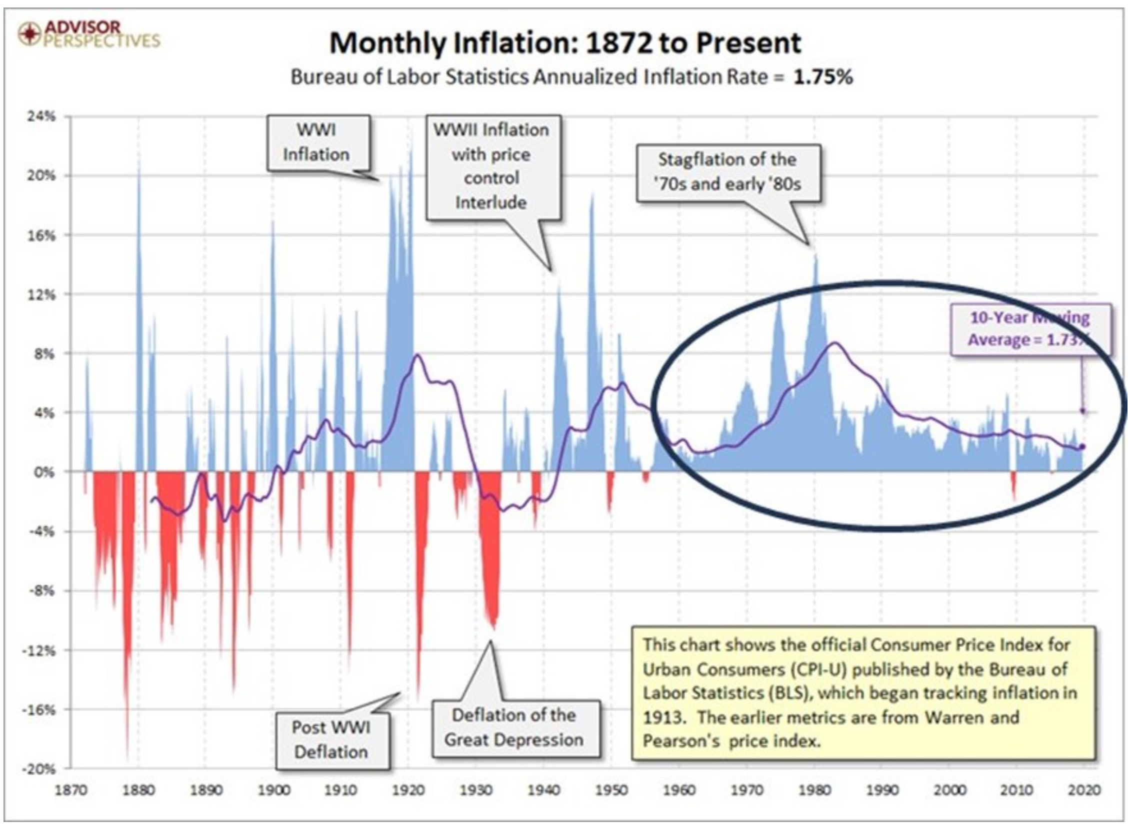
Covered Call Commentary

April| 2021

How Will Inflation Affect Covered Calls?

With record government spending and skyrocketing deficits, the airwaves are abuzz with talk of inflation. Inflation can actually be a net positive for covered call strategies (relative to long-only strategies), which we will discuss further below. But before we get into that, we through we'd take a step back and look at inflation over the many decades since the late 1800s.

One of the first things that jumps off the page is how much the picture has changed over the last 50 years compared to the preceding 100 years. With the exception of the mid-late 1970s, which one might argue was fueled by the Baby Boomer generation hitting their peak spending years, inflation has generally ranged between 2-4%. And there has only been one (very short) blip of deflation, during the 2008-09 financial crisis. Compare this to the wildly volatile swings that we saw, nearly every decade prior, with inflation ranging from -12% to +20%. The difference is of course an incredibly active Federal Reserve Bank, particularly since the early 1980s. Many would argue that we "should" have seen a significant period of deflation following the financial crisis, but the Fed's accommodative policies have prevented this from coming to fruition.

