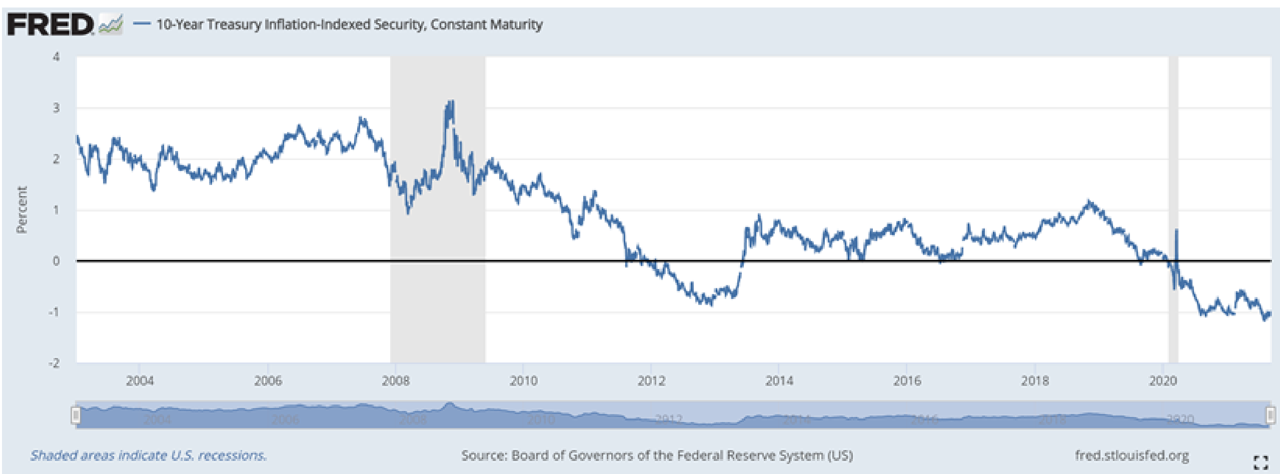
Covered Call Commentary

August | 2021

Negative Real Rates & Your Retirement

What are negative real rates? First of all, a real interest rate is the inflation-adjusted level of interest rates. So, for example, in 2006 when the 10 year Treasury bond was yielding 4.5% (in nominal terms) and the inflation rate was 2%, that meant the *real* (inflation adjusted) interest rate was 2.5%. These were relatively healthy numbers.

Today, however, interest rates are near all time lows, while inflation is on the rise. These forces are working against each other. The same calculation today gives a very different result. Today's 10 year Treasury bond yields 1.3%, but applying the current inflation rate of 2.4% drives the real interest rate down to -1.1%. And many people believe inflation is actually much, much higher than this official figure. After all, GDP was up 4.3% in Q1 and 6.1% in Q2. This means today's real interest rate could actually be as low as -4%.



How Does This Affect Your Retirement?

What does this mean, exactly? And how does it affect your retirement? There is no question low and negative interest rates are bad for pensions and retirees who are trying to generate enough income from their assets to meet their liabilities through lower volatility bonds. And we don't want to be too grim, but it basically means retirees will be bailing water out of a sinking boat for a while. The days of putting your retirement account in a 6% bond portfolio and calling it a day are over. We will revisit some of the data from last month's commentary to illustrate this point.

According to the world's leading investment firms, future stock returns (over the next 7-10 years) are expected to be in the low-mid single digits. See below.

Future Stock Return Forecast (7-10 years)	
Blackrock	6.1%
JP Morgan	5.6%
Grantham	-4.4%
Morningstar	1.7%
Research Affiliates	0.3%
Vanguard	4.5%
Average	**2.3%**

Source: https://www.morningstar.com/articles/962169/experts-forecast-long-term-stock-and-bond-returns-2020-edition

