Covered Call Commentary

March | 2023

Q1 Review: Steady Performance In The Face Of A Banking Crisis

March was definitely a contrast of winners and losers. The tech sector was up 10.9% in March, while the financial sector returned -9.6%. The S&P 500 index returned 3.7%. Without tech, March's return would have been 0.7%. Our hedged strategy, which uses covered calls to add yield and downside protection to the portfolio, returned **+2.6%**.

Huge dispersion in Q1, with growth dominating value

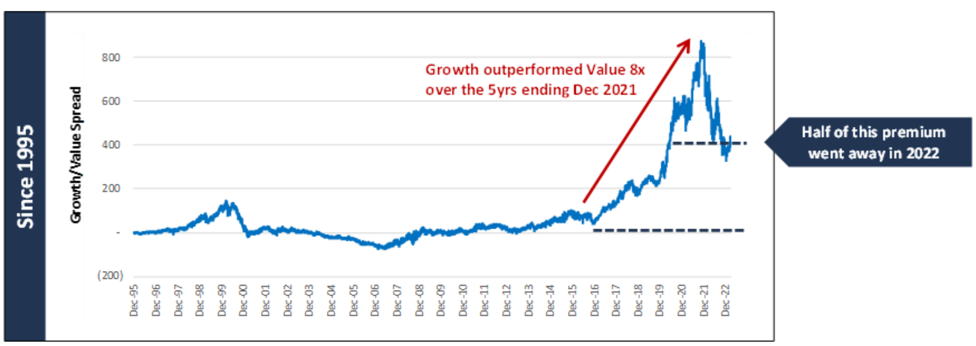
Growth stocks dominated value stocks for the entirety of Q1, with Big Tech leading the way. Growth stocks rose nearly 15% on the quarter, driven by a 21% return in tech stocks, while value stocks and dividend payers returned less than 1% each. Financials and energy stocks were both down roughly 5% for the quarter. Our strategy, which leans toward value, delivered a solid **+3.8%** return for the quarter.

U.S. Equities	Q1 2023
U.S. Market	7.40
Value	0.18
Growth	14.79
Dividend Composite	0.55

Source: Morningstar

Long term relative performance: Growth vs Value

Looking at the long-term trends, nearly half of the recent growth premium has now disappeared.



Portfolio Highlights

We have often discussed how covered calls tend to behave in different market environments. Given the broad dispersion of Q1, it's a good time to illustrate this with our actual holdings in Q1 2023. (*)

- **Sideways & Declining Stocks**. Covered calls tend to outperform if a stock is declining or moving sideways. This was certainly true in Q1, with our covered call positions outperforming by 3.0-3.5% relative to just owning the underlying stocks. See top two sections below.
- **Rising Stocks**. When a stock is moving up gradually, a covered position can typically keep up with a long-only position. This held true in Q1, as our hedged positions showed no drag relative to the performance of the underlying stocks. See bottom, left.
- **Exploding Stocks**. Covered calls tend to underperform vs. long only positions rocketing higher in a short period of time, like tech stocks did in Q1. However, by actively rolling our options positions, we were able to capture between 65-70% of the upside in this category. We are pleased with this result. See bottom, right.

Sideways Moving

Name	Stock	Options	Net
AJG	1.1%	1.6%	2.7%
XOM	0.2%	4.2%	4.4%
KMI	-1.6%	2.9%	1.3%
ABBV	-0.5%	3.3%	2.8%
Median	**-0.1%**	**3.1%**	**3.0%**

Covered call better

Declining

Name	Stock	Options	Net
RF	-11.1%	1.8%	-9.3%
JNJ	-11.6%	3.5%	-8.1%
HD	-10.2%	3.5%	-6.7%
WMT	-7.9%	8.7%	0.8%
Median	**-10.6%**	**3.5%**	**-7.2%**

Covered call better

Rising

Name	Stock	Options	Net
MDLZ	7.0%	-3.0%	4.0%
MCD	6.7%	0.3%	6.9%
TMUS	3.5%	1.7%	5.1%
PGR	1.9%	0.0%	1.9%
Median	**5.1%**	**0.1%**	**5.2%**

