Covered Call Commentary

October | 2023

Quality Shines In A Lopsided Market

As of this writing, the S&P 500 is +16.6% year to date. But its been well documented that the largest companies in the index, the so-called Magnificent Seven, have made the market look stronger than it actually is. When the S&P's performance is **measured on an equal weight basis, the return drops to a paltry 1.2% YTD**. This is the more appropriate index for active managers who own 30-50 names and are not loaded up with big tech. Our strategy, which holds 35 names and has a value tilt, is +9.1% YTD. We are pleased with this result. We have achieved this performance by focusing on quality, which is the topic of this quarter's commentary.

We ran some statistical analysis on the S&P 500 last month. Specifically, we compared the YTD stock performance for each quintile of the index using various factors, including market capitalization plus five of our top "quality" factors (ROIs, leverage, default probability, dividend yield and dividend growth). With all the buzz about the Magnificent Seven this year, it's no surprise that the largest companies have outperformed their smaller counterparts. By a lot (spread of 24.3% between the top and bottom quintiles). But it's not just about size. These mega-cap companies also happen to be amongst the highest **quality** companies in the US. The most profitable 100 companies in the S&P (as measured by Cash Flow ROIs) have outperformed the bottom 100 by a whopping 19.2% so far this year. And the most significant factor in today's rising rate environment has been default probability*. The top S&P quintile (lowest default probability) has outperformed the bottom quintile by 27.1% year to date! The message is clear. Investors have dumped any/everything speculative in favor of strong balance sheets and cashflows. And they have been willing to pay higher prices to get them. Valuation has not been a factor (in fact, the highest P/E stocks have done the best). This has been true for some time.

The one traditional quality measure that has not worked this year is dividend yield. As we've written in the past, dividend yields alone are not great predictors of shareholder value. Many dividend payers also carry leverage, and a dividend yield can be artificially high if a cut is looming. Dividend **growth** is much more strongly correlated with stock performance, which is why we focus on it more than just yield.

2023 YTD Performance

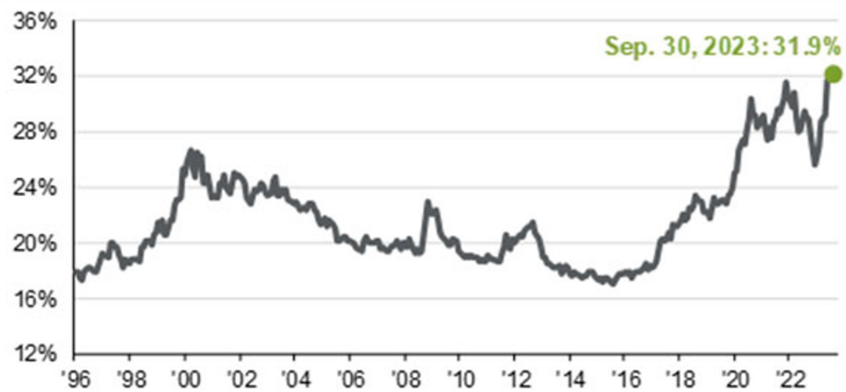
	Top Quintile	Bottom Quintile	Spread
Market Cap	14.7%	-9.5%	24.3%
Cash Flow ROI	15.7%	-3.6%	19.2%
Leverage	12.3%	-2.4%	14.7%
Default Prob %*	18.9%	-8.2%	27.1%
Dividend Yield	-10.8%	14.0%	-24.8%
Dividend Growth	3.3%	0.1%	3.2%

Note: Performance data as of 9-30-23. Default probability estimates are from the Merton model, which incorporates the Black-Sholes option pricing model to quantify corporate default risk. This statistical model helps quantify how capable a company is at meeting financial obligations, servicing its debt, and weighing the **general** possibility that it will go into credit default.

Large Cap vs Small Cap

We've written about market concentration quite a bit so will not dive deep on that here, except to point out that the weighting of the top 10 stocks has hit a new 50 year high (31.9%). Clearly, this trend has been detrimental to small cap stocks, particularly since 2015. And with quality in favor and many small companies over-levered, we don't expect to see this change anytime soon.

