price can sometimes more than offset the gains you received from your hedge. This normalizes itself over the subsequent period as volatility reverts back toward its equilibrium.

In this particular period (Feb-Mar), volatility spiked from an extremely complacent reading of 14 to more than 80, matching its level from the height of the panic during the 2008 Global Financial Crisis, as the S&P 500 dropped approximately 33%. And by month end, while the volatility index had declined to approx. 60, it certainly had not "normalized" (the long-term average of the CBOE Volatility Index is 20).

The CBOE Volatility Index (VIX) is a calculation designed to measure the expected volatility of the S&P 500 index over the next 30 days as derived by the prices of options on the S&P 500 index. This rise in VIX, from 14 to over 80, means that expected volatility jumped so much that option premiums rose dramatically as investors sought insurance protection for their portfolios. This immense rise in option prices caused BXM (typically much less volatile than the S&P) to fall by 30% during those same 23 days.

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From the market top to the low point on March 23, our covered call portfolios outperformed the S&P 500 index by 10.5% and outpaced BXM by 7.0%. We have continually suggested that a high-quality portfolio of companies with a more stable net exposure than BXM can lead to better results during periods of high volatility. This proved again to be true. By the end of the quarter, our strategy had added to its outperformance over BXM, beating the benchmark by 850 basis points (8.5%).

On top of this, the current portfolio now has over 900 basis points of option income yet to be harvested (collected but not yet realized). This level of option income is among the highest in 10 years and should help provide further downside protection should the quarantine continue for longer than anticipated. This concept is explained further in the next section.

Two Components of Option Gains

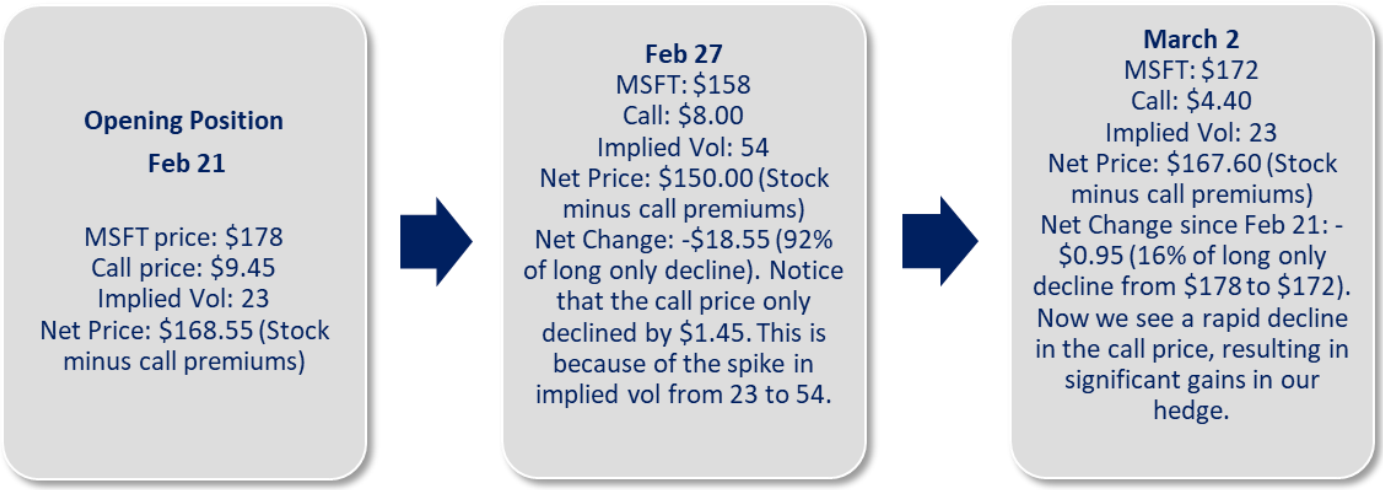
900 basis points still to come? We're definitely entering some advanced topics now, so congratulations on graduating from Options 101! There are actually two separate components of option gains that a covered call position will provide during a market decline:

1. The initial protection from the call premiums collected

2. A second component once volatility normalizes

The distinction between these two becomes especially evident during market crashes and major drawdowns. As mentioned earlier, when markets experience a shock, option prices spike higher and the rise in implied volatility can actually offset some of the hedging benefits of the call options. But importantly, as markets pause (or even rise), the implied volatility (of the option price) drops and we tend to see the stock and option **both** benefit. The option gain/loss is made up (primarily) of (1) time, (2) delta and (3) implied vol. The total change of all three components create the total price change. We often see 100% upside capture during this brief normalization period.