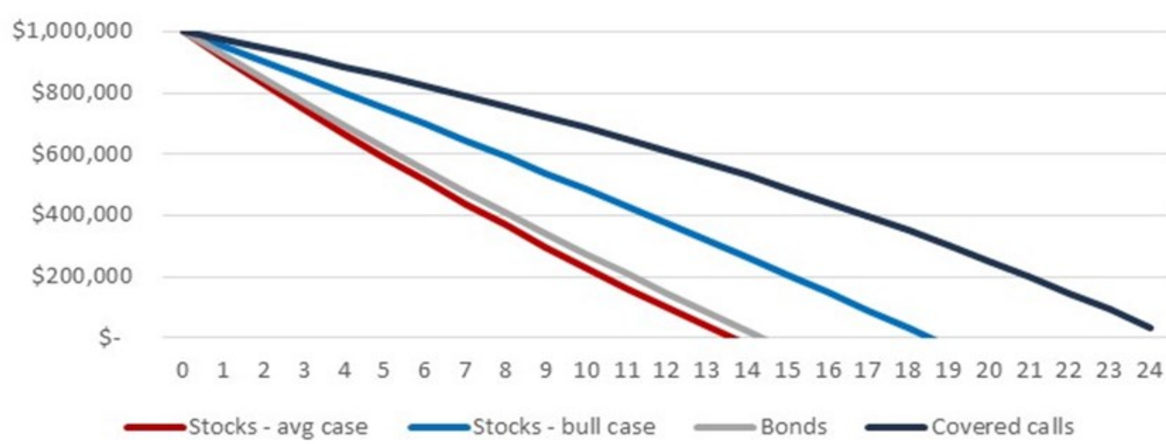
And according to the Federal Reserve SCF (Survey of Consumer Finances), the average 65 year old in the U.S. has retirement savings of approximately $220,000. The median is much, much lower. But to illustrate our point, we will **assume a retiree has $1,000,000 saved up** at the time of their retirement.

Now let's assume this person needs to withdraw approximately $5,000 per month (6% annual) for livings expenses. In the old days, when inflation was relatively low, bonds yielded 6% and stock dividends were 3-4%, this was a very achievable scenario. But today, bonds are only getting ~2% and dividends are just over 1%. And let's assume an inflation rate of 5%, which may seem high but is well below the levels we saw in the 1970s, when inflation spiked as high as 14% and averaged approximately 7% for the decade.

Let's do the math. If this retiree is invested in stocks at the average forecasted return of 2.3% (from above), he or she would be out of money after 13 years! Even assuming the most bullish forecast for stocks (Blackrock's 6.1%), this person's $1,000,000 nest egg would be gone in 18 years.

One asset class that stands to do well during an inflationary environment, of course, is covered calls. Re-read our April 2021 commentary for the detailed evidence and analysis on that. For this category, we have assumed the average stock return of 2.3%, plus an additional 6% for annual net option yield (total of 8.3%). This is in line with our 20 year average annual return. And because the past 20 years have been deflationary, not inflationary, we believe this is fairly conversative.

Hypothetical Nest Egg Over Time



Asset Class	Gross Rtn	Inflation	Net Rtn	Years Funded
Stocks - avg case	2.3%	-5.0%	-2.7%	13
Stocks - bull case	6.1%	-5.0%	1.1%	18
Bonds	3.1%	-5.0%	-1.9%	14
Covered calls	**8.3%**	**-5.0%**	**3.3%**	**24**

Note: 3.1% bond return is the average from the three inflationary decades (1940s, 1960s & 1970s)