Similar Return

Exploding

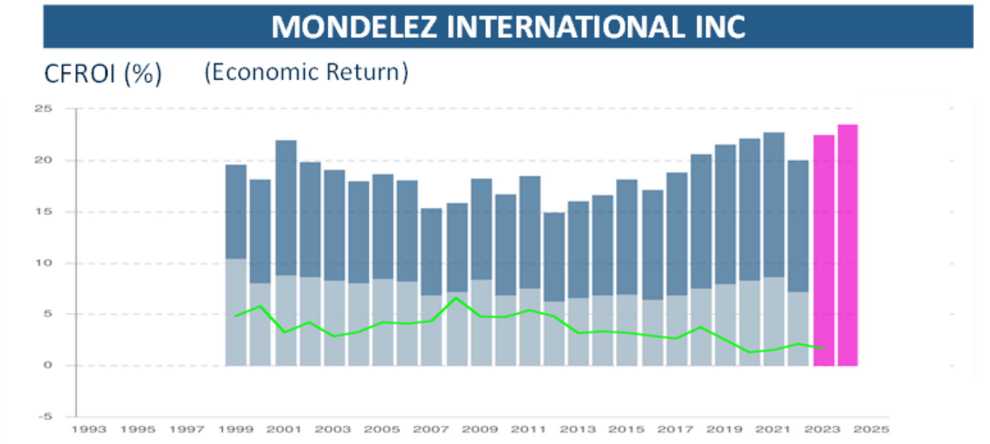
Name	Stock	Options	Net
AAPL	27.1%	-8.6%	18.5%
QCOM	22.5%	-10.5%	12.1%
ANET	21.1%	-6.9%	14.2%
GOOGL	17.6%	-4.2%	13.3%
Median	**21.8%**	**-7.8%**	**14.1%**

Long-Only Better

(*) For definition please go to page 8.

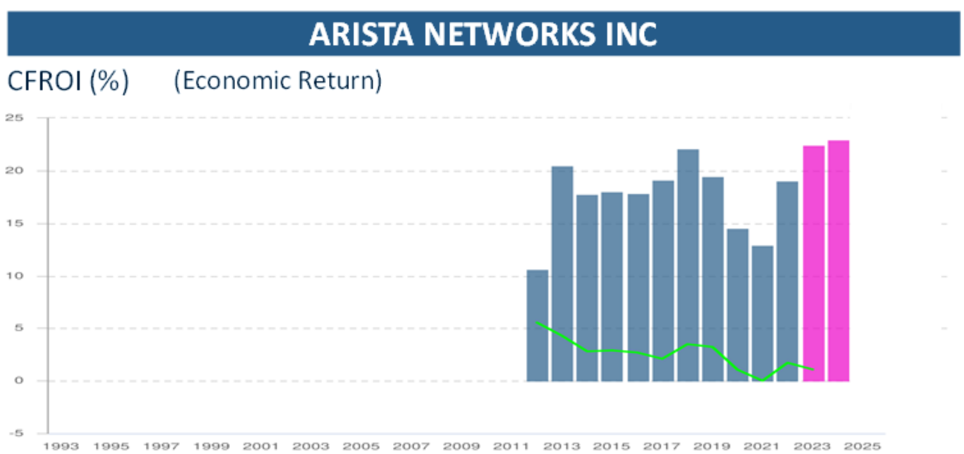
We have included some individual example trades below.

Two names we BOUGHT on fundamental strength: Mondelez (MDLZ) & Arista (ANET)



Mondelez (MDLZ)

- Consumer staple powerhouse formerly known as Kraft Foods
- Strong, improving Cash Flow ROIs (see chart above)
- Dividend yield 2.3%, 5yr dividend growth 12.4%
- Below average leverage, 0% default risk (based on the Merton model)
- Three straight positive earnings revisions; has beat estimates in four straight quarters
- Significant share-repurchase program ($2 billion last year)



Arista (ANET)

