Van Hulzen Asset Management

For Financial Professional Use Only

Covered Call Benchmarks

A Commentary On The Right Covered Call Benchmark

VAN HULZEN COVERED CALL STRATEGY

STRATEGY OBJECTIVE

The Strategy's investment objective is to seek total return with less volatility than equity markets in general.

Large Cap Blend/Value

Targets Low Volatility

Option and Dividend Income

INVESTMENT STRATEGY

- The portfolio consists primarily of high quality ultra large cap dividend-paying US stocks.
- Fundamental process for selecting stocks driven by a return-on-capital framework that provides for quality comparisons of companies across industries, sectors and geography.
- Seeks to generate portfolio income of 6-8% through dividends and option income.
- Risk management: Tolerable-risk models, values-at risk models and stop loss procedures to manage portfolio risk.

HOW TO INVEST

Van Hulzen Asset Management LLC
4370 Town Center Blvd, Suite 220
El Dorado Hills, CA 95762
(916) 608-4284

PORTFOLIO MANAGERS

Craig Van Hulzen
John Pearce
Stefan ten Brink
(stefan@vaminvest.com)

What's The Right Benchmark For Covered Calls?

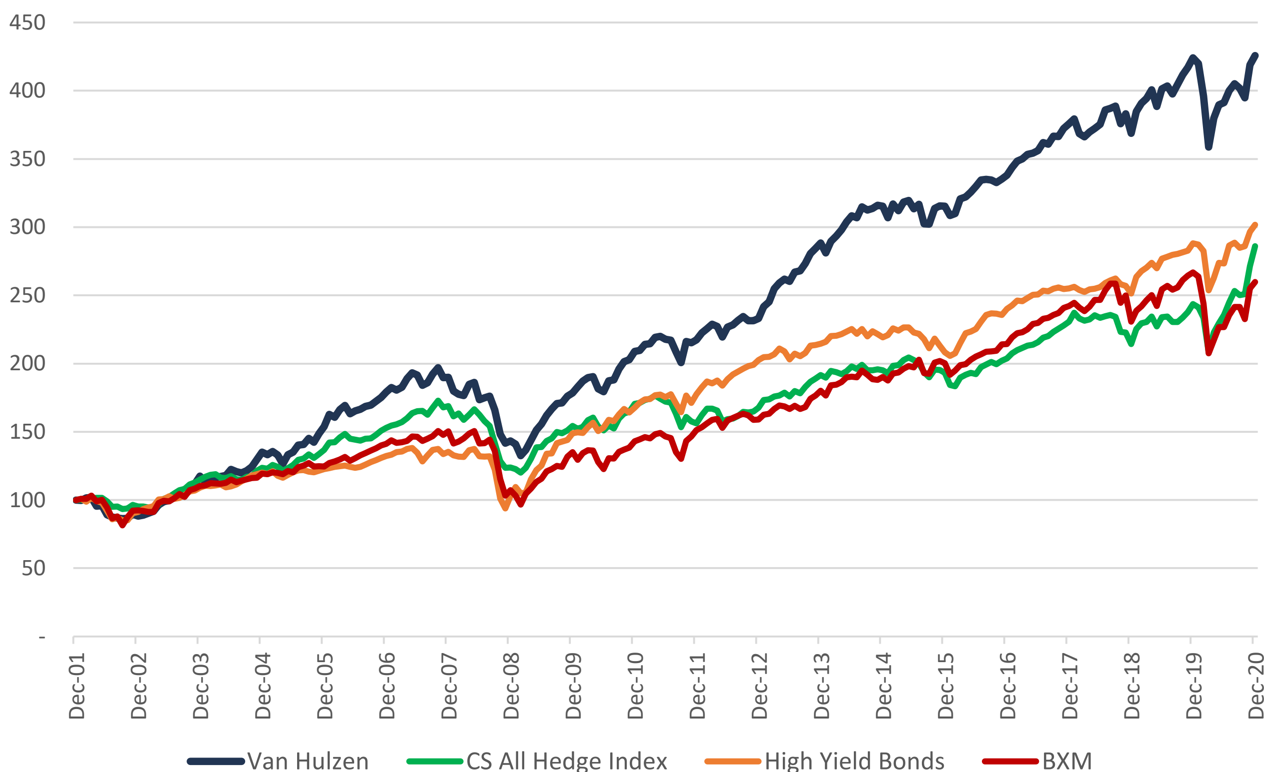
This is actually an important question, and the short answer is it's all about risk. While everyone tracks the stock market and tends to use the S&P 500 as a broad performance benchmark, there are times that this is completely inappropriate. It's important to remember that covered calls are a hedged strategy. When you write a covered call, you are making a deliberate decision to forego potential price upside (above your strike price) for current period income, or option yield. This is why we are always focusing on "risk-adjusted" returns rather than absolute returns. So when stocks go up more than 60% in a short period of time, as they did in the last 9 months of 2020, the "long-only" stock market is not an appropriate benchmark.