Weighting of Top 10 Stock in the S&P 500



Source: JP Morgan Asset Management (as of 9/30/23)

Spread Between S&P 500 and Russell 2000

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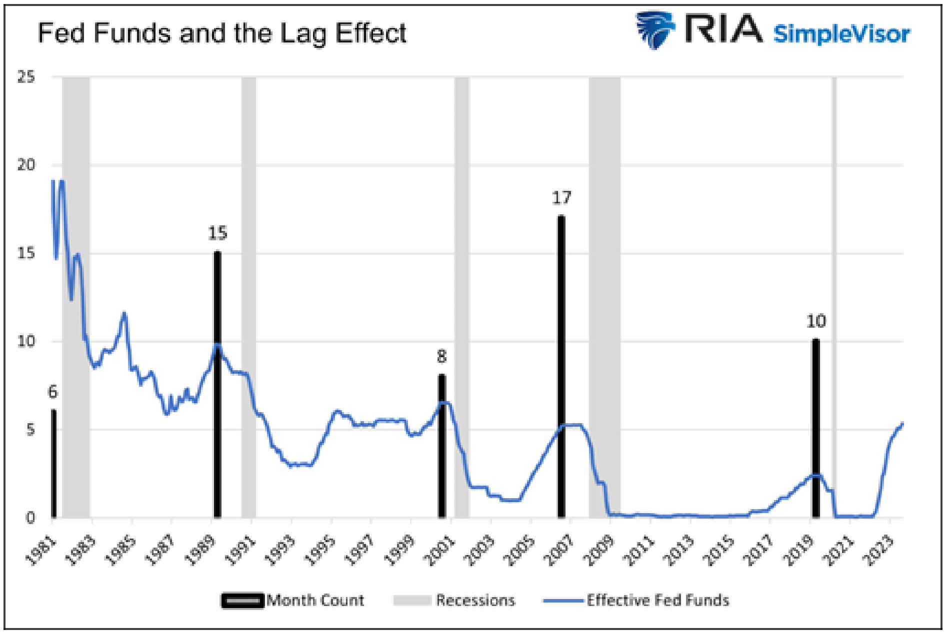
The Infamous "Lag Effect

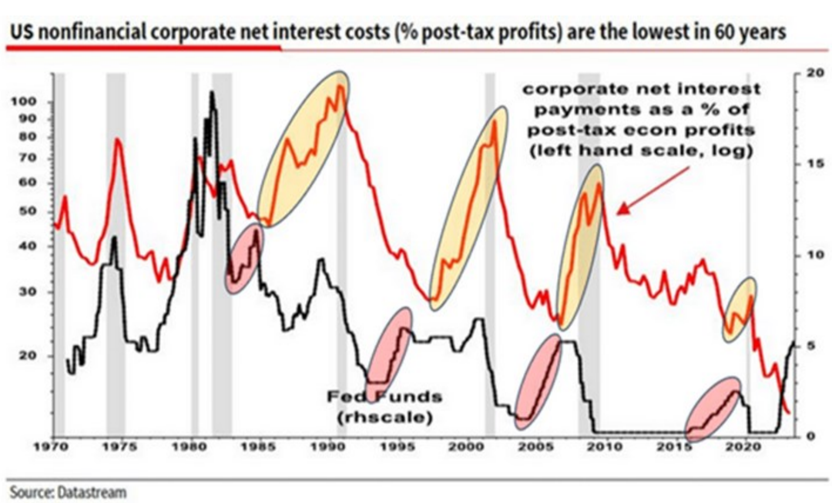
"Where is the recession everyone has been calling for over the last year? Despite surging interest rates, there are few signs of distress amongst corporate borrowers. This is because most companies locked in low rates over the past three years and have not had to scramble to refinance…yet. There is often a delay, called the lag effect, between higher interest rates and economic weakness. The graph below shows the Fed Funds rate and the time, in months, from the last rate hike preceding each recession since 1981. The average delay between the final rate increase and recession has been 11 months. The last Fed hike was in July 2023. Assuming that was the Fed's final rate increase for this cycle, we may not see a recession until mid-2024. Or, given how many companies locked in low rates just 1-2 years ago, even longer. But it will come eventually.



The Wealth Divide Continues To Widen, In Corporate America Too!

It's been well documented that the easy money policies of the past three years disproportionally benefited the wealthy, as asset values exploded and wealthy Americans own the majority of the assets. And the recent interest rate hikes are exacerbating the wealth divide even further, because while rate hikes can be very bad for borrowers, they are very good for savers. While the average American has seen their marginal borrowing rates explode, the wealthiest among us are now collecting 5.5% on their cash balances, which are large.