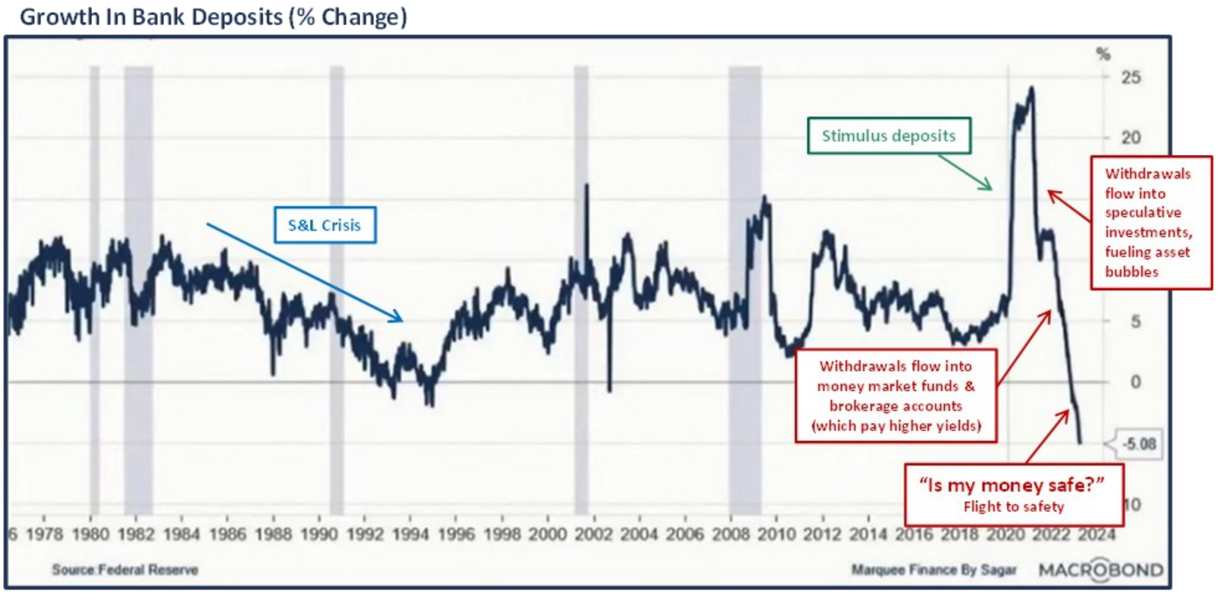
- Leader in cloud networking solutions, with 5yr sales growth of 21.6%
- Over the last 18 months, have had nine positive earnings revisions (none were negative) and have beaten estimates every quarter.
- No dividend, but of course covered calls give us a yield of 8-10% on this stock
- Significant share-repurchase program ($700 million last year)
- Zero debt. $3 billion of cash on hand.

<u>A name we SOLD on technical breakdown: Regions Financial (RF)</u>

- RF is a regional bank with the highest Cash Flow ROE among US banks, but it was caught up in the regional banking crisis and saw its shares plunge in March.
- We sold RF when it broke our technical support line of $22. When this happens, we step aside and add the company to our watch list.
- Our view is there is still significant risk in the regional bank space, particularly related to commercial real estate. And as a singles and doubles strategy, we do not tolerate strikeouts.
- **Impact**: We lost 9.8% on the stock (since its original purchase in 2022), but made +8.8% on the options (2022 & 2023 combined), <u>nearly offsetting the entire loss</u>.
- Replaced with a non-bank financial (Progressive Corp)

Speaking of the Banking Crisis…We've Been Here Before

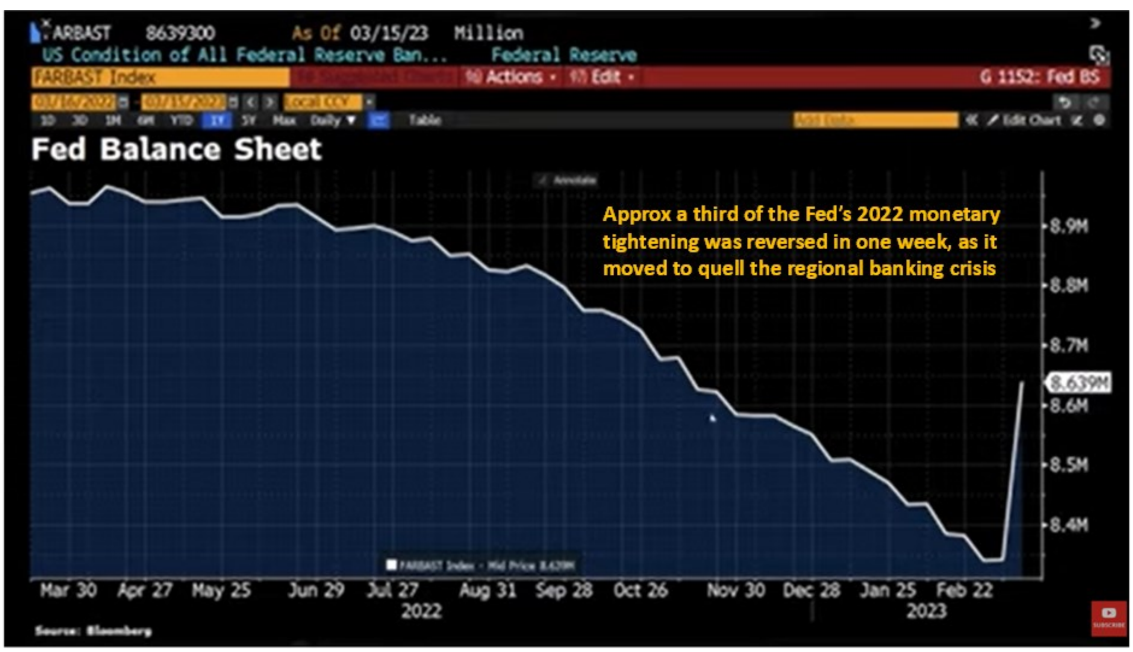
Aspects of today's regional banking crisis are eerily similar to the S&L crisis of the 1980s. But before we get to that, let's look at the fallout so far. There has been a max exodus of bank deposits in the past year. There's no question that deposits were artificially inflated due to covid stimulus programs, but the decline ever since has been even more alarming. See below.



