Covered Call Commentary

May | 2022

Shot Across The Bow. What's Next?

Our covered call strategy has performed very well during this challenging, "nowhere to hide" environment. Through May 31, our performance compares to the broad indices as follows. Our focus on quality, income and protection has paid off in spades.

2022 Year To Date

Van Hulzen Covered Call Strategy	- 5.2%
Cov Call Index (BXM)	- 7.5%
S&P 500	-12.8%
Nasdaq Composite	-22.5%
High Yield Bonds	- 7.2%

What's Next?

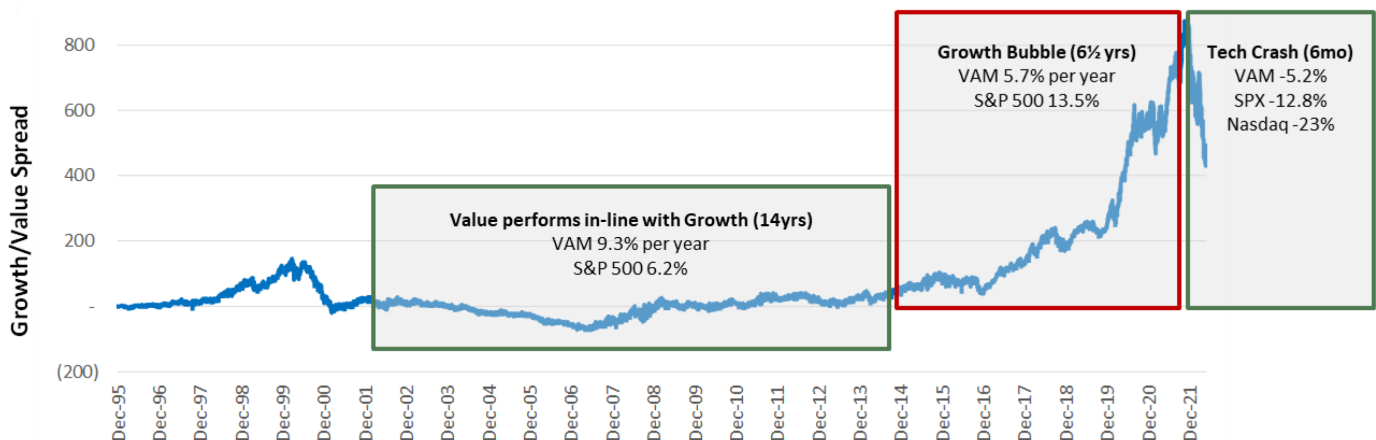
Growth stocks had an unprecedented run over the past 5 years, out-performing value stocks by a whopping 13% per year (23.6% versus 10.6%) through December 2021. Well, that premium has cut in half in just the past 5 months! See below.

This "growth bubble" period has been terrible for most income strategies, which invest in lower beta, dividend paying stocks. Covered calls were no exception. But the world changed in 2022. With inflation rising quickly, the Fed ending its accommodative policies, and several geopolitical blow-ups (Russia's invasion of Ukraine and the prolonged China lock-down) creating huge supply chain constraints, markets have shifted into defensive mode. The key question, of course, is **what is next**?

Two forces we have discussed extensively with our clients are the value/growth trade-off and the impact of volatility on market performance. We will drill into each of these topics below.