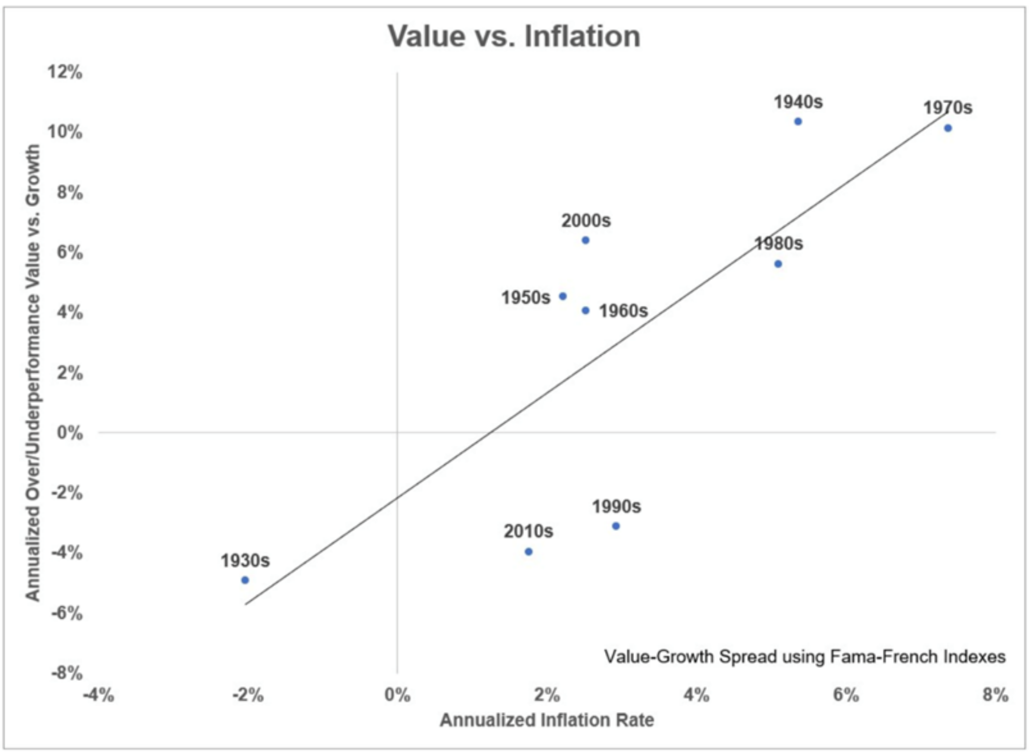


What can we take away from this? There's no question that we are seeing some inflationary pressures in certain commodities and things like housing and health care. But there are also offsetting forces, such as innovation, which is inherently deflationary. And then there is the Fed. One might argue, based on the chart above, that we have much less of a free-market economy than we used to. And the Fed is unlikely to allow inflation (or deflation, for that matter) to get out of control.

Tailwinds for Covered Calls

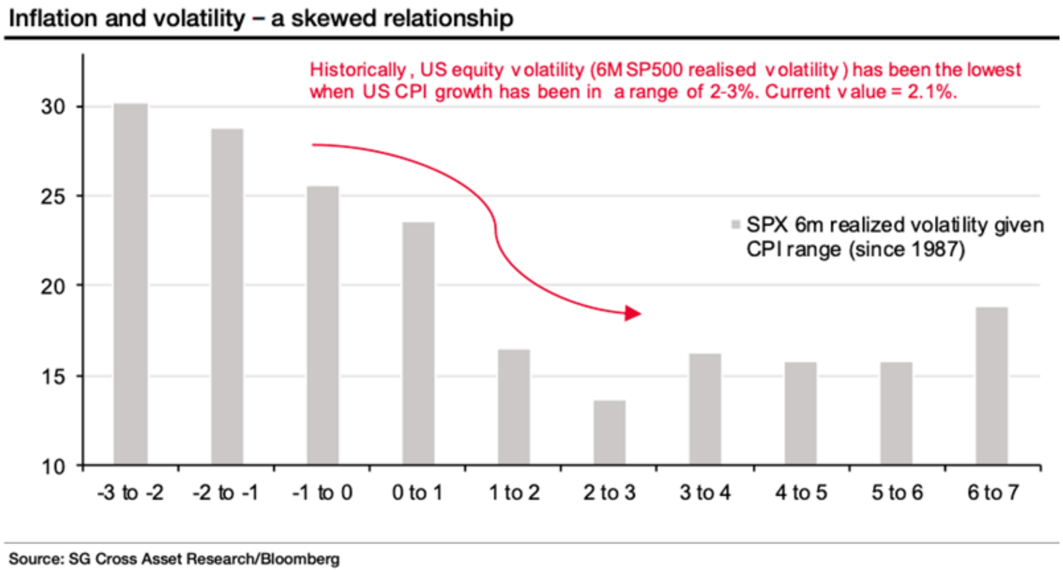
Regardless of where you stand with respect to inflation expectations, it's important to understand how inflation would affect your investments. And we are strong believers that it would create a tailwind for our covered call strategy. There are two primary reasons for this:

