Covered Call Commentary

July | 2024

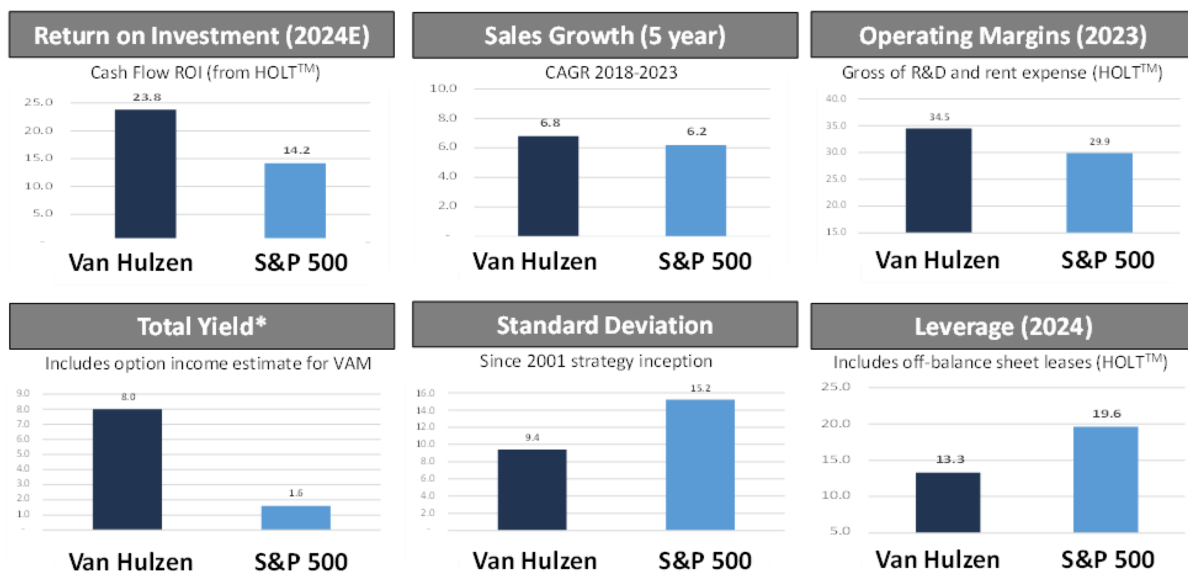
Defining Quality

One of the key differences between the “peak valuations” of the late 1990s and today’s valuations is quality. The tech bubble of the late 1990s was driven by speculation of **future** profits. Today’s valuations, while also extremely stretched, are at least supported by record earnings. The key question is whether these trends can continue, of course.

So today’s winners are higher quality. But there is no consensus definition of quality. So we thought we would share our definition, as well as some research on the connection between quality and shareholder value.

How we define quality

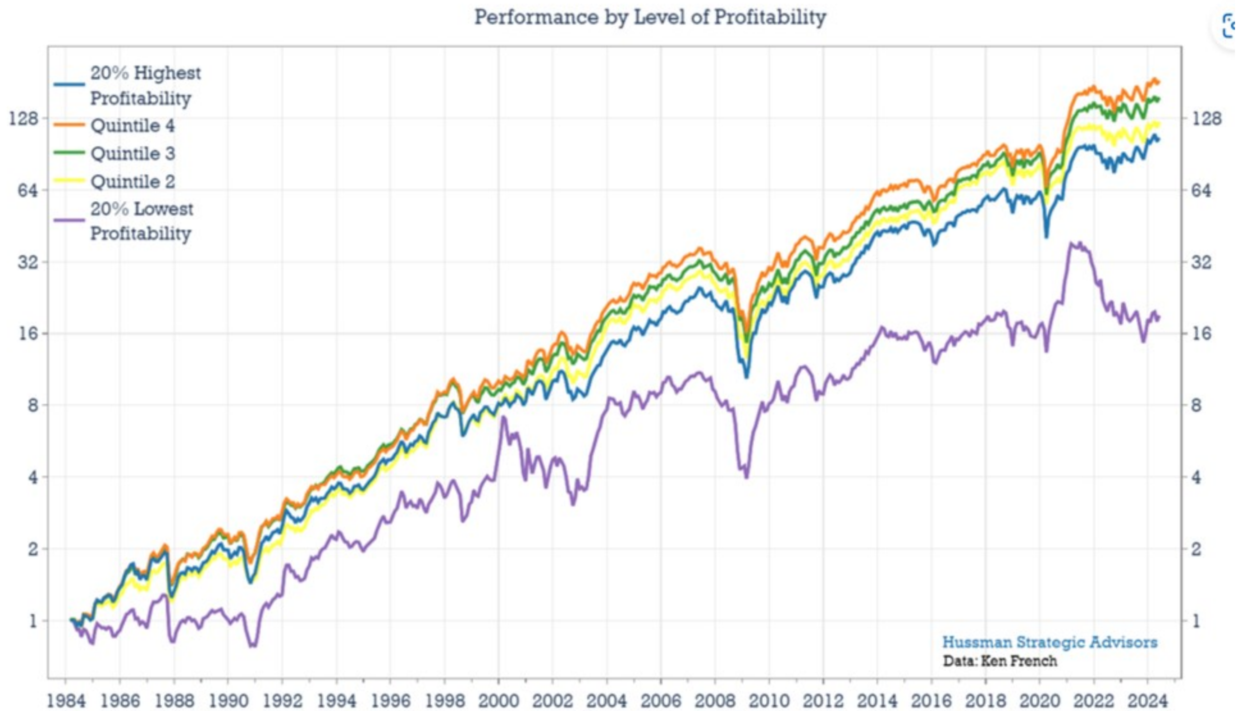
Our holdings are leaders in today’s most relevant industries, with strong ROIs, margins, asset efficiency and sales growth. We do not speculate. Our holdings also have above average dividend yields (enhanced further by the call premiums we collect) and low leverage. We do not tolerate default risk.