The problem: **If banks don't have deposits, they can't make loans…and economic growth grinds to a halt**

Fed To The Rescue!? Liquidity is Back.

Just like that, approximately a third of the Fed's 2022 monetary tightening was reversed.



The 2023 regional banking crisis is centered around long term ("risk-free") treasury bonds, which are on the balance sheets of many banks. These bonds have cratered in value as a result of the Fed's rate hikes.

The irony here, of course, is that you could argue that the Fed was at least partially to blame for this crisis in the first place. The Fed's easy money policies, combined with massive stimulus in 2020, created excess bank deposits that needed to be invested. And the Fed's message that it "wasn't even thinking about thinking about raising rates" gave banks the confidence to move further out the yield curve in order to find decent yields. The value of these "risk-free" investments then cratered when the Fed hiked rates by nearly 500 basis points in a year. And as deposits have left the regional banks, lending activity has significantly contracted.

Not Our First Rodeo

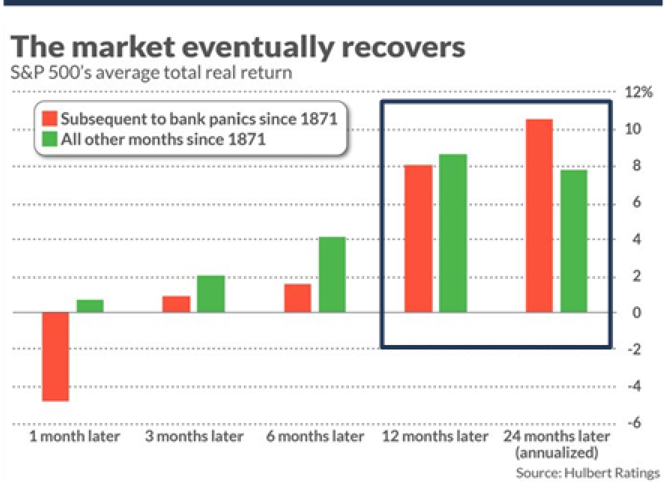
This is hardly our first banking crisis. There have been nine major banking crises in the past 200 years.* And a According to MIT research (2021), the average banking crisis leads to a decline in GDP of approx. 3%. That's not an insignificant hit, and it would certainly drive today's GDP into negative territory.

Perhaps the crisis that was most similar to today's was the S&L crisis of the 1980s and early 1990s. The FDIC backed up most deposits, as they have today, but well over 1,000 savings and loan banks failed, nonetheless. Like today, the S&L crisis began when the Fed raised rates higher than the yields being collected by the banks. The S&L crisis took nearly a decade to peak, however, as there was little oversight of the banks and the S&Ls took advantage of a new security, called the "junk" bond, to get financing (they also invested heavily in junk bonds, in order to increase their yields). Many banks took liberties with the accounting rules, as well. All this added to the price of the ultimate bail-outs of the early 1990s.

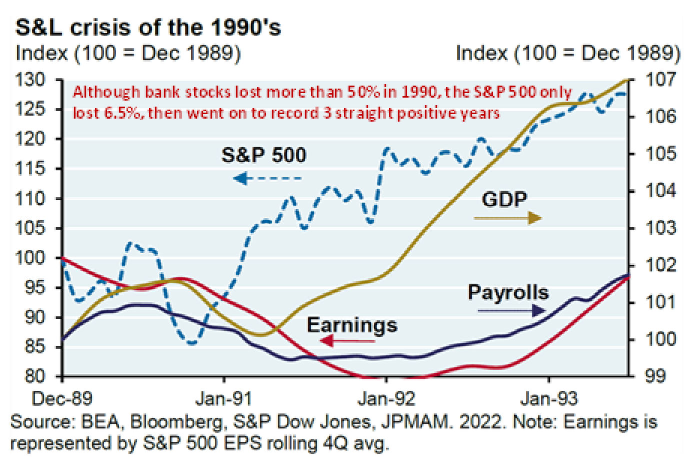
Mark Hulbert (of Hulbert Ratings) studied all the bank panics since 1870 and found that, on average, the stock market damage tends to be temporary. See the chart below, left. By 12 months out, stock market returns were nearly in line with "normal" periods, and returns were actually slightly higher after 24 months.