So what is? We believe it's important to look at a strategy's risk profile when benchmarking performance. Since our inception in 2001, our covered call strategy has registered a standard deviation of 9.3%, nearly 40% lower than the S&P 500 (at 15.0%). And while we have held our own against the S&P over the very long term, there are benchmarks that make a lot more sense to compare us to. For example, the CBOE buy-write index (BXM), the high yield bond index, and the hedge fund index all have standard deviations in the 9-11% range over the same track record. Clearly, covered calls are the best benchmark for us. But we thought we would show the other two indices as well, as these categories also compete for risk-adjusted allocations. See below.

RISK		
CATERGORY	STANDARD DEVIATION	
Van Hulzen Covered Call	9.3%	
Similar Risk Profiles		
Covered Call Index (BXM)	11.1%	9.7% average
High Yield Bonds (HYG)	9.4%	
Hedge Fund Index (Credit Suisse)	8.5%	
S&P 500	15.0%	

This is a diverse group. Covered calls and high yield bonds are both income vehicles, whereas hedge funds are primarily focused on risk reduction. But it's interesting to note that the three have delivered returns in a tight 5-6% range over the past 19 years (since our inception). See below:

RETURN		
CATERGORY	ANNUAL RETURN	
Van Hulzen Covered Call	7.9%	
Similar Risk Profiles		
Covered Call Index (BXM)	5.2%	5.6% average
High Yield Bonds (HYG)	6.0%	
Hedge Fund Index (Credit Suisse)	5.7%	
S&P 500	8.6%	



Current Market Environment

With rates at all-time lows and valuations as stretched as we've ever seen them, we believe investors should be more cautious than normal and prioritize income and downside protection over price appreciation. And with volatility at elevated levels, we believe covered calls continue to be a great investment allocation.

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:

<u>Equity investors</u>: 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.

<u>Fixed income investors</u>: 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 1-3% 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?

RISK CONSIDERATIONS:

Past performance is not a guarantee of future results. Dividends are not guaranteed and must be declared by a company's board of directors

Van Hulzen Asset Management (VAM) is a SEC registered investment advisor located in El Dorado Hills, CA. VAM and its representatives are in compliance with the current registration requirements imposed upon registered investment advisors by those states in which VAM maintains clients. VAM may only transact business in those states in which it is registered or qualifies for an exemption or exclusion from registration requirements. Past performance is not a guarantee of future results. The results achieved by individual clients will vary and will depend on a number of factors including the particular underlying stock and its dividend yield, option market liquidity, interest rate levels, implied volatilities, and the client's expressed return and risk parameters at the time the service is initiated and during the term. Investing in options involves risk that must be considered and reviewed with a professional prior to investing. This presentation is not intended for the giving of investment advice to any single investor or group of investors and no investor should rely upon or make any investment decisions based solely upon its contents. The iBoxx USD Liquid High Yield Index measures the USD denominated, sub-investment grade, corporate bond market. The index includes bonds with minimum 1 years to maturity, minimum amount outstanding of USD 400 mil. Bond type includes fixed-coupon, step-up, bonds with sinking funds, medium notes, callable and putable bonds. Performance shown in above graphs is gross of fees. The overall Morningstar Rating is based on risk-adjusted gross returns, derived from a weighted average of the three-, five-, and 10-year (if applicable) Morningstar metrics. Relative performance represents the difference between a $100 hypothetical investment in Van Hulzen's covered call strategy versus a $100 hypothetical investment in each respective benchmark. FPAC-0087-21

The Strategy involves risk including the possible loss of principal. There is no assurance that the Strategy will achieve its investment objectives. The use of leverage embedded in written options will limit the Strategy's gains because the Strategy may lose more than the option premium received. Selling covered call options will limit the Strategy's gain, if any, on its underlying securities and the Strategy continues to bear the risk of a decline in the value of its underlying stocks. It is not possible to invest directly in an index

Van Hulzen Asset Management, LLC | 4370 Town Center Blvd, Suite 220 | El Dorado Hills, CA 95762

Website: vaminstitutional.com
Main Office: (916) 608-4284

.