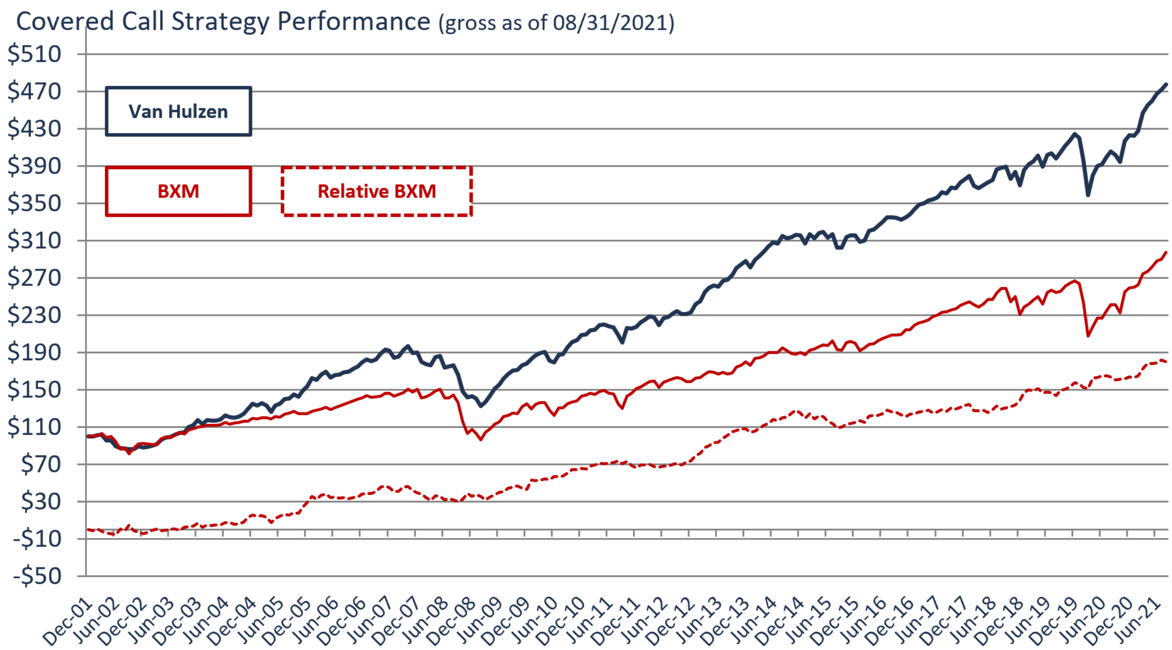
If you're wondering if these forecasted stock returns are too low, we would just remind you that the S&P 500 has only approached today's sky high valuation multiples twice in the past 100 years, in 1929 and 1999. And the 10 year average annual stock return for the decade following these periods was 1.8% and 1.4%, respectively.

Key Takeaways

According to a Forbes article in August 2019, titled *What Negative Interest Rates Mean For Your Retirement*, retirees will need to "buy riskier assets and embrace that they will need to accept more volatility in order to achieve their goals." We couldn't disagree more. Now is not the time to add risk, especially credit risk. If you are a retiree, we believe now is the time to shift your objectives from growth to income. And while attractive sources of income are hard to come by these days, there are solutions. It may be time to take another look at covered calls.

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)*	Aug 2021	3M	6M	YTD	1 Year	3 Years	5 Years	7 Years	10 Years	Inception
Van Hulzen (Gross)	1.2%	3.9%	11.7%	12.8%	17.8%	7.2%	7.3%	6.1%	8.6%	8.3%
Van Hulzen (Net)	1.2%	3.7%	11.4%	12.4%	17.2%	6.6%	6.7%	5.5%	7.9%	7.4%
BXM	2.6%	5.4%	13.3%	14.6%	23.2%	4.8%	7.3%	6.2%	8.2%	5.7%
Difference (Gross-BXM)	-1.4%	-1.6%	-1.5%	-1.7%	-5.4%	2.4%	0.0%	-0.1%	0.4%	2.6%

*Inception date : 12/31/2001. Figures greater than one year are annualized. Van Hulzen returns represent actual returns from composite of accounts

The foregoing content reflects the opinions of Van Hulzen Asset Management and is subject to change at any time without notice. Content provided herein is for informational purposes only and should not be used or construed as investment advice or a recommendation regarding the purchase or sale of any security. There is no guarantee that these statements, opinions or forecasts provided herein will prove to be correct. Past performance is not a guarantee of future results. Indices are not available for direct investment. Any investor who attempts to mimic the performance of an index would incur fees and expenses which would reduce returns. All investing involves risk including the potential for loss of principal. There is no guarantee that any strategy will be successful. The CBOE S&P 500 BuyWrite Index (BXM) is a benchmark index designed to track the performance of a hypothetical buy-write strategy on the S&P 500 Index. The BXM is a passive total return index based on (1) buying an S&P 500 stock index portfolio, and (2) "writing" (or selling) the near-term S&P 500 Index (SPXSM) "covered" call option, generally on the third Friday of each month. The S&P 500 Index consists of 500 stocks chosen for market size, liquidity, and industry group representation. It is a market-value weighted index (stock price times number of shares outstanding), with each stock's weight in the Index proportionate to its market value. It is widely used as a benchmark of U.S. equity performance. It is not possible to invest directly in an index: FPAC- 0375-21