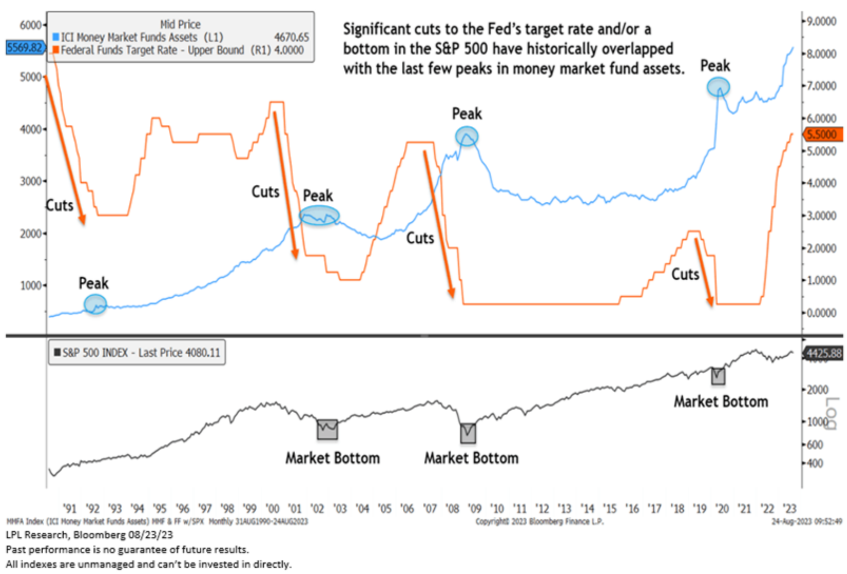
Covered Call Commentary

September | 2023

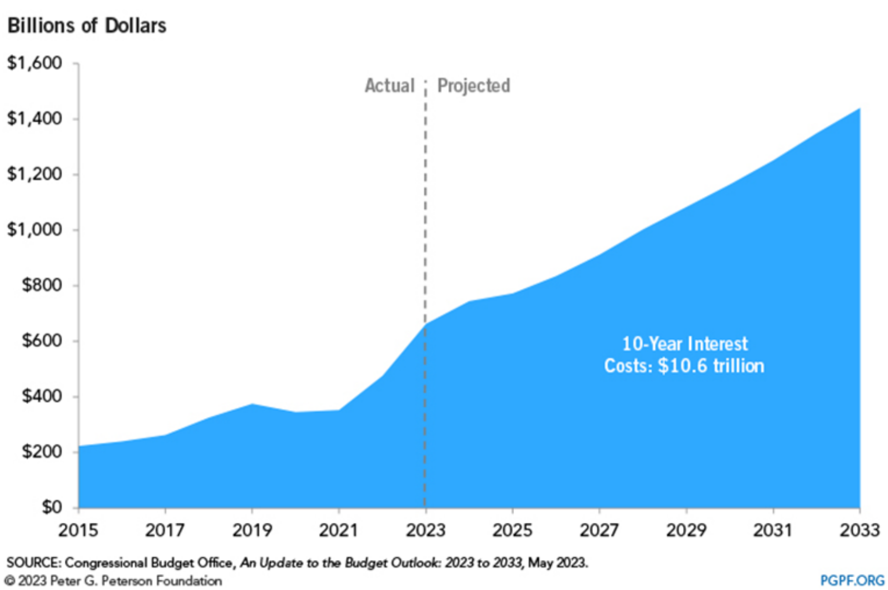
Strong Relative Performance / Deep Dive on Apple

Stocks consolidated some of their 2023 gains in the third quarter. The S&P 500 returned -3.3% in Q3 and the BXM (covered call index) returned -2.8%. Our covered call strategy showed nice outperformance, down just –1% for the quarter. Our insistence on quality continues to pay off.

There is no shortage of market uncertainty today. Long treasury yields have spiked recently and cash continues to pile into short term cash equivalents, which are now at a 30 year high (see below). Investors are more risk-averse than they have been in some time.



Net Interest Costs



The sovereign debt crisis continues to worsen. And as the US government's interest expense goes higher and higher, its solvency comes more and more into question. Bears believe this can only end badly, some even calling for a potential depression. Bulls believe the Fed will continue to print money to monetize the debt, which would likely continue to lift asset values.
We are ready for any outcome. Our strategy is hedged (~35% lower risk than long-only stocks) and targets a strong 6-8% yield. It was designed to do well in strong markets while also weathering the nastiest storms.

