TSX CALL

SPECIAL COMMENTARY

Evolve U.S. Banks Enhanced Yield Fund

CALL invests in large cap U.S. banks with the added value of a covered call strategy applied on up to 33% of the portfolio.

As at March 17, 2020

TICKER: CALL (Hedged); CALL.B (Unhedged); CALL.U (USD)

UPDATE:

US Banks have suffered significant declines through the market sell-off as investors weighed the impact of Federal Reserve rate cuts on bank net interest margins (“NIM”). NIM is the measure of the spreads earned by banks between the rates at which they borrow and the rates at which they lend. Spreads are under pressure from declining policy rates which have been released in a series of surprise announcements, most recently on a Sunday.

Furthermore, investors are revising their valuation models for US Banks to consider the increased likelihood, some might say certainty, of a recession resulting from the COVID-19 crisis. Everything from global trade to local shopping patterns are under pressure from the quarantine effort. While the trend to online commerce is likely to accelerate over the coming months, online business alone is unlikely to offset traditional commercial activity.

Unlike 2008, there is little fear of instability in the financial system and no talk of a need to bail anyone out. Regulatory measures are being debated to relax rules to free up bank capital as a way to provide relief to consumers. Any such changes are likely to mitigate the effects of a downturn on bank balance sheets.

The Evolve US Banks Enhanced Yield Fund (“CALL”) has suffered a drop of -44.73% since the peak of the market on February 19th. None of the constituents have been immune to the sell off though the larger names such as JP Morgan Chase & Co. and Bank of America Corp. have fared slightly better dropping -2.28% and -15.42% respectively.

On Feb 21st we rolled our options into the March expiry. Given the levels of the markets at the time we made the decision to be fully deployed and wrote against the maximum 33% of the portfolio. This turned out to be a profitable decision.

At time of writing we have captured the full premium from this roll and closed all open contracts.

As we look to the next month, we are on the sidelines for the time being. While volatility remains high (the average implied volatility for calls 2-5% out of the money, one month from expiry is currently 104), premiums are not appropriately compensating us for the technical risk of selling at today’s prices.

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Bear markets are characterized by one-or-two day sharp rallies which can easily whipsaw a trader out of a short call position for a loss. In the past week we have seen many names move as much as 10% in either direction in a single day.

Our aim is to capture premium safely for investors and our risk systems are designed with that goal foremost in mind.

We are trailing the market down and will be establishing new calls when new lows have been confirmed for multiple trading sessions. We are looking for a breakout to either side. At the moment, the safest approach is to stay on the sidelines and respect the signals from our risk systems.

MACROECONOMIC HIGHLIGHTS:

With the threat of coronavirus and fears over the prospects for global growth roiling the markets as February wore on, the year's shortest month felt a lot longer for many investors. The Dow Jones, the S&P 500, and the Nasdaq were all down more than 3% on the month, with little relief in sight for March, as skittish investors moved funds from equities into safe-haven assets.[i]

For many of the big American banks the hit was even harder, as falling interest rates—specifically Treasury yields—plunged to all-time lows in February, leading to lower interest margins for banks.[ii] As a result, the fund showed negative returns on the month.

First Republic Bank released Q4 earnings in February. First Republic delivered a positive earnings result of 10.3% in Q4 2019, driven by top-line strength. The bottom line increased 7.8% from a year earlier. These results were driven by an increase in NII and non-interest income, a strong balance sheet, and a decline in provisions. Net income available to common shareholders grew to US$235.6 million in Q4, up 9.5% year-over-year. For full-year 2019, the company reported net income of US$881.3 million, up from US$796.1 million in 2018. For 2019, the company reported net revenues of US$3.3 billion, up 9.7% from the year prior.[iii]

February was also a busy hiring month for First Republic. The bank hired away a trio of Washington State advisors from Wells Fargo & Co.'s private bank to bolster First Republic's growing private wealth brokerage unit. The trio of investors—based in Bellevue, Wash., a wealthy Seattle suburb—had been generating US$4.3 million in annual revenue at Wells Fargo prior to the move. There move is the second such move of a billion-dollar-plus team to First Republic. In January, the bank also recruited a 10-person J.P. Morgan Securities team in Florida that were producing $14 million in annual revenue.[iv]

Wells Fargo & Co. entered into a deferred-prosecution agreement with the Department of Justice that will see the bank pay $3 billion to settle U.S. investigations into a series of consumer abuses. The deal also resolves a complaint by the Securities and Exchange Commission. Of note for

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shareholders is that the settlement is in line with the more-than $3 billion the bank originally set aside in late 2019 for the resolution of the matter. Shares climbed in extended trading after announcement of the deal. CEO Charlie Scharf, who took over in October, continues to conduct a review of all Wells Fargo & Co. operations to ensure such incidents do not recur.[v]

At its annual investor day in February, JPMorgan Chase pledged to facilitate $200 billion in environmental and economic development deals as an expansion of its previous sustainable financing goals. The investment bank also announced that it will pull back from advising and lending to the coal-mining industry, restrict financing new coal-fired power plants, phase out “credit exposure” to coal by 2024, and will no longer fund new oil and gas drilling projects in the

PERFORMANCE ATTRIBUTION:

For February 2020, CALL held a diversified portfolio of banks and finance companies. Top-performing holdings were First Republic Bank, Huntington Bancshares Inc., and Truist Financial Corp, though all these saw negative returns on the month. By weight, CALL's largest exposures were to Truist Financial Corp, First Republic Bank, and Ameriprise Financial, Inc.

SOURCES:

[i] https://finance.yahoo.com/news/stock-market-news-feb-25-143702055.html
[ii] https://www.fool.com/investing/2020/02/28/heres-why-jpmorgan-chase-and-most-other-bank-stock.aspx
[iii] https://finance.yahoo.com/news/first-republic-bank-frc-0-163004273.html
[iv] https://advisorhub.com/first-republic-hires-4-3-million-wells-team-to-open-office-near-seattle/
[v] https://www.bloomberg.com/news/articles/2020-02-21/wells-fargo-pays-3-billion-avoids-prosecution-for-sales-abuses
[vi] https://www.cnbc.com/2020/02/25/jpmorgan-says-it-will-fund-200-billion-in-sustainable-deals-this-year.html

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