Covered Call Commentary

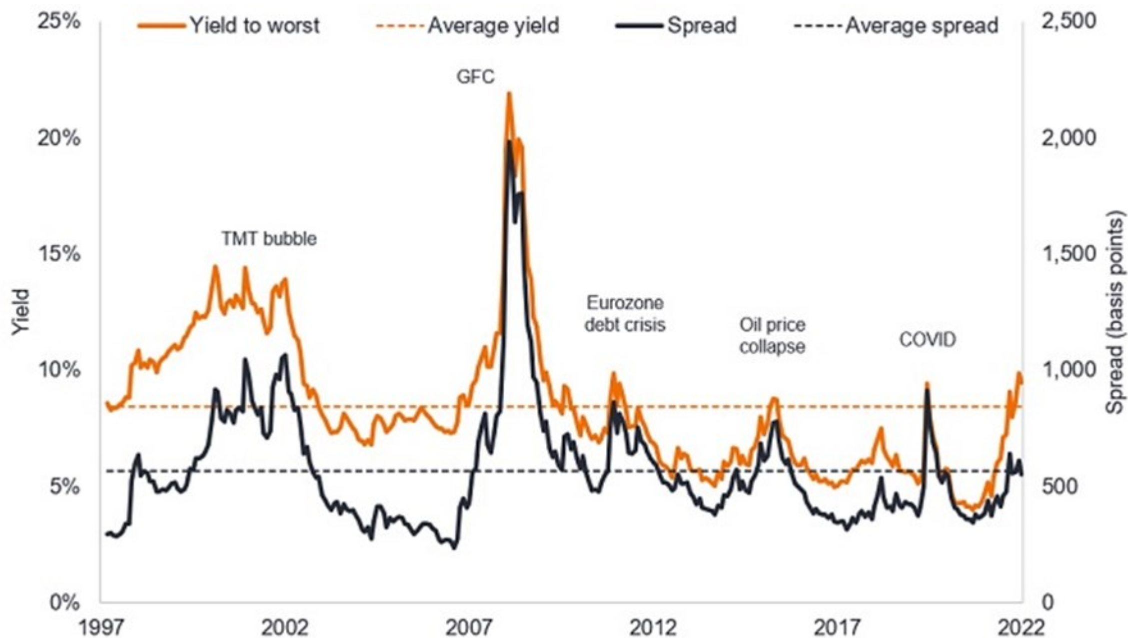
April | 2023

Lipstick On A Pig

A Commentary on High Yield Bonds

We have never fully understood the value proposition of high yield bonds. As covered call managers who specialize in alternative sources of income, you might call us a little biased – but we believe the category is called "junk" for a reason. In addition to their well-known inflation and interest rate risks, high yield bonds have significant ***credit*** risk. And the volatility of this category is 2-3x its investment grade counterpart. Yields on junk bonds are tempting at 8-9%, but you rarely actually get the full yield because a number of them end up defaulting. And although defaults were a paltry 1.3% in 2022, Fitch estimates that they will rise to 4.8% by September of this year. The 20 year average default rate is about 3.5%, by the way, so we are projected to trend considerably higher in the coming months.

Defaults help explain how high yield bonds have an average annual total return of only 5.2% over 20+ years despite an average yield of more than 8%. Buyer beware.