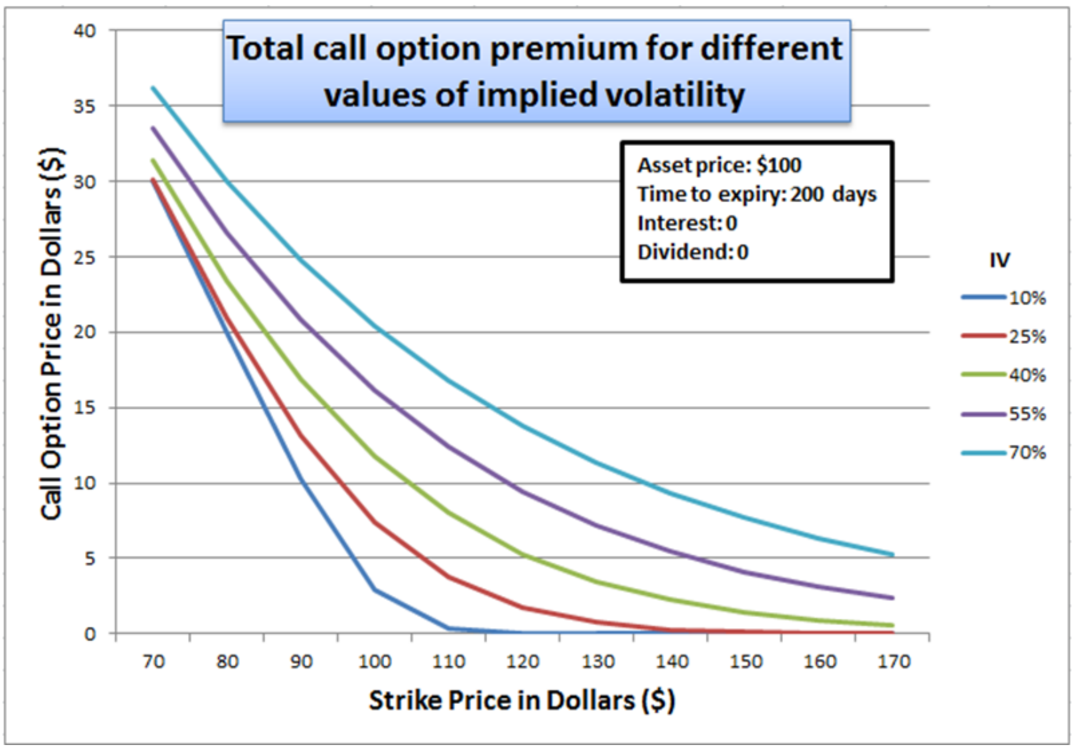
1. Value typically out-performs growth during inflationary periods. Value has out-performed growth over the long term. We sometimes lose sight of that fact, especially after a 5 year stretch like we've just been through. But as you can see below, value stocks have out-performed growth stocks in 6 of the last 9 decades. And the 3 decades where growth out-performed were amongst the lowest periods of inflation. This makes intuitive sense, as growth stocks have higher multiples (and thus more years of future cashflows baked into their valuations), so when inflation expectations rise, the discount rate rises as well, bringing down warranted values.