This is just as true in Corporate America as it is on Main Street. Net interest payments (interest expense less interest income) have actually plummeted as rates have risen. This is because corporate America has record cash balances on their books, earning 5%+, while the average rate on their debt remains very low (another lag effect). Companies with loads of cash are thriving, while companies that are cash-strapped are (or will soon be) scrambling. The chart below shows that net interest costs are at 60-year lows, but it also shows this metric tends to rise quickly once a recession hits.



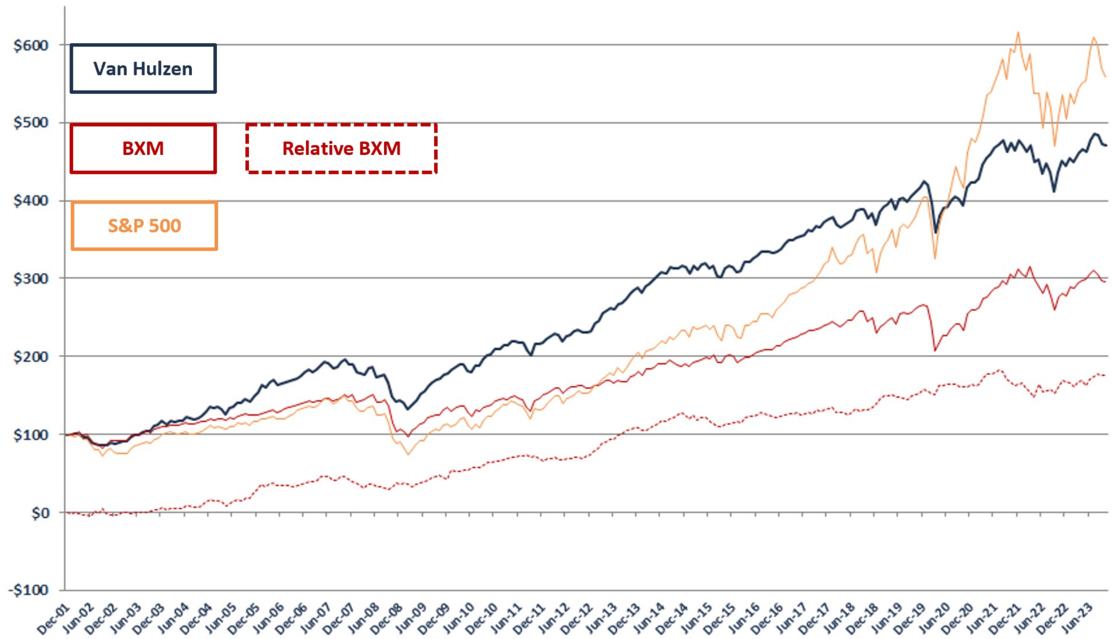
Key Takeaways

- Quality has rarely mattered more than it does today. Our back-testing shows that the highest quality companies have dominated their lower quality peers.
- The largest companies continue to dominate the financial markets. After decades of earning next-to-nothing on their large cash balances, they are now earning 5%+ interest on that cash. This is a huge advantage over smaller, cash-strapped companies.
- We believe these trends will continue for the foreseeable future, as an economic slowdown will hurt smaller, levered companies much more than companies with stronger balance sheets.
- Our portfolio is significantly advantaged in this regard. Our holdings have higher ROIs, higher dividend growth and lower debt. Plus we use call options to add additional yield and valuable downside protection.
- Our strategy is well hedged and is currently yielding more than 8%. 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 10/31/2023)



Returns (annualized)*	Oct 2023	3M	6M	YTD	1 Year	3 Years	5 Years	7 Years	10 Years	Inception
Van Hulzen (Gross)	-0.3%	-2.8%	1.1%	6.2%	8.2%	6.2%	4.6%	5.1%	5.3%	7.4%
Van Hulzen (Net)	-0.4%	-2.9%	0.9%	5.7%	7.6%	5.6%	4.1%	4.5%	4.7%	6.5%
BXM	-0.7%	-4.9%	-0.5%	6.6%	7.3%	8.3%	3.9%	5.0%	5.4%	5.1%
Difference (Gross-BXM)	0.3%	2.1%	1.7%	-0.4%	0.9%	-2.1%	0.8%	0.1%	-0.1%	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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