EVOLVE ETFs

Enhanced Income Strategies

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Combining Modest Leverage with Covered Calls

Levered ETFs have gained considerable attention in recent years as investors seek ways to boost returns without dramatically altering their core portfolio. While high leverage may evoke concerns about volatility and risk, modest leverage—typically around 25%—presents a more measured approach that can align well with long-term investing goals. This level of leverage can enhance returns in rising markets while providing a cushion for risk when combined with complementary strategies, such as covered calls.

Chart 1: Levered ETF when index rises

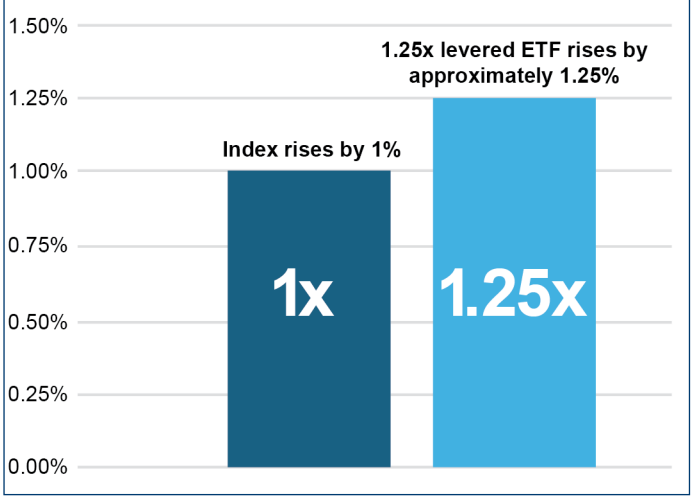
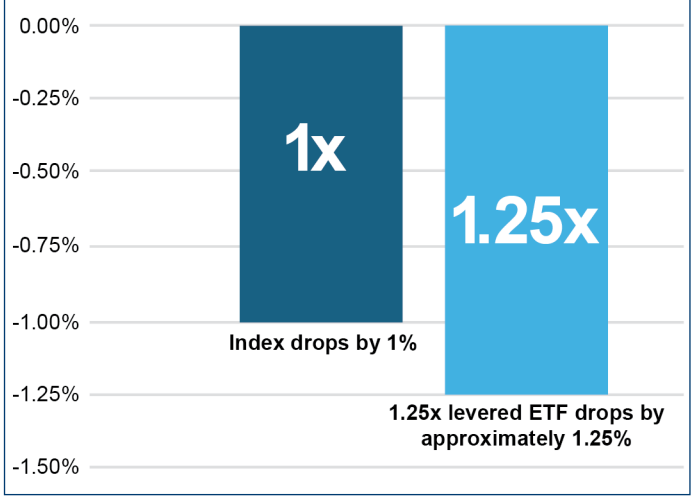


Chart 2: Leveraged ETF when index drops



The above illustrations are provided for Educational Purposed Only. The examples are provided solely to demonstrate the concept of a 1.25x modest leverage and does not represent actual investment outcomes or fund behaviour of any entity or security discussed.

Why Modest Leverage?

Modest leverage involves borrowing a portion of the investment amount—typically 25%—to increase the total capital deployed in a portfolio. This allows investors to amplify their returns by gaining more exposure to market movements than the initial capital would otherwise allow. Unlike higher levels of leverage, which may increase volatility, modest leverage is designed to strike a balance between risk and reward.

In a scenario where interest rates are relatively low or lowering, the cost of borrowing is manageable, making this strategy attractive for risk-conscious investors seeking an edge in their portfolios. In a rising market, the leverage cost can often be offset by enhanced returns; however, it's important to remember that while leverage can amplify gains, it also magnifies losses in downturns.

Below is the 5-year price return of the S&P 500® Index, compared to the S&P 500 1.25x Leverage Carry-Free Daily Index. As highlighted in Chart 3, the levered Index outperforms the S&P500® Index. This illustrates how daily leveraged strategies can potentially amplify index returns in trending markets, though they may also increase risk.