Portfolio Highlights

Each quarter, we review the portfolio in the context of different market environments. As a reminder, here are the four categories(*):

- **Sideways & Declining Markets**. Covered calls tend to outperform in sideways moving, as well as declining, markets. Our covered call positions in these categories all outperformed in Q3, by an average of 3.3% relative to just owning the underlying stocks. See top two sections below.
- **Rising Markets**. When market gains are gradual and moderate, covered calls can typically keep up with long-only stocks. This also held true in Q3, as our hedged positions showed no drag relative to the performance of the underlying stocks. See bottom, left.
- **Exploding Markets**. Covered calls tend to underperform when stocks rocket higher in a short period of time. This was true again in Q3. However, by actively rolling our options positions, we were able to capture approximately 77% of the upside in this category (8.5% divided by 11.1%). We are pleased with this result. See bottom, right.

Sideways Moving

Name	Stock	Options	Net
ROP	0.9%	0.9%	1.8%
UNH	-1.6%	1.6%	0.0%
KMI	-2.1%	1.9%	-0.2%
V	-3.0%	2.8%	-0.2%
Median	**-1.8%**	**1.7%**	**-0.1%**

Covered call better

Declining

Name	Stock	Options	Net
FTNT	-24.4%	5.6%	-18.8%
HSY	-19.4%	1.9%	-17.5%
WM	-11.7%	4.1%	-7.6%
AAPL	-10.9%	6.8%	-4.2%
Median	**-15.5%**	**4.9%**	**-10.7%**

Covered call better

Rising

Name	Stock	Options	Net
IBM	6.1%	0.5%	6.6%
CSCO	4.7%	-0.2%	4.5%
AJG	4.1%	1.1%	5.2%
DHR	3.5%	-0.1%	3.4%
Median	**4.4%**	**0.2%**	**4.5%**

Covered call similar

Exploding

Name	Stock	Options	Net
ABBV	12.0%	-5.4%	6.5%
PXD	11.7%	-1.3%	10.4%
XOM	10.5%	-3.0%	7.4%
GOOGL	9.3%	-2.1%	7.2%
Median	**11.1%**	**-2.6%**	**8.5%**

Long-Only Better

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

Apple Analysis

We thought we'd highlight Apple this quarter, for the following reasons:

- Apple is the largest stock in the world and a must-own for most equity portfolios
- However, AAPL is fundamentally expensive, on nearly every valuation measure:
  - 26x Forward P/E
  - 7.2x Price/Sales
  - 45x Price/Book
  - PEG ratio: 2.2x
  - Percent Future of 69%(*)
- So how can you justify holding AAPL? *Especially* at its 7.5% S&P 500 weighting!
- Our answer to these questions is covered calls. See analysis below…

*Percent future is a metric provided by Credit Suisse HOLT™ which estimates the percentage of a stock's current valuation attributable to investments the company hasn't yet made. The average % Future for the S&P 500 is currently 40%.

Current AAPL Position

We own a 6-7% AAPL position in client accounts and currently have the AAPL Dec 190 calls on. We opened this option position on Sept 7, when AAPL was trading at $177. We collected $4.20 for these options, which was a 2.3% yield for 3 months (approx. 9% annualized), while also allowing for 7% price appreciation for 3 months, giving us a potential 3-month total return of more than 9%.

Apple's stock price has gone sideways over the past month, so there has been no price appreciation realized, but we have already realized more than half of our option gains. We don't rely on price appreciation to get a healthy return. We get paid as time goes by.

Covered Call Performance vs Long-Only

Apple had a monster first half, gaining 49.7%. This performance put it at the top of our "Exploding" category for the first two quarters. Our position was hedged, of course, so we didn't participate in the entire move, but we did manage a 32.4% return on AAPL for the first half (65% upside capture).

Apple's stock price had a terrible Q3, with a 3-month return of -10.9%. Our options gained 6.8% in the quarter, however, limiting our losses to just -4.2% (38% downside capture).

65% upside capture and 38% downside capture gives us a 1.7x upside/downside ratio. We are happy with this and accustomed to getting it.

