VAN HULZEN ASSET MANAGEMENT

For Financial Professional Use Only

Lipstick On A Pig

A Commentary on High Yield Bonds

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

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PORTFOLIO MANAGERS

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We have never understood the value proposition of high yield bonds. As fundamental, bottom-up value managers, you might call us a little biased, but we believe the category is called "junk" for a reason.

Despite residing in the fixed income category, which of course traditionally has a reputation for safety and stability, high yield bonds carry significant credit risk and offer very little downside protection during equity market declines. The volatility of this bond subset is 2-3x its investment grade counterpart. The drawdown in junk bonds was a whopping -32% during the 2008 financial crisis. This is because elevated credit risk leads to widespread defaults whenever markets hit turmoil.

Owning stocks and high yield bonds are a bet on the same outcome and therefore offer practically no diversification. To us, there couldn't be a more fitting ticker for the category's leading ETF: JNK!

We suspect that the average investor in this ETF does so for the yield and does not truly understand what they are buying (or the level of risk they are taking). These junk corporations entice too many income-seeking investors, who are often retirees living on their own fixed income sources in order to meet their living expenses.

For those of us who know there is a blue-chip, high quality strategy that can offer the same or better yields than HY bonds, we cannot fathom investing in junk companies.

Owning a portfolio of individual debt issues of poor credit corporations is the same as building a housing development on foundations of sand. The first weather event could wash away the foundation and damage the entire development.

Say an acquaintance you met at a party asks you for a loan. He says he'll pay you 6% interest. Granted, his business hasn't made a profit in almost 5 years, but he tells a pretty good story about the future prospects. You take a look at his financials and find the following:

Financials	
Revenues	$ 13,000
Operating Earnings	$ 1,500
Capex	$ -500
Interest Expense	$ -1,000
Wiggle Room	$ 0

The company has $200 if cash on hand and $13,000 (!!) of debt. You, being a math wizard, do a quick calculation and figure out that this business has a default probability of approx. 43%. This concerns you, because a 43% chance of losing your entire investment and a 57% chance of earning 6% has a negative probability outcome.

You bump into another friend at the party and he says he's investing in a well-known company that pays a 3% dividend yield and has almost zero default risk. This friend says he's using covered calls to boost that yield to 9-10%. Seeing as you were contemplating a 6% upside without any price appreciation potential, you are intrigued by the 9% yield and some upside that can be earned in the covered call investment.

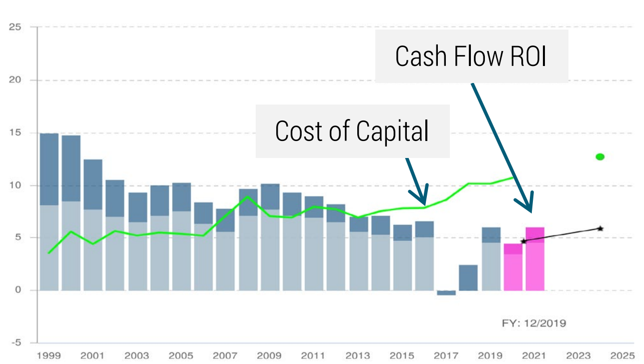
The Real World

We believe most informed investors would choose the safer bet with the higher yield, which is why (as mentioned earlier) we just don't understand how so many investors put their money into junk bonds.

Although the above example is stylized, the numbers are based on a real-life company, which is a Top 10 holding in the high yield index iBOXX. The company is Community Health Systems (ticker CYH). And the alternative idea is based on one of our top 10 holdings. We have presented a fundamental comparison of the two companies below:

Community Health Systems (CYH)