But profitability is not enough

A study conducted earlier this year yielded some very interesting results. The Equal Weight S&P 500 was split into five quintiles of profitability. And the shareholder returns were measured over 10, 20 30 & 40 years. The bottom quintile of profitability was consistently last in shareholder returns. This is intuitive, as these companies are typically characterized by significant losses, slow growth, high debt and low credit ratings. But interestingly, the most profitable firms were not the top quintile for returns. The other four quintiles formed a very tight band, as you can see in the chart below, but the **most** profitable quintile actually ranked fourth in all periods studied.

This makes sense to us, as once a firm is profitable the factors that drive stock performance the most are (1) changes in profitability, and (2) growth. Mature companies with limited growth prospects (think consumer staples companies) tend **not** to be the best stock performers.



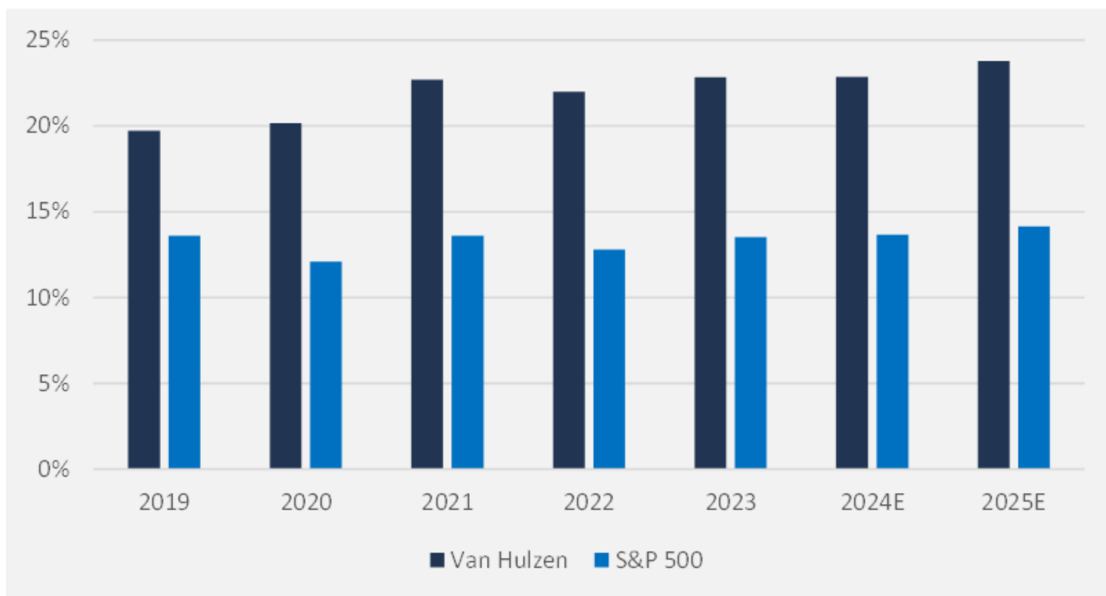
How our portfolio stacks up

Our portfolio holdings do tend to have much higher ROIs than the index, given that consistency is a key component for a covered call strategy and we stay away from early stage companies and turnaround candidates. But we also pay a lot of attention to changes in ROI as well as sales growth.