Of course, few of these periods had to reckon with multiple bubbles deflating at the same time (bonds, tech, crypto, commercial real estate). It's always possible that this time is different. And this study focused on the broad stock market. The financials sector is a different animal. It tends to fall further and underperform for longer. At the peak of the S&L crisis (1990), banks lost more than 50% of their value, while the broader market only dropped 6.5%.

Impact of Bank Crises on Stock Returns



S&P Crisis of the 1980s



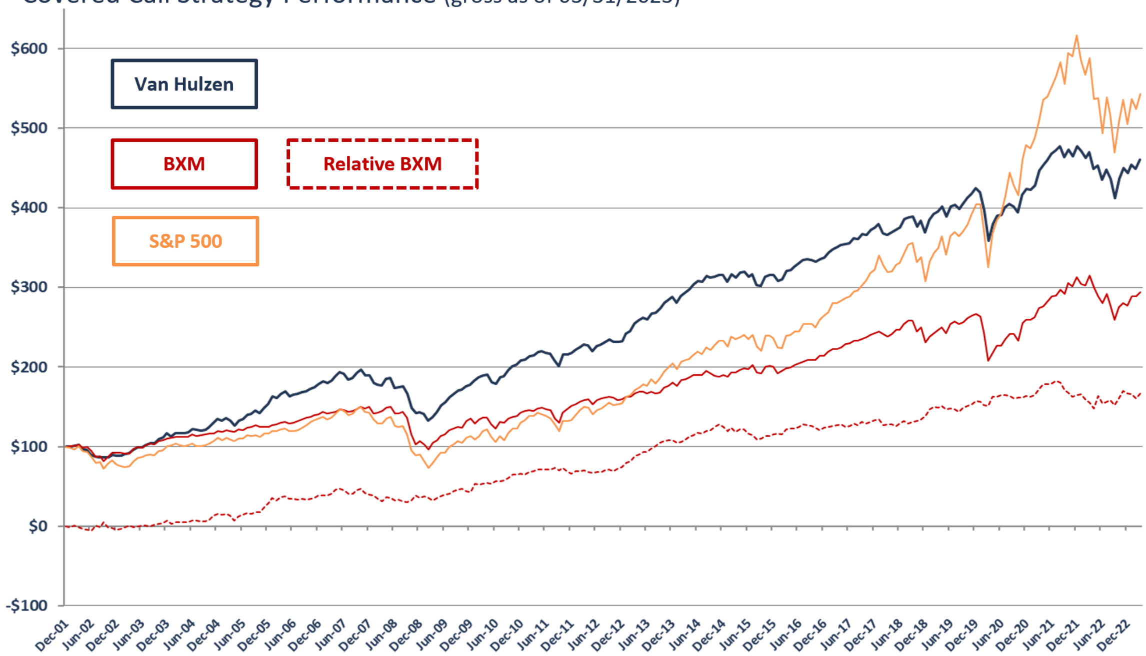
Key Takeaways

- This is a great market for covered calls. The outlook for the economy is very uncertain, and most economists are projecting mid-single digits for equity returns over the next 7-10 years.
- As Big Tech continues to consolidate, we believe value stocks will perform better than they have in recent years.
- Regional banks still present a serious risk to the economy, particularly with regard to their commercial real estate exposure. But studies show that the long term fallout of banking crises is typically concentrated in the banking sector.
- We were underweight banks to begin with, but we are out of them now, having reallocated to non-bank financials. And as our RF example shows, we managed to nearly breakeven on the positions we sold. That alone is a testament to the value of 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.

Covered Call Strategy Performance (gross as of 03/31/2023)



Returns (annualized)*	Mar2023	3M	6M	YTD	1 Year	3 Years	5 Years	7 Years	10 Years	Inception
Van Hulzen (Gross)	2.6%	3.8%	11.9%	3.8%	-2.0%	8.7%	4.7%	5.3%	6.1%	7.5%
Van Hulzen (Net)	2.6%	3.6%	11.6%	3.6%	-2.6%	8.1%	4.1%	4.7%	5.5%	6.6%
BXM	1.9%	6.0%	13.2%	6.0%	-6.9%	12.3%	4.2%	5.7%	5.8%	5.2%
Difference (Gross-BXM)	0.7%	-2.2%	-1.3%	-2.2%	4.8%	-3.6%	0.5%	-0.4%	0.3%	2.3%

*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. Definitions: Sideways: between –2% and +2%, Rising: between +2%-10%, Declining: worst performers, Exploding: Best performers. FPAC-0177-23