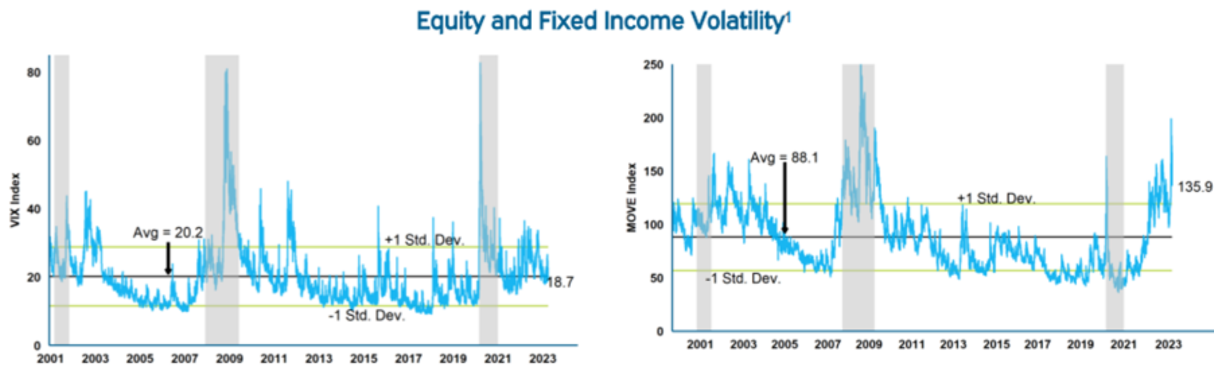
Equity-like drawdowns

The drawdown in junk bonds was a whopping -32% during the 2008 financial crisis. This is because the elevated credit risk leads to widespread defaults whenever markets hit turmoil, relying on diversification to (hopefully) protect you from losing your money. But during crisis times, even diversification isn't enough.

In 2022, high yield bonds returned -11.2%, versus -7.3% for our covered call strategy.

Fixed Income Volatility: End of an Era

During the record 40-year bull market in bonds, which ended in late 2021, investors became accustomed to bonds providing stability to their portfolios. But that has changed. See the chart below, which shows fixed income vol approaching their 2008 financial crisis highs, despite equity volatility below its long-term average of 20. And with the Fed committing itself to a “higher for longer” interest rate policy, most economists expect this uncertainty/volatility to continue. Investors need solid fixed income alternatives.