Chart 3: S&P 500 1.25x Leverage Carry-Free Daily

Source: S&P Global as at May 30, 2025,

The S&P 500 1.25x Leverage Carry-Free Daily Index reflects 125% of the return (positive or negative) of the S&P 500 on a daily basis. The S&P Carry-Free Leveraged Indices are designed to generate a multiple of the underlying index return, without taking into account the cost of borrowing capital to generate the excess index exposure.

The S&P 500® Index is a widely followed benchmark of U.S. large-cap equities, representing 500 of the largest publicly traded companies and covering approximately 80% of the available market capitalization.

How do Levered ETFs work?

Levered ETFs use financial leverage to amplify returns by borrowing additional capital to invest in more assets than the original investment amount. Here's a simplified breakdown:

1. Initial Investment: Suppose you invest $100 in a levered ETF.
2. Leverage Application: The ETF uses leverage (in this case, 25%) to borrow an additional $25. This allows the fund to invest a total of $125 in assets, even though you only invested $100. So, $100 buys $125 worth of exposure to the underlying assets.
3. Collateral: The original $100 investment serves as collateral for the $25 borrowed.
4. Cost of leverage: ETFs pay an institutional cost of leverage which is typically the overnight rate plus a spread.
5. Impact on Returns (assuming no leverage cost for simplicity): If the value of the underlying assets increases by 10%, the $125 worth of assets would grow by $12.50 (10% of $125). This means your original $100 investment would now be worth $112.50 (a 12.5% return). However, the same leverage also amplifies losses. If the underlying assets fall by 10%, your $125 worth of assets would lose $12.50, reducing your $100 investment to $87.50 (a 12.5% loss).

Leverage magnifies both gains and losses, which is why it's often seen as a more aggressive, higher-risk strategy. However, in more stable industries that tend to have less aggressive drawdowns leverage can be particularly effective.

How the Cost of Leverage Affects ETF Returns

Levered ETFs must pay a borrowing rate on the levered portion of the portfolio. The cost of leverage is paid directly out of the Net Asset Value (NAV). This means that the impact of leverage expenses is embedded in the fund's returns.

Let's assume the cost of this leverage is the Bank of Canada overnight rate + 0.55%. As the Bank of Canada increases rates, the cost of this leverage (and the drag on returns) increases. In contrast, as rates come down, the cost decreases. Given the current path of interest rates in Canada, levered ETFs should become cheaper for investors.

Does the Benefit of Leverage Outweigh the Cost?

The answer to this question will ultimately depend on the return profile of the underlying holdings. In positive markets, the enhanced return typically more than covers the additional cost of leverage. Having said that, in declining markets the cost of leverage works against investors.

What are Covered Calls?

A covered call is an options strategy used within ETFs to generate additional income. In this strategy, the ETF holds a portfolio of stocks (or other assets) and sells call options on a portion of those holdings. A call option gives the buyer the right, but not the obligation, to buy the underlying asset at a specified price within a certain period.

By selling these call options, the ETF collects premiums, which are passed to investors through distributions. However, if the asset's price rises above the option's strike price, the ETF may have to sell the asset at that price, potentially limiting the upside. In essence, covered calls can enhance income but may cap potential gains during strong market rallies. This strategy is commonly used to reduce volatility and generate steady cash flow for income-focused investors..

The Symbiotic Relationship Between Leverage and Covered Calls

When modest leverage is combined with covered calls, the strategy creates a synergistic effect. The leverage amplifies the potential returns of the underlying asset, while the covered calls help to reduce volatility and mitigate downside risks in sideways or declining markets by generating additional income. Through this approach, investors have the ability to pursue enhanced returns and income while also potentially reducing the volatility that often accompanies leverage.

