

Quest for Yield: The Search for Income Alternatives

With rates still at record lows and poised to go higher, the fixed income space could be on the cusp of a generational secular change. Just as falling rates have fueled the massive bull market in bonds over the past 40 years, rising rates represent a significant hurdle. Shorter duration bonds already have near-zero yields, and longer duration bonds face significant price risk (particularly bond funds that face supply/demand issues as well). **Investors are actively looking for income alternatives.**

According to Stephanie Link, chief investment strategist and portfolio manager at Hightower Advisors,

“With interest rates so low, we have to think out-of-the-box for yield. Depending on your risk profile and your timeline, maybe that’s a combination of Treasury inflation-protected securities, preferred stocks, gold, bond-like stocks — such as an AT&T or Verizon — and stock-like bonds, including investment-grade corporate debt. I’d put a little emerging-markets debt in that basket too.”

Covered calls are another great way to enhance your yield in this type of environment, with volatility still high and value-stocks poised for a comeback relative to growth. **We are getting 8-10% annual yields** on our covered call investments, and unlike bonds there is minimal interest rate risk or credit risk.

An Unprecedented Low Yield Environment

Today’s low yield environment has made it incredibly hard to find reliable sources of income without sacrificing quality. Although the Fed seems committed to keeping short rates in check for now, 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.

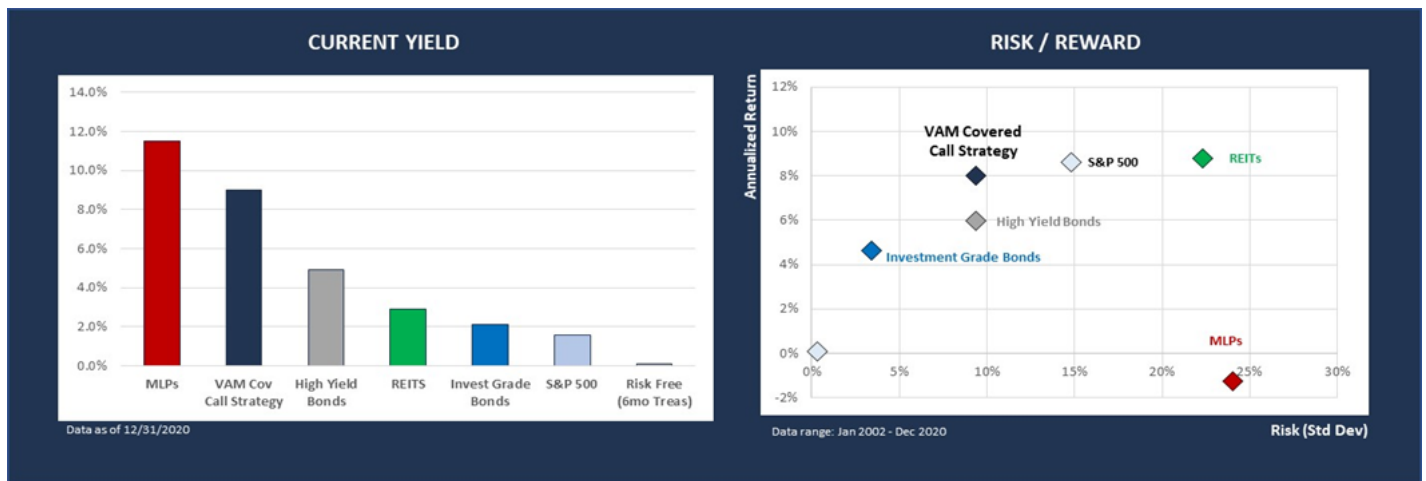
10 Year Treasury Yield



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 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). And of course, a covered call portfolio can carry less market risk than long-only stocks. This balanced combination of income and price appreciation is shown below, compared to the other major asset classes. Our covered call strategy has performed roughly in-line with the S&P and REITs over the past 19 years, but at significantly lower 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.

History of Covered Calls

Over 30 years ago the Chicago Board of Options Exchange (CBOE) and Standard & Poor's (S&P) created the standard for covered call benchmarks known as the CBOE S&P 500 Buy-Write Index (BXM). The BXM Index is designed to track the performance of a hypothetical buy-write strategy on the S&P 500 Index (for more info, see www.cboe.com/micro/bxm/introduction.aspx). Several high-profile studies have helped to bring covered calls to the forefront of equity allocation discussions as well.