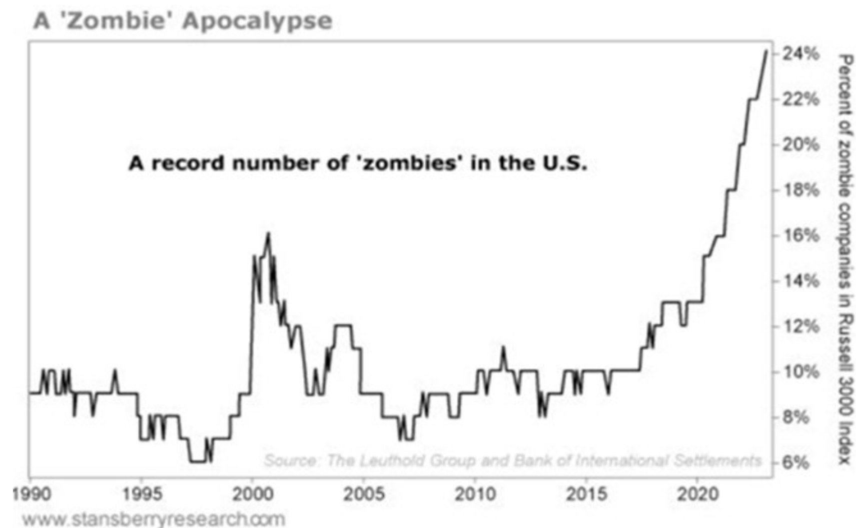


Source: Meketa Investment Group, May 2023

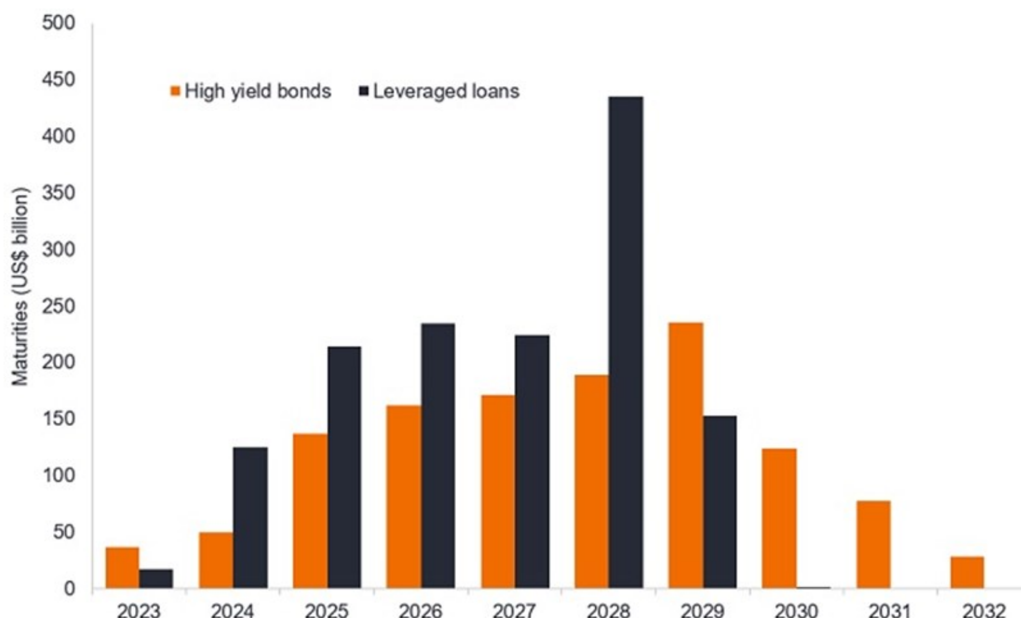
The Walking Dead

There is no denying we are in a banking crisis. But the damage thus far has been related to interest rate and duration risk, not credit risk. It will come. Zombie companies have become a hot topic lately, as rates have increased significantly over the past year and more and more companies are stretched. An impending recession will not help.

Most define a zombie as a company that doesn’t produce enough profit to service its debts. There are a bunch of companies that fit that description…about 3x the number that existed just 15 years ago (see chart below). You can use interest coverage and other metrics to find them. Notable names are Bed Bath & beyond, Carvana, Gamestop and AMC.



These zombie companies rely on high yield debt as a critical source of financing. Luckily, most of these loans were locked in at very low rates over the past few years and have not begun to mature yet (see below). But the vast majority will mature over the next 2-5 years and will have to be refinanced at higher rates. This is going to cause pain for a great many companies. Many of these issuers are regional banks.



Source: BofA Global Research, 30 September 2022

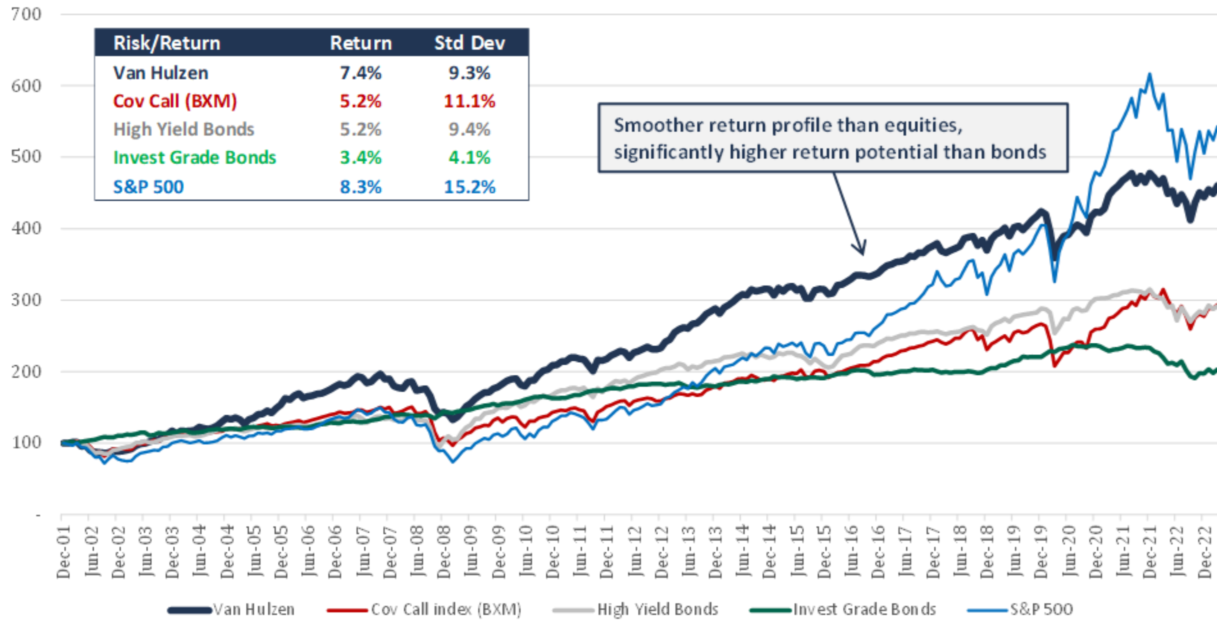
The high yield bond market has had the backing of the US government in recent years. Statements that the Fed would step in and buy these bonds to support prices stabilized a freefalling market in 2020.

