

Covered Call ETFs 101

Winter 2023



Income-seeking investors are facing significant headwinds in 2023. Dividend stocks, traditionally considered a cornerstone of a yield-focused strategy have suffered losses as the bear market continues. As interest rates are expected to rise further, bond prices continue to bleed, leaving even conservative fixed-income investors with heavy losses.

When investing in dividend stocks, investors seeking consistent income must screen for high yields, which can leave them vulnerable to companies with unsustainable payout ratios and poor fundamentals. Investors using bonds must move up in duration or down in credit quality to capture higher yields, which exposes them to greater interest rate or default risk, respectively.

In highly volatile markets, one investment tactic that has the potential to outperform is a covered call strategy. Covered call strategies allow investors to generate enhanced yields on household names often already in portfolios, without sacrificing significant upside.

What is an option?

An option is a financial derivative that gives the holder the right, but not the obligation, to buy or sell an underlying asset at a specified price on or before a certain date. Options are contracts that are traded on financial markets, and can be used as a tool to hedge risk, generate income, or speculate on the direction of asset prices.

There are two main types of options: call options and put options. A call option gives the holder the right to buy the underlying asset at a specified price (also known as the strike price), while a put option gives the holder the right to sell the underlying asset at the strike price.

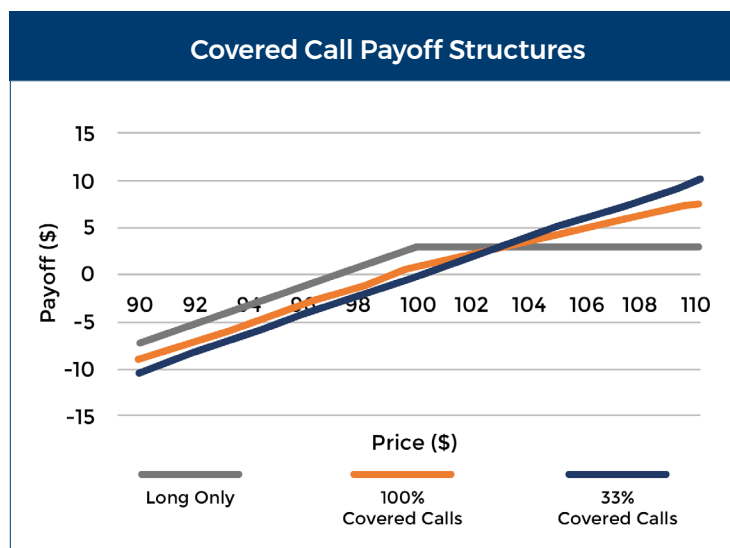
The price of an option is known as the premium. The premium reflects the probability of the option being exercised, as well as, the time remaining until the expiration date and the volatility of the underlying asset.

What is a Covered Call?

A covered call is an options trading strategy in which the portfolio manager (PM) holds a long position in an asset and sells (writes) call options on that same asset with the purpose of generating income through the premiums received from the sale of the options. The long position in the asset is said to “cover” the short position in the call options, hence the name “covered call.”

As an example, the portfolio holds 100 shares of a stock and the PM sells one call option contract, which represents the right to buy 100 shares of the stock at a certain price (the strike price) on or before a certain date (the expiration date). If the stock price stays below the strike price, the option buyer will not exercise their right to buy the shares, and the investor will keep their shares and the premium as profit. However, if the stock price goes above the strike price, the option buyer will likely exercise their right to buy the shares at the agreed upon strike price. The PM will, therefore, be obligated to sell the shares but would still get to keep the premium collected as profit.

To illustrate the example above, let's say the portfolio holds 100 shares of Company XYZ stock, currently trading at \$50 per share. The PM sells one call option with a strike price of \$55 and a premium of \$2 per share, collecting \$200. If the stock price remains below \$55 at the option's expiration date, the option will expire worthless, and the PM retains the \$200 premium as profit. If the stock price rises above \$55, the option will be exercised, and the PM must sell the shares at the agreed upon strike price of \$55. In this scenario, the PM would miss out on any further stock price appreciation above \$55 but would still have collected the \$200 option premium as profit.



This chart is for illustrative purposes only.

What are the benefits of Covered Call strategies?

1. Enhanced Yield

One advantage of covered call investing is that it allows investors to generate income from their stock holdings. By selling call options on stocks already owned, the option premium provides a source of income without having to sell the stock. This can be particularly appealing for investors who want to hold onto their stocks for the long term but are looking for ways to generate income in the meantime.