Looking all the way back to the 2021 market peak, AAPL has been on a rollercoaster ride. But point to point, our clients are up ~2% on their AAPL covered call position, while the stock price is still -5.3% from its 2021 peak of $188. It's worth noting that AAPL is a core, long-term holding, so we are not trading in and out of the position.

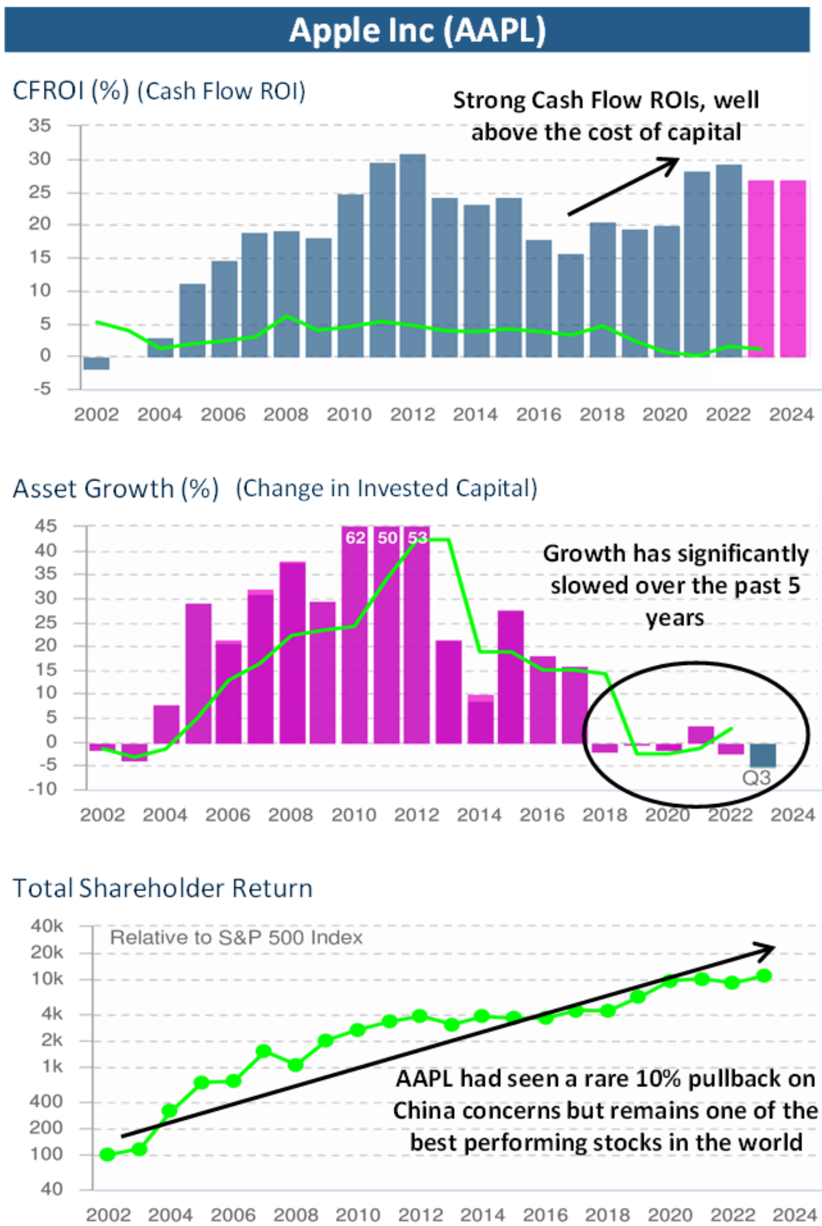
Fundamental Analysis

Apple is incredibly profitable, with a whopping 27% Cash Flow ROI. The Company has very little debt and $62 billion of cash on hand. AAPL pays a 0.6% dividend and fits solidly into the Quality category.

However, Apple is not the growth company it used to be. It has only logged sales growth of >10% in 3 of the last 10 years, and its capital investment is basically zero (bet of inflation) over the past 5 years. Recently, its growth prospects in China (a huge market) have come into question as the government considers banning its products.

Apple is a great company with a dominant market position. And as the world’s largest stock, it is a must-own in equity portfolios. From a fundamental standpoint, it is a sub-optimal holding. But from a covered call perspective, it is a fantastic holding.