Over the past 5 years, the ROI of our median holding has improved from 19.7% to 23.8%, a 21% change, compared to just a 4% change for the median S&P 500 company.

And despite screening for consistency and predictability of cashflows, given the nature of our strategy, our holdings also tend to be market leaders with above average top line growth. The 5 year sales growth of our portfolio is 6.8% versus 6.2% for the index. See below.

Cash Flow ROIs over time



Key Statistics

	Van Hulzen	S&P 500
CFROI 2019	19.7	13.6
CFROI 2025E	23.8	14.2
% Change	**21%**	**4%**
5 Year Sales Growth	**6.8**	**6.2**
Leverage	**13.3**	**19.5**

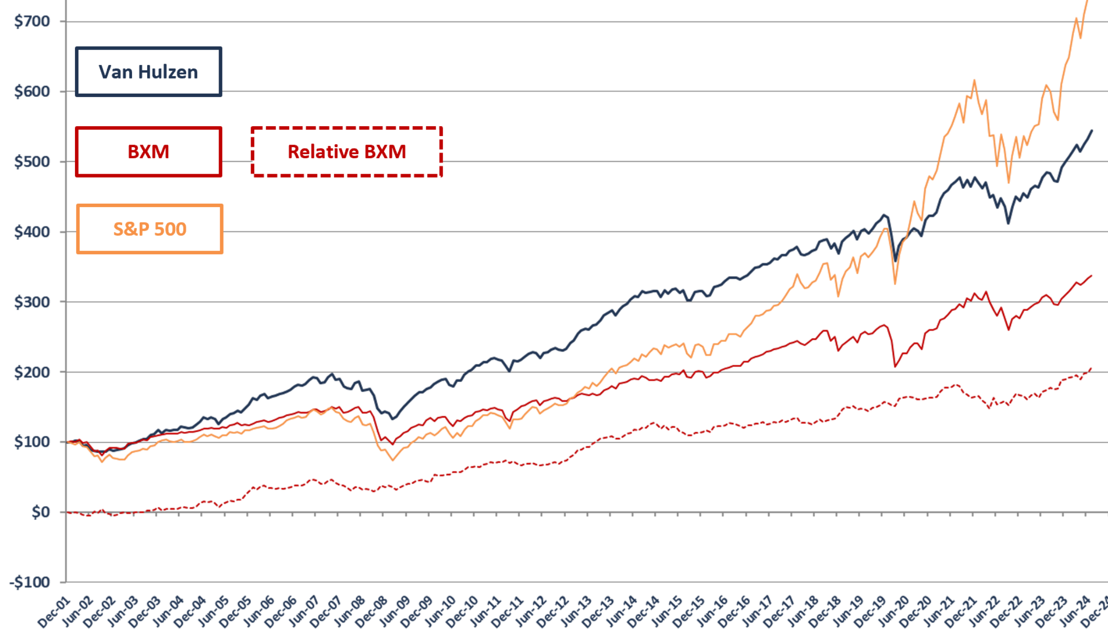
Key Takeaways

- Quality has been a critical factor for investing in recent years, as rates have risen and speculation has gone out of favor
- Although today's market valuations are stretched, there is real profitability underpinning these valuations. This is in stark contrast to the internet bubble of the late 1990s.
- There is no consensus definition of quality, but we focus on improving Cash Flow ROIs, above average sales growth rates, and low debt/default risk as our primary factors.
- This approach has served us very well over the last 22+ years
- Today's market conditions are particularly uncertain, but 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 07/31/2024)



Returns (annualized)*	Jul 2024	3M	6M	YTD	1 Year	3 Years	5 Years	7 Years	10 Years	Inception
Van Hulzen (Gross)	2.1%	5.8%	7.1%	9.0%	12.2%	4.8%	6.1%	6.0%	5.9%	7.8%
Van Hulzen (Net)	2.1%	5.7%	6.8%	8.6%	11.6%	4.3%	5.6%	5.4%	5.3%	6.9%
BXM	1.1%	4.0%	6.9%	8.8%	8.6%	5.2%	5.6%	5.4%	5.9%	5.5%
Difference (Gross-BXM)	1.0%	1.7%	0.2%	0.2%	3.6%	-0.3%	0.6%	0.6%	0.0%	2.3%
S&P 500	1.2%	10.0%	14.8%	16.7%	22.1%	9.6%	15.0%	14.1%	13.2%	9.3%

*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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