The credit risk in this category is higher than its been in decades. And while the Federal Reserve has instilled some confidence in this category over the past few years, society's appetite for bail outs will likely wane. And this does not change the fact that many of these companies will not be able to meet their obligations. To us, the Fed's commitment is tantamount to putting **lipstick on a pig**.

A Better Risk-Return Profile

We believe covered calls are an ideal alternative to junk bonds. Our strategy, which has a 21+ year track record, actually has a slightly lower standard deviation than the IBOX high yield bond index (9.3% versus 9.4% over the same time period). And our strategy has out-performed the IBOX by 2.2% per year! We have done this by investing in high quality companies with fortress balance sheets and using call options to increase yield and reduce risk.

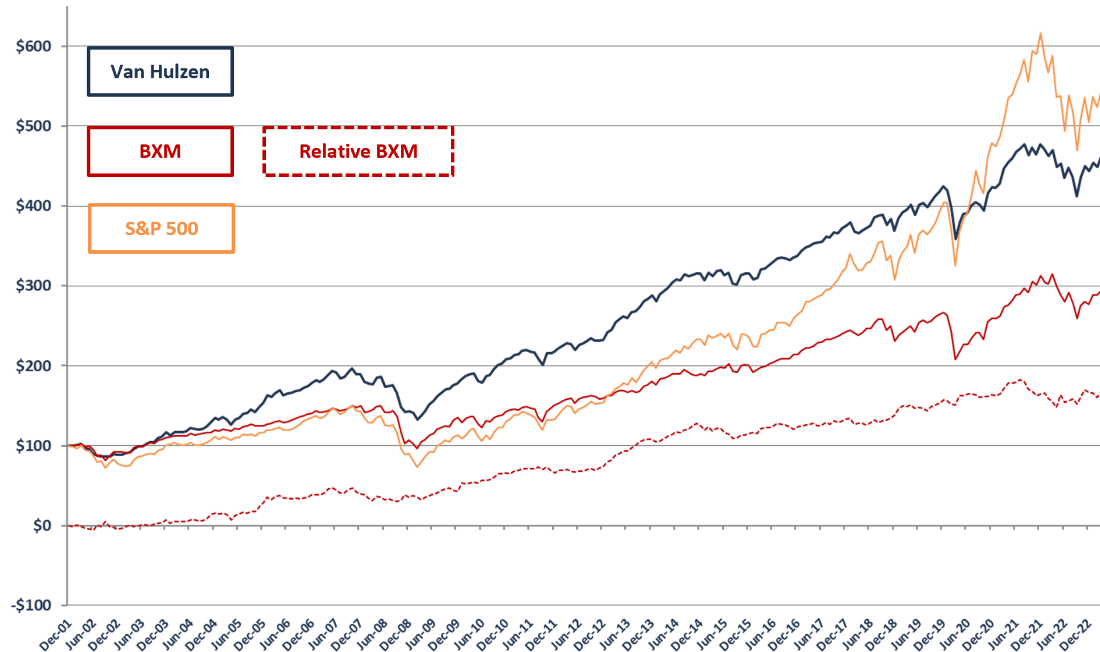
We have charted our cumulative performance below, relative to a broad group of benchmarks, including the IBOX high yield index. On a cumulative basis, investing $100 into our strategy would have resulted in $460 compared to $292 for high yield bonds over the same period.



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 04/30/2023)



Returns (annualized)*	Apr 2023	3M	6M	YTD	1 Year	3 Years	5 Years	7 Years	10 Years	Inception
Van Hulzen (Gross)	1.2%	2.5%	6.9%	5.0%	3.9%	7.0%	4.8%	5.4%	6.0%	7.5%
Van Hulzen (Net)	1.1%	2.4%	6.7%	4.8%	3.3%	6.5%	4.2%	4.8%	5.4%	6.6%
BXM	1.2%	2.9%	7.8%	7.2%	-1.1%	11.0%	4.2%	5.8%	5.8%	5.2%
Difference (Gross-BXM)	0.0%	-0.4%	-0.9%	-2.2%	5.0%	-3.9%	0.5%	-0.4%	0.3%	2.2%

*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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