The CBOE website references three studies in particular from the past 10 years that look at the risk- return dynamics of covered calls. All three firms conducting these studies (Callan Associates, Ibbotson, and Asset Consulting Group) concluded that over the time period studied, a passive buy-write strategy had a superior risk-return profile over long-only equities, achieving similar long term returns at significantly lower risk. And while a passive buy-write strategy (index replication) indeed has solid relative characteristics, an active buy-write strategy has the potential to further improve the outcome. Yet the active application of buy-write strategies can differ significantly in both process and outcome. In short, not all covered call strategies are created equal.

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.

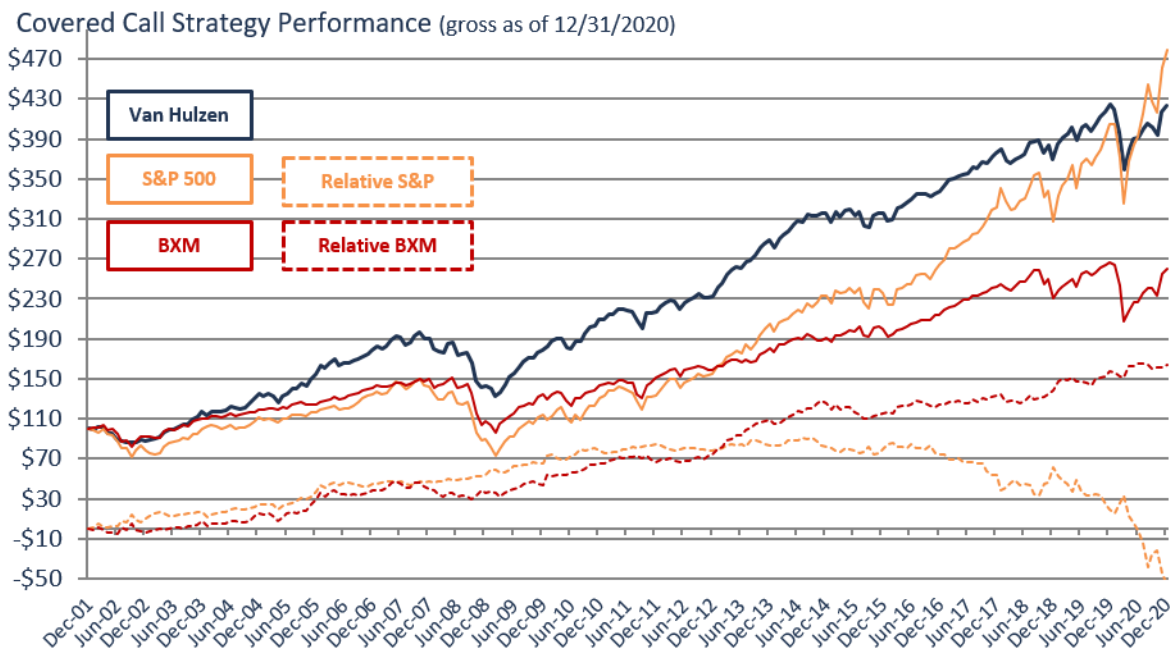
Fixed income investors: Today's low yield environment has made it incredibly hard to find reliable sources of income without sacrificing quality. And on top of that, interest rates stand poised to eventually rise, which will almost certainly increase the volatility and cut into the returns of this asset class. With treasury yields at all-time lows and investment grade corporate bonds yielding 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?

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.



Returns (annualized)*	Dec 2020	3M	6M	YTD	1 Year	3 Years	5 Years	7 Years	10 Years	Inception
Van Hulzen (Gross)	1.6%	5.3%	8.1%	-0.3%	-0.3%	4.0%	6.1%	5.6%	7.3%	7.9%
Van Hulzen (Net)	1.6%	5.2%	7.8%	-0.8%	-0.8%	3.5%	5.4%	5.0%	6.5%	7.0%
BXM	1.8%	7.5%	14.6%	-2.8%	-2.8%	2.3%	5.3%	5.4%	6.1%	5.1%
Difference (Gross-BXM)	-0.2%	-2.2%	-6.4%	2.5%	2.5%	1.7%	0.7%	0.3%	1.2%	2.7%

*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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