Top 10 HYG & JNK Holding

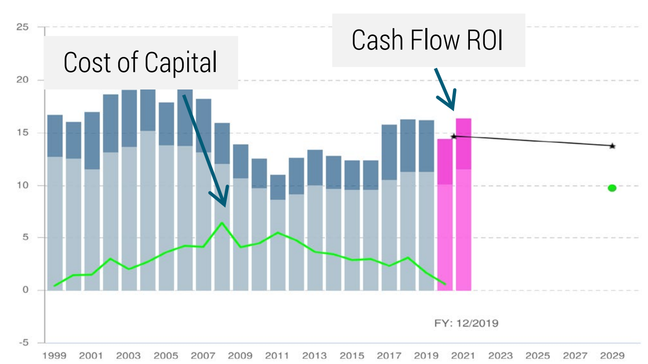


Key Statistics

- 98% market leverage
- CCC+ rated
- 1.1x Interest coverage
- 43% default probability

Example A

Top 10 Van Hulzen Covered Call Holding



Key Statistics

- 7% market leverage
- AAA rated
- 39x Interest coverage
- 0% default probability

Source: Credit Suisse HOLT

As you can see, there is a stark difference between the two opportunities. CYH has an ROI well below its cost of capital, carries nearly 100% leverage, is barely covering current interest payments, and in fact has a 43% default probability according to the Merton model, which uses debt totals and maturity dates to assess a company's risk of credit default.

Example A, on the other hand, earns an ROI 4-5x its cost of capital, carries very little leverage and has 0% default risk according to the Merton model.

We don't want to pick on CYH in particular, and we wish them luck refinancing their debt and surviving this difficult time. But we do believe it's a good example of the type of risks that are buried in high yield bond funds. And while the Federal Reserve has instilled some confidence in this category by announcing that they may buy some of these ETFs, this does not change the fact that many of these companies will not be able to meet their obligations.

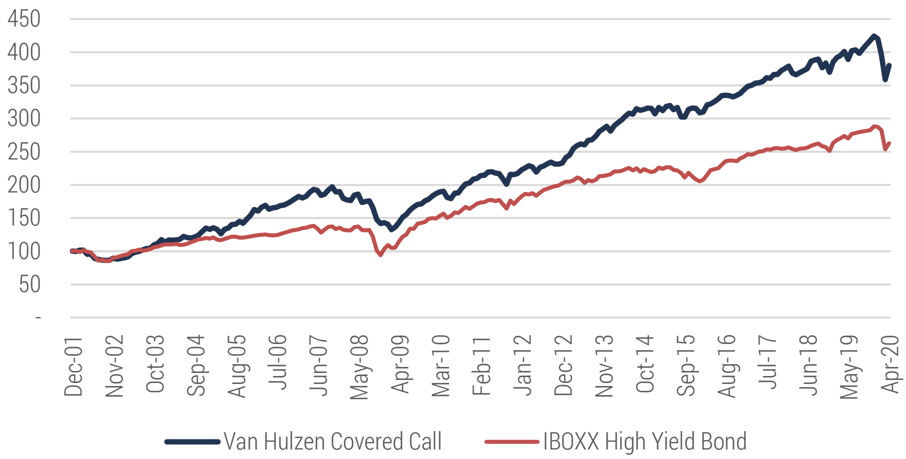
To us, the Fed's commitment is tantamount to putting **Lipstick On A Pig**.

A Better Risk-Return Profile

None of this even addresses the fact that bonds have enjoyed a nearly 40-year bull market as rates have dropped from mid-teens to zero and will inevitably face significant headwinds once rates begin rising again.

We believe covered calls are the perfect alternative to junk bonds. Our strategy, which has an 18+ year track record, actually has a slightly lower standard deviation than the IBOXX high yield bond index (9.3% versus 9.4% over the same time period). And our strategy has out-performed the IBOXX by 2.2% per year! We have done this by investing in high quality companies with fortress balance sheets and using call options to increase yield and reduce risk, just as our example highlighted.

We have charted our cumulative performance below, relative to the IBOXX high yield index. On a cumulative basis, investing $100 into our strategy would have resulted in $380 compared to $262 for high yield bonds over the same period.



There is of course another key distinction between the two approaches: while junk bonds struggle during periods of higher downside volatility, covered calls can actually thrive in that environment.

For more information of this unique aspect of our strategy, please vaminstitutional.com

RISK CONSIDERATIONS: Review Code FPAC-0396-20:

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

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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