There is currently over $3B AUM in 25% levered covered call ETFs in Canada of which Evolve ETFs manages over $300M.
*Source: Bloomberg, as at October 31, 2024

The following example illustrates how leverage and covered calls can interact in a simplified model. The portfolio's delta represents how much the ETF participates in the underlying asset's returns. For instance, an ETF with a delta of 1.5 will move 1.5% for every 1% change in the underlying asset. In this scenario, we assume the ETF invests in a single stock with 25% leverage and writes covered calls on 33% of the portfolio, set 3% out-of-the-money (OTM).

Chart 4: 33% Covered calls and 25% Leverage Portfolio Delta			
	Portfolio Delta		
	Down Market	Range-Bound (<3%)	Up market (>3%)
Long underyling	1	1	1
25% Cash Leverage	0.25	0.25	0.25
Short 3% OTM Call, 33% Coverage	0* 33% = 0	0* 33% = 0	-1* 33% = -0.33
Portfolio Delta	1.25	1.25	0.92

The above chart is provided for Educational Purposed Only. This example is provided solely to demonstrate how leverage and covered calls can interact and does not represent actual investment outcomes or fund behaviour of any entity or security discussed.

In a down market, the ETF would experience the full impact of the 1.25x drawdown of the underlying asset. While the leverage magnified the drawdown, the option premiums would provide a cushion, softening some of the drawdown.

In a range-bound scenario, defined as between 0% and 3% growth, the portfolio would also achieve roughly 1.25x the underlying asset's returns. Here, the underlying's price remains below the strike price, so the options expire worthless, allowing the ETF to keep the premium without forfeiting any upside.

In an up market where the underlying price exceeds the strike price (>3%), some potential gains are capped due to the covered calls, resulting in a portfolio delta closer to 0.92. With the added leverage, the portfolio has greater upside potential than a non-levered portfolio with 33% covered calls (which would have a delta closer to 0.67). Despite the reduced upside capture, the ETF still retains the option premiums, offsetting a portion of the lost upside.

An active approach to covered calls differs from this simplified example as it is designed to be dynamic and adapt to changing market conditions. The objective is to earn the target distribution yield, while maintaining as much up capture as possible. To accomplish this, two main levers are typically adjusted: the portion of the portfolio that is covered and the extent to which calls are written further out-of-the-money (OTM) to maximize potential upside.

The Relationship Between Levered ETFs and Interest Rate-Sensitive Sectors

The relationship between declining interest rates and levered ETF performance is especially important for sectors that tend to benefit from lower interest rates, such as utilities, real estate, and financials. Utility companies, which are typically capital-intensive and rely heavily on debt financing for infrastructure projects and expansion, often perform better when borrowing costs are low. Lower interest rates allow utilities to finance their operations and growth at a lower cost, increasing their profitability. Declining interest rates benefit financial stocks by boosting loan demand, increasing asset values, and enhancing income from refinancing and non-interest services. Modest leverage amplifies the returns of these stocks during favorable interest rate environments, providing a double tailwind.

Considerations and Potential Drawbacks

While modest leverage can enhance returns, it is not without risks. Leverage magnifies losses in the same way it amplifies gains. In prolonged market downturns, the increased exposure can lead to significant underperformance compared to non-levered portfolios.

Additionally, covered call strategies work well in certain market conditions, such as range-bound, declining or slightly rising markets, but they can cap upside potential if the underlying securities experience strong growth. When combined with leverage, this could limit the return potential while still exposing the investor to the downside risks of leverage.

Another consideration is the cost of leverage itself. Borrowing to enhance returns introduces an additional layer of costs, which may erode the potential gains, particularly in a declining market.

Conclusion

Modest leverage offers investors a compelling tool for boosting returns while maintaining a more measured risk profile than traditional high-leverage strategies. When paired with covered call writing, it creates a potentially powerful combination of income generation and amplified returns.

For investors seeking to enhance their portfolio's performance without venturing into overly speculative territory, modest leverage combined with covered calls can provide an attractive solution—one that offers meaningful long-term rewards.

Disclaimer