HOLT’s Relative Wealth Chart



Source: Credit Suisse HOLT™

Key Takeaways

- We have many of the same key takeaways as last quarter.

- 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.

- The stock market has not been this concentrated at the top since the 1960s. This typically doesn't bode well for markets (the lost decade of the 1970s followed the concentration of the 1960s).

- After this rebound run in Big Tech, we believe value stocks will perform better in the next decade than they did in the past decade. Perhaps better than growth, perhaps in-line with growth. We are indifferent about this.

- We will continue to stick to our knitting. All of our positions are high quality and are constructed like the Apple example above. This approach has created strong Alpha for us in the past.

- When the next significant pullback occurs (be it months or years away), our 21-year track record suggests that our strategy will lose much less than the market and "break-even" in about half the time. There's no guarantee of this, but it's been true in 5 of the 6 significant selloffs over the past 20 years.

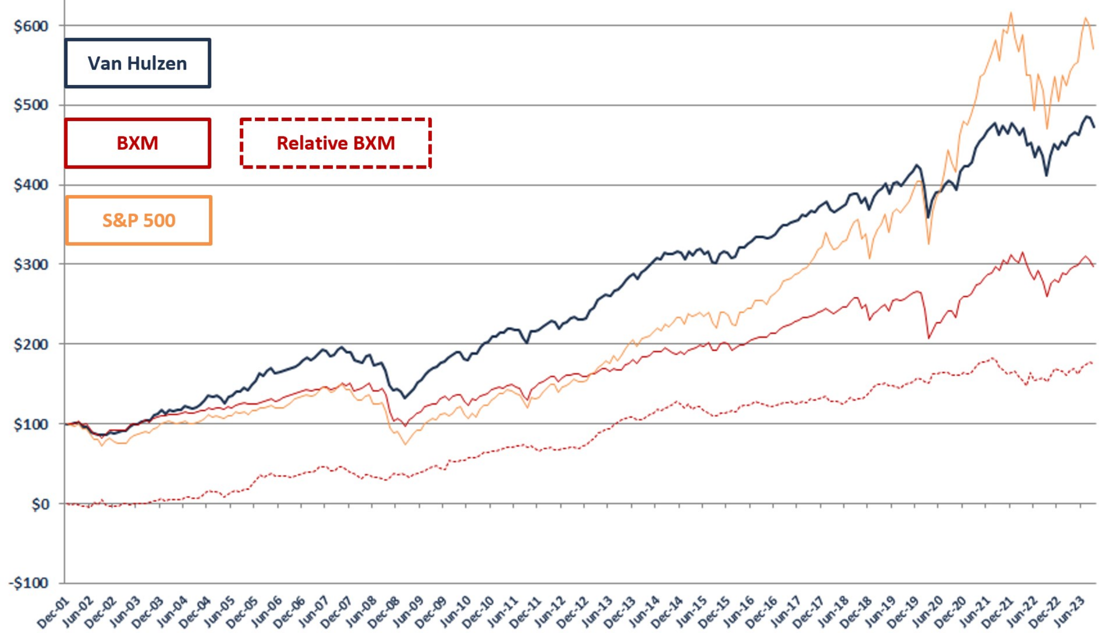
- Our track record also suggests that we tend to participate in 87% of the market's gains over the long run (7.5% average return over 21+ years, vs 8.6% for the S&P 500) but take significantly less risk in the journey.

- We are ready for whatever the market throws at us.

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 09/30/2023)



Returns (annualized)*	Sep 2023	3M	6M	YTD	1 Year	3 Years	5 Years	7 Years	10 Years	Inception
Van Hulzen (Gross)	-2.2%	-1.0%	2.7%	6.6%	14.9%	5.6%	4.0%	5.1%	5.6%	7.4%
Van Hulzen (Net)	-2.2%	-1.1%	2.4%	6.2%	14.3%	5.0%	3.4%	4.5%	5.0%	6.5%
BXM	-2.7%	-2.8%	1.3%	7.3%	14.6%	7.2%	2.8%	5.2%	5.9%	5.1%
Difference (Gross-BXM)	0.5%	1.9%	1.4%	-0.8%	0.3%	-1.6%	1.1%	-0.1%	-0.2%	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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