Value vs Growth

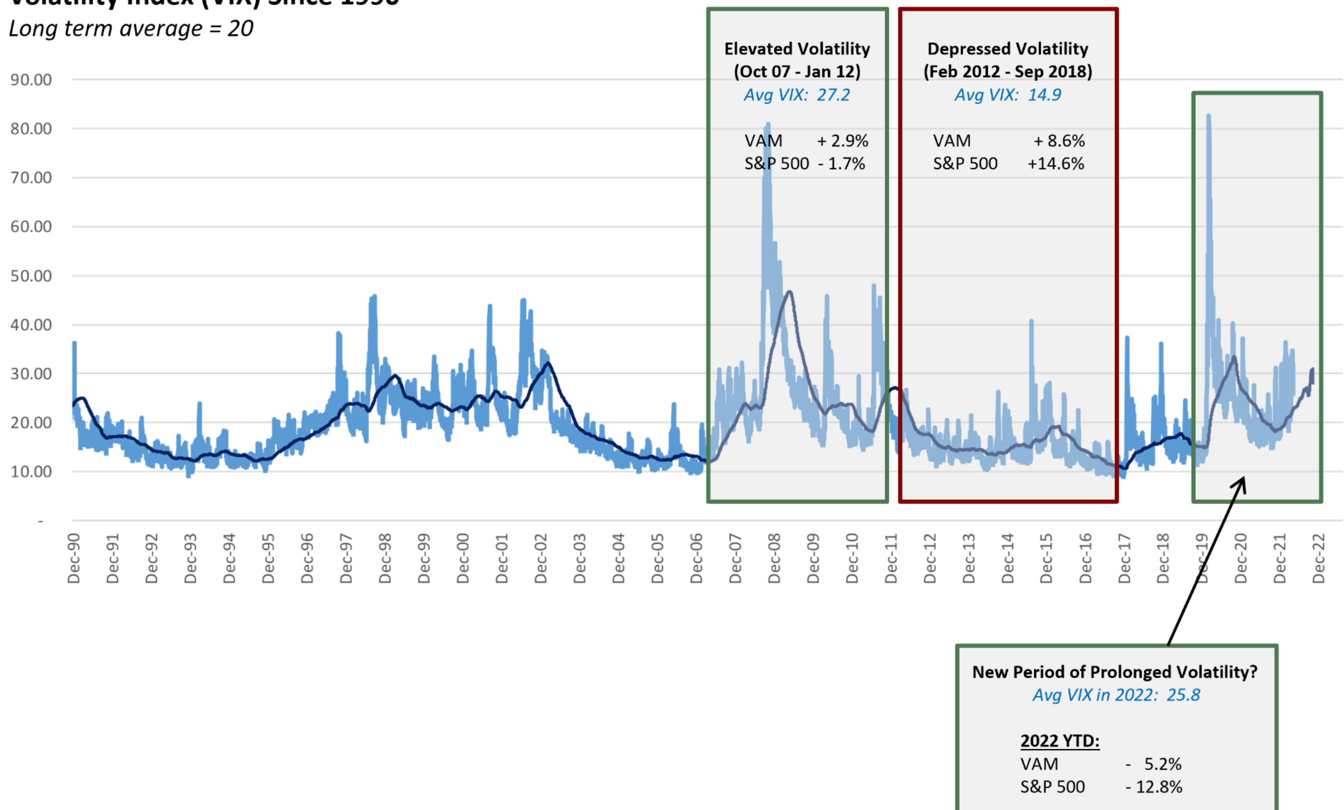
The chart below shows the Growth/Value spread (the historical performance of growth stocks divided by the performance of value stocks). As you can see, value and growth stocks performed in-line with each of there for a long period of time during the first 14 years of the 2000s. Growth stocks then demolished value stocks for 6½ years (as discussed above), and since then value stocks have significantly out-performed.



It is intuitive that our covered call strategy, which is value-income oriented and significantly hedged, would under-perform the S&P during the growth bubble, just as it makes sense we would significantly out-perform during the growth sell-off. But what we would like to examine is the longer period from 2002 to 2015. During this 14 year period, our covered call strategy outperformed the S&P 500 by more than 3% annually (+9.3% versus +6.2%). This is meaningful. When markets move sideways or moderately higher, the incremental income generated by covered calls not only delivers downside protection, it can also add meaningful incremental returns to your portfolio!

Volatility

The second factor we'd like to discuss is volatility. Markets tend to move in cycles, and so does volatility. During periods of depressed volatility ("risk-on" periods), growth stocks tend to outperform "hedged" strategies that incorporate protection into their design. For example, we've highlighted several distinct periods on the long-term chart of the VIX (below). From the market peak in October 2007 through early 2012, which includes the worst months of the Great Recession, the daily VIX averaged 27.2, about 36% higher than its long-term average of 20. The S&P 500 had an average annual return of -1.7% during this 4½ year period. Our strategy outperformed by 4.6% per year during this challenging period. In contrast, from February 2012 to September 2018 (6½ years), it paid to be more growth oriented. Our strategy delivered an average annual return of 8.6%, which is solid, but the growth-oriented S&P did much better.



The key question is where are we now? The first half of 2022 seems to indicate that we are embarking on another (potentially lengthy) period of elevated volatility. If this is true, hedged strategies – particularly ones that leverage options – should outperform.

A "Double V" Market: An Ideal Environment for Covered Calls

1. Elevated volatility. Covered calls do better during volatile markets, as call premiums are higher and provide more income.
2. Preference for Value stocks. Covered calls are an income strategy and will do better when income-oriented value stocks out-perform growth stocks.

