Covered Call Commentary

December | 2022

Making The Uncertain *More* Certain

2022 was a historic reckoning for financial markets, as the Federal Reserve found itself behind the curve in an unexpected battle against inflation and raised rates at the fastest pace in 40 years. 2022's total increase, 425 basis points, exceeded the previous record of 400bp from 2004-2006, in only a ***quarter of the time***. This was by far the steepest increase since Volker's infamous battle against the inflation of the 1970s.

Not surprisingly, these actions sent both stocks and bonds reeling. Of course, nasty stock declines happen every decade or so, but 2002 was the worse year for bonds **on record** (going back nearly 200 years), setting new records for all of the categories listed below.

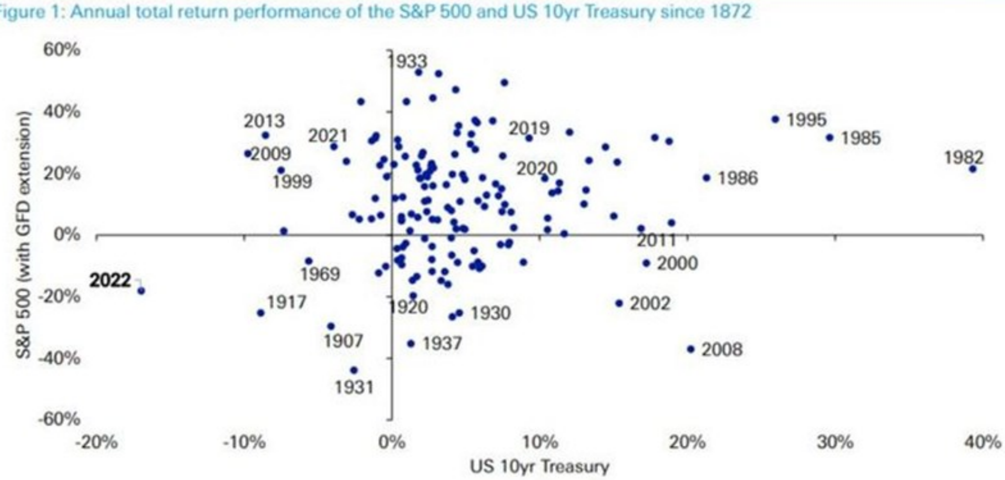
Returns on U.S. bonds hit new historic lows in 2022

	2022 return	Previous worst-performing 12-mo. period	Return
Intermediate-term U.S. Treasurys	**−10.6%**	Oct 1994	**−5.6%**
Total bond	**−13.1%**	Mar 1980	**−9.2%**
Long-term U.S. Treasurys	**−29.3%**	Mar 1980	**−17.1%**
Long-term investment grade	**−27%**	Jan 1842	**−22.9%**

Table: Gabriel Cortes / CNBC
Source: Analysis by Edward F. McQuarrie, professor emeritus, Santa Clara University

The combined performance of US stocks and bonds produced the worst year for investors since 1872. And it's not even close (see below). Traditional 60/40 portfolios have suffered terribly. And most economists are pessimistic about 2023 as well, with the odds of a recession at ~50%.

Figure 1: Annual total return performance of the S&P 500 and US 10yr Treasury since 1872



Source : GFD, Deutsche Bank

We Have A Solution

Luckily, we have a solution. Our hedged equity (covered call) strategy has something for both equity and fixed income investors.

For Equity investors:

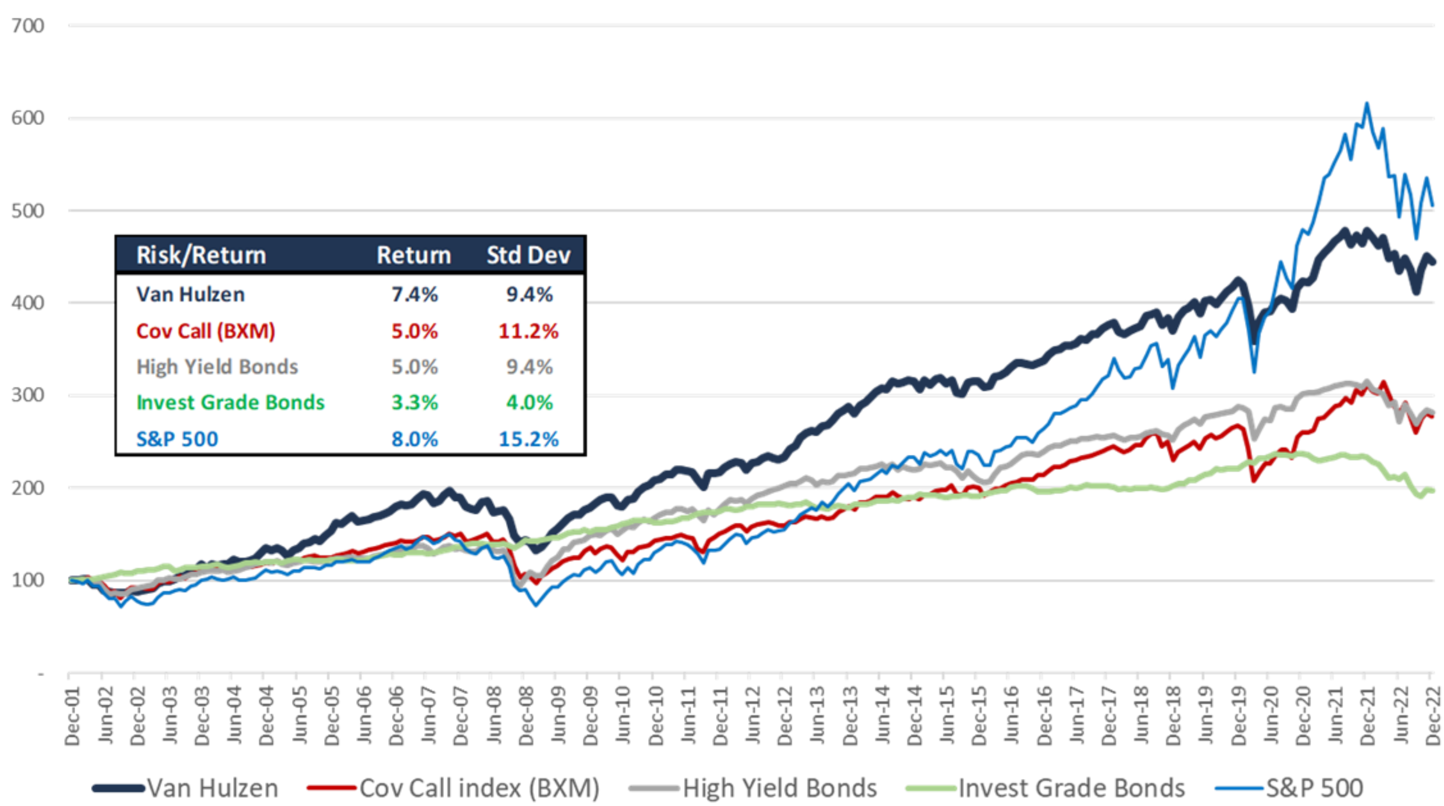
- 21+ year track record that lags the S&P 500 by only 0.9% per year (7.5% vs 8.4%)
- 38% **less risk** than the S&P 500 (as measured by standard deviation)
- 3% dividend yield / 7-8% total yield

For Fixed income investors:

- Standard deviation equal to high yield bonds over 21 years
- Superior credit quality & near-zero default risk (based on Merton model)
- Annual returns 2.4% **ahead** of high yield bonds & 4.2% ahead of investment grade
- 7-8% targeted yield

2022 Results

Our strategy delivered a return of -7.1% in 2022. The returns of our primary benchmarks were: -18.1% for the S&P 500, -11.4% for the covered call index (BXM), and -10.7% for the high yield index (IBOXHY).



Alpha	Relative to...			
a = Rp – [Rf + (Rm – Rf) ß]				
	CC Index	**High Yield**	**Inv Grade**	**S&P 500**
Rp = Realized return of portfolio	7.4%	7.4%	7.4%	7.4%
Rm = Market return	5.0%	5.0%	3.3%	8.0%
Rf = risk-free rate	3.3%	3.3%	3.3%	3.3%
ß = Beta	0.7	0.7	2.4	0.5
Alpha	**2.9%**	**2.8%**	**4.1%**	**1.5%**

Making The Uncertain *More* Certain

Delivering long term alpha is about discipline and consistency. We do not chase short term trends, and we have execute our model consistently, month after month, for over 20 years.

Perhaps what makes this strategy so compelling today is its ability to turn uncertain outcomes into **more** certain outcomes, by trading off what we believe is "excess" price upside for current period income. This extra income provides yield (if needed) as well as downside protection.

Let's look at some examples from 2022. From our perspective, there are four distinct stock market environments: (1) sideways moving, (2) declining, (3) rising moderately, and (4) exploding (!!). We have put together examples for each of these categories using our actual holdings during 2022. As of the time of this exercise (Nov 29), JNJ had traded sideways, Comcast had declined, Exxon had gradually risen, and Target had exploded (over a very short period of time). See below.

Sideways Moving Example: JNJ	
Original purchase (4/5/22)	$(178.26)
Current price (11/29/22)	$ 176.09
Dividends collected	$ 3.39
Option gain/(loss)	$ 10.71
Gain/(loss) on cov call position	$ 11.93
Cov call return *(7 months)*	**6.7%**
Long-only return *(incl dividends)*	0.7%

Covered call better

Declining Stock Example: CMCSA	
Original purchase (4/14/22)	$ (42.85)
Current price (11/29/22)	$ 35.48
Dividends collected	$ 0.54
Option gain/(loss)	$ 5.22
Gain/(loss) on cov call position	$ (1.62)
Cov call return *(7 months)*	**-3.8%**
Long-only return *(incl dividends)*	-15.9%

Covered call better

Rising Stock Example: XOM	
Original purchase (5/3/22)	$ (86.59)
Current price (11/29/22)	$ 110.54
Dividends collected	$ 2.67
Option gain/(loss)	$ (1.01)
Gain/(loss) on cov call position	$ 25.61
Cov call return *(6 months)*	**29.6%**
Long-only return *(incl dividends)*	30.7%