Here's an example (using MSFT) of a "round trip" with volatility spiking from low to high, then back to low.



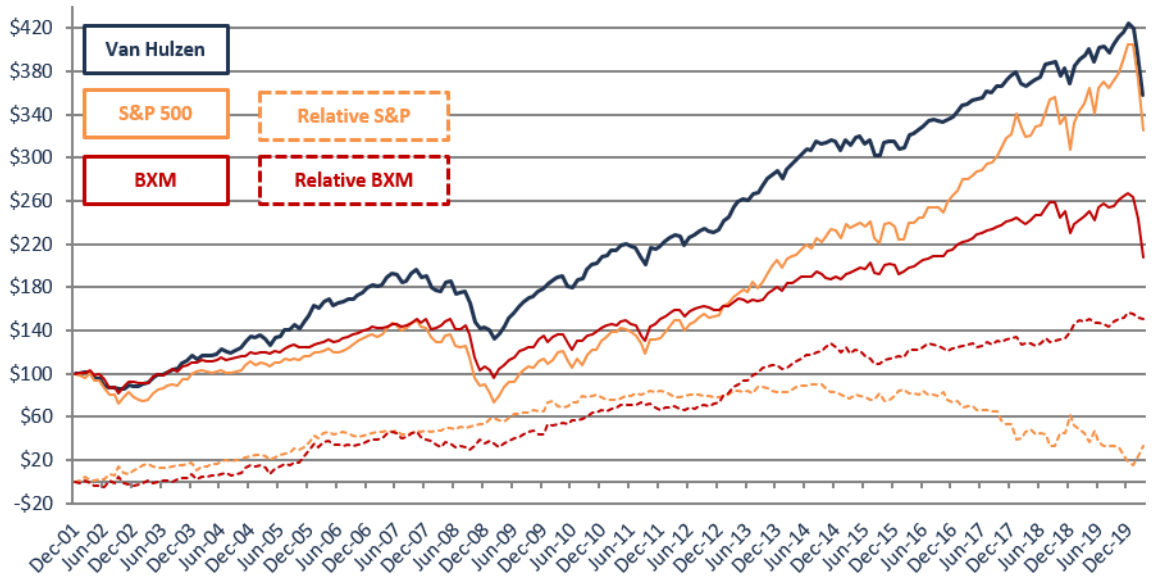
Net Impact

This example "round trip" for MSFT results in a loss of only -0.6% on the position, while the long only stock loss was -3.4%...but during the middle of the trade (at the vol spike high point) the trade was -10%, not much better than the long-only position. As you can see, the full impact of the option protection is only realized as volatility normalizes. Or as the options approach expiration, whichever comes first.

Van Hulzen Covered Call Strategy

The Van Hulzen Covered Call strategy invests in US companies that we consider to have high shareholder yield (dividends and share repurchases) and uses call options with the goal of reducing portfolio volatility and creating incremental income. The goal is a portfolio that has equity exposure while seeking higher than average annual income (target of 6-8% annual), although there is no guarantee that the strategy will achieve its objective, generate profits or avoid losses. Below you will find the graph of the Van Hulzen Covered Call Strategy and the Covered Call Index BXM.

Covered Call Strategy Performance (gross as of 03/31/2020)



Returns (annualized)*	Mar 2020	3M	6M	YTD	1 Year	3 Years	5 Years	7 Years	10 Years	Inception
Van Hulzen (Gross)	-9.4%	-15.4%	-11.4%	-15.4%	-9.2%	0.8%	2.8%	5.0%	6.6%	7.3%
Van Hulzen (Net)	-9.4%	-15.5%	-11.6%	-15.5%	-9.7%	0.2%	2.2%	4.3%	5.8%	6.3%
BXM	-14.9%	-22.2%	-18.9%	-22.2%	-15.7%	-2.4%	1.4%	3.2%	4.3%	4.1%
Difference (Gross-BXM)	5.5%	6.8%	7.5%	6.8%	6.6%	3.2%	1.4%	1.8%	2.3%	3.2%

*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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