If we are in fact embarking on a reflationary period, value stocks should continue to out-perform as they have in the past two quarters. This will benefit income-oriented strategies like ours, which typically has a 70-75% value tilt.

2. Elevated inflation (positive or negative) typically creates market volatility, which leads to higher options prices. This is no secret. In fact, the Volatility Index (VIX) is derived from the options market. We have spent the vast majority of the last 30 years with inflation range-bound between 1-3%. This has kept option prices depressed. But of course, when option prices do rise, you want to be a seller of options – not a buyer of options. Our strategy does just that. And right now, we are collecting annualized option premiums of more than 10% in many cases. This compared to an average of 4-6% over the past decade.





Source: https://medium.com/deribitofficial

Key Takeaway

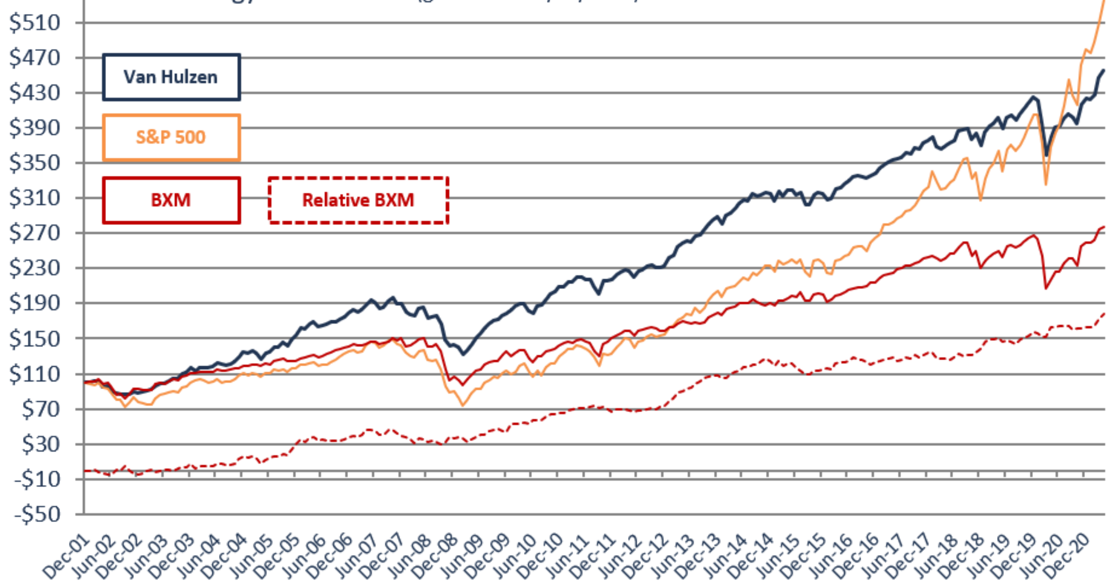
Nobody knows what the future holds. But the current momentum appears to indicate that inflation is on the rise, even if only modestly. This will create headwinds in many asset classes, particularly in the fixed income and growth equity categories. But it's nice to know that this environment will actually benefit your covered call portfolio.

We are getting 10%+ yields and currently carry about 40% less risk than the S&P 500. And while our value tilt created some headwinds last year, these winds have clearly shifted.

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 04/30/2021)



Returns (annualized)*	Apr 2021	3M	6M	YTD	1 Year	3 Years	5 Years	7 Years	10 Years	Inception
Van Hulzen (Gross)	1.8%	7.6%	15.4%	7.4%	19.6%	7.1%	7.1%	6.2%	7.6%	8.1%
Van Hulzen (Net)	1.7%	7.5%	15.1%	7.2%	19.0%	6.6%	6.5%	5.6%	6.8%	7.2%
BXM	0.8%	6.5%	19.0%	6.6%	27.4%	4.6%	6.7%	5.8%	6.4%	5.4%
Difference (Gross-BXM)	0.9%	1.1%	-3.6%	0.8%	-7.7%	2.5%	0.4%	0.4%	1.1%	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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