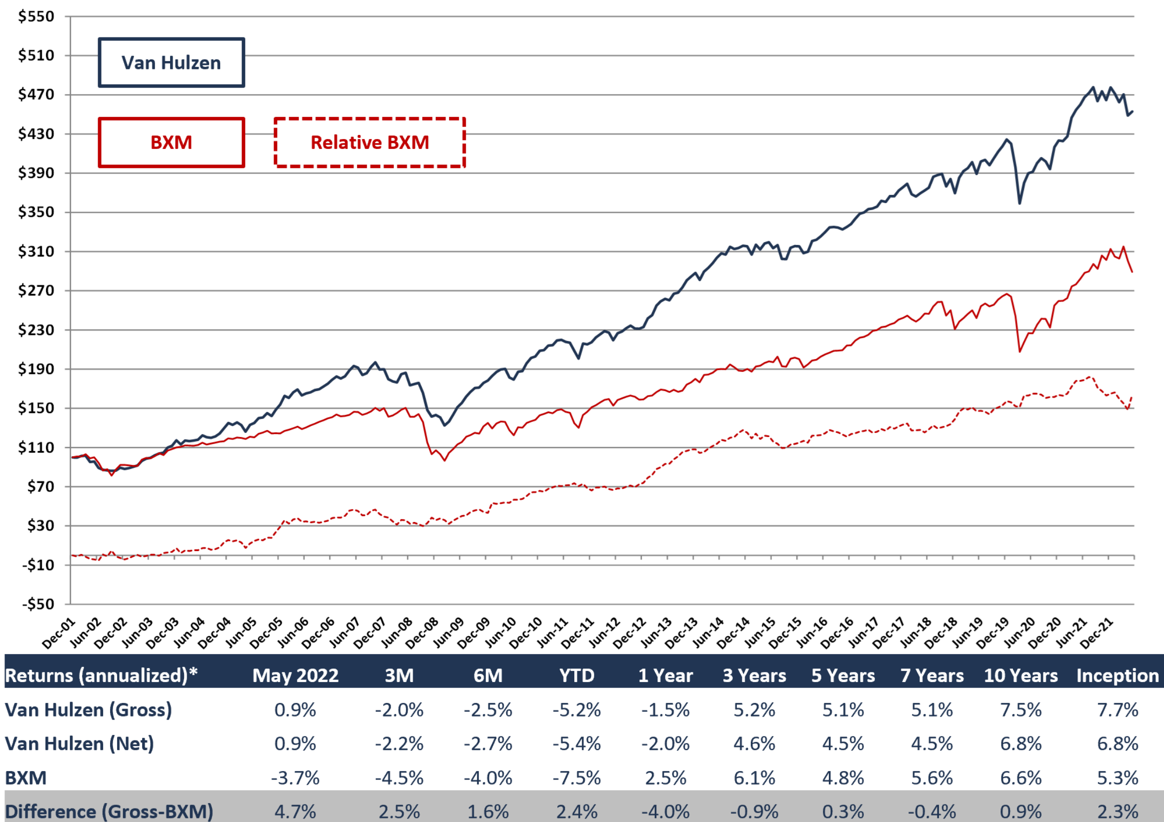
You might call this a "Double V" environment (Volatility & Value). It's been almost 10 years since we last saw these two factors working together. And while it's rare for a hedged strategy to out-perform long-only stocks in up markets, that's exactly what we saw in those early years. Our high-quality, blue-chip names were in favor and elevated market volatility allowed us to collect outsized option yields.

In fact, value stocks don't even have to outperform. As section one above demonstrates, value stocks only had to keep up with growth stocks in the past for us to outperform the market.

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 05/31/2022)



Returns (annualized)*	May 2022	3M	6M	YTD	1 Year	3 Years	5 Years	7 Years	10 Years	Inception
Van Hulzen (Gross)	0.9%	-2.0%	-2.5%	-5.2%	-1.5%	5.2%	5.1%	5.1%	7.5%	7.7%
Van Hulzen (Net)	0.9%	-2.2%	-2.7%	-5.4%	-2.0%	4.6%	4.5%	4.5%	6.8%	6.8%
BXM	-3.7%	-4.5%	-4.0%	-7.5%	2.5%	6.1%	4.8%	5.6%	6.6%	5.3%
Difference (Gross-BXM)	4.7%	2.5%	1.6%	2.4%	-4.0%	-0.9%	0.3%	-0.4%	0.9%	2.3%

*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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