Similar return

Exploding Stock Example: TGT	
Original purchase (6/21/22)	$(144.22)
Selling price (8/5/22)	$ 165.11
Dividends collected	$ -
Option gain/(loss)	$ (7.83)
Gain/(loss) on cov call position	$ 13.06
Cov call return *(6 weeks)*	**9.1%**
Long-only return *(incl dividends)*	14.5%

Long only better

As you can see from the illustrations, our covered call positions delivered an equal or better absolute return in all cases except for Target. The value of covered calls is crystal clear in the sideways and declining stock examples, as they resulted in much higher returns (+6% for JNJ and +12% for Comcast). But we also delivered an equivalent return on Exxon, despite a nice increase in the stock price. As this demonstrates, we can usually “stay out of the way” (avoid capping stock price appreciation) as long as the rise is gradual.

Which brings us to Target… We purchased Target at $144 in June 2022 and sold the August $155 calls, giving us roughly 5% call premiums for the next 6 weeks. The shares rose very quickly after we purchased it, blasting through our strike price on its way to the mid $160s. Once the options went in the money (ITM), we had collected most of our profit and closed the position. Our covered call return in this case (9.1%) fell short of what the hypothetical return would have been if we had simply owned the shares uncovered (14.5%). But gaining 9% in just 6 weeks is a win to us, and we were happy to move on to another position. At $165, Target was now expensive according to our investment process.*

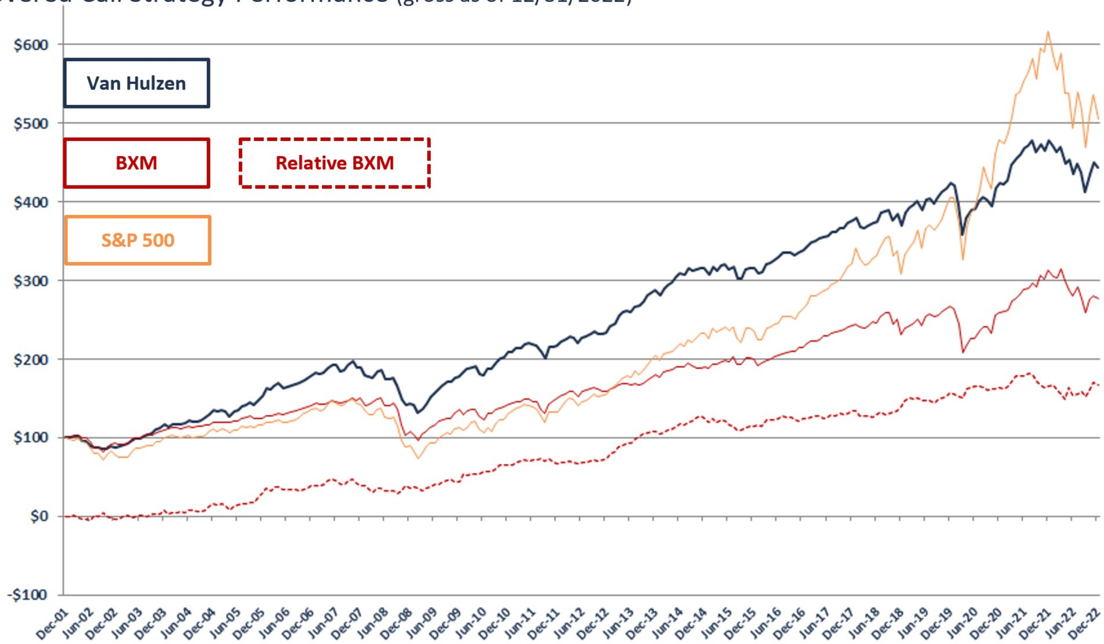
Depending on how you score it, you might say our success rate was “3 for 4” on these examples, since our Target return was slightly lower than it could have been if we held it long-only instead. But we would disagree, arguing that all 4 trades did their job in increasing our income, lowering our risk, and making the uncertain a little **more** certain.

**By the way, we are very confident in our investment process and the target prices we use to set option strikes. As of this writing (more than 6 months after our initial trade), Target is trading at $156, just a dollar higher than our original strike.*

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 12/31/2022)



Returns (annualized)*	Dec 2022	3M	6M	YTD	1 Year	3 Years	5 Years	7 Years	10 Years	Inception
Van Hulzen (Gross)	-1.4%	7.8%	2.1%	-7.0%	-7.0%	1.5%	3.4%	5.0%	6.7%	7.4%
Van Hulzen (Net)	-1.5%	7.7%	1.8%	-7.6%	-7.6%	1.0%	2.8%	4.4%	6.0%	6.5%
BXM	-1.3%	6.8%	-1.3%	-11.4%	-11.4%	1.3%	2.7%	4.8%	5.7%	5.0%
Difference (Gross-BXM)	-0.1%	1.0%	3.4%	4.3%	4.3%	0.3%	0.7%	0.3%	0.9%	2.4%

*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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