2. Lower Volatility and Reduced Drawdown

A covered call strategy can help to reduce drawdown by generating income through the sale of call options, which can partially offset losses in the value of the underlying asset. It's important to note that a covered call strategy does not eliminate the risk of drawdown. If the value of the underlying asset declines more than the premium collected, investor may still experience a drawdown in their portfolio value. However, because the investor holds a long position in the underlying asset, the maximum loss is limited to the purchase price of the asset less the premium received. This strategy is in contrast to naked call options, where the investor does not hold the underlying asset and is exposed to unlimited risk.

3. Tax Efficient Yield

The premiums received from the sale of call options are taxed more favourably as capital gains rather than ordinary income, reducing the tax burden for the investor.

In what market environment do Covered Call strategies work best?

Covered call strategies can be used in a variety of market environments, but they may be particularly effective in neutral or sideways markets where the price of the underlying asset is not expected to fluctuate significantly. In these types of markets, it is less likely the option will be exercised resulting in foregone upside in the stock price or that the premium received is not sufficient to offset the losses in value of the underlying asset.

Having said that, an experienced covered call manager can take advantage of stock market volatility. When the stock price is volatile, the value of the call options can also be volatile, resulting in higher option premiums. The vast majority

of options expire worthless. Therefore, option writing in aggregate results in a transfer of economic value from the option buyer to the option seller (writer). This is because the option seller is selling volatility.

A skilled call writer can harvest this premium while maintaining up capture by using tactical quantitative risk management techniques.



These charts are for illustrative purposes only. Illustration is based off a hypothetical 2% OTM option for Morgan Stanley (MS US).

Why Covered Call ETFs?

Covered call ETFs are a simple way to add a covered call strategy to an investing portfolio. Through a covered call ETF, investors may benefit from the capital appreciation of a basket of equities while also benefiting from an increased yield due to the premium collected on the calls. Covered call ETFs provide investors with a hands-off-approach to options trading and are typically regarded as a one ticket solution to a complex and time-consuming strategy. They trade on major stock exchanges and have ticker symbols, meaning they can be bought and sold just like a stock.

What is the difference between active and systematic covered call strategies?

A systematic covered call strategy is one in which the PM follows a predetermined set of rules to select the underlying assets, strike prices, and expiration dates for the call options. It typically consists of writing one call option contract for every 100 shares held in a portfolio and repeating the operation from one expiration date to the next regardless of market conditions.

An active covered call strategy is one in which the PM manually selects the strike prices, and expiration dates for the call options based on their individual judgment and market analysis. This type of strategy requires the PM to actively monitor their positions and make decisions about when to sell call options and when to hold or close the positions. In addition, the PM may decide how much of the portfolio should be 'covered' at any given time.

Why Evolve?

Evolve's experienced portfolio management team has a track record of over 5 years in actively managing covered call ETFs. We tactically manage our option positions daily and adjust them depending on market conditions. Our objective is to meet our overall target portfolio yield while maintaining up capture by using tactical quantitative risk management techniques.

Characteristics of Evolve's Active Covered Call Strategy:

- We have the ability to write covered call options on up to 33% of the portfolio. Therefore, we can be very tactical on individual names as long as the overall portfolio doesn't exceed 33% coverage. The % of covered calls written for each security is an active decision that is made using various custom tools and indicators that guide us in our decision-making process. This is different than a systematic strategy which would write calls on exactly 33% of each security.
- Typically, we will write options 2-5% out-of-the money (OTM) but are not limited to that range.
- Calls are typically written with 1 month to expiry, but sometimes we will write out further.
- We will often write multiple options with different strike prices and expiries in order to receive a desired premium with a desired risk profile.
- We actively choose to either be assigned or buy back in-the-money (ITM) options based on the options strike level versus our adjusted cost base (ACB) (whichever is more beneficial for tax purposes). We also take into consideration the ex-dividend date of equities.
- We consistently enter \$0.05 for our short calls to take advantage of any unexpected market moves or trading mistakes made by other market participants.
- We will buy back options before expiry if there is an alternative option strike/expiry that provides more premium opportunity with lower risk.
- There will be times that we make an active decision to not write any calls on a specific security or portfolio. In these cases, trailing stop alerts are implemented to help guide us when to reinstate the covered call program. As an example, due to the sharp sell-off in February 2020 premiums did not favour selling March 2020 lows. During this time, we significantly reduced the number of calls we sold, outperforming a theoretical systematic strategy that would have remained 33% covered.