In this issue of Market Commentary, Zeigler Capital Management, LLC discuss how covered call strategies work and how they can help to complement an individual investors portfolio.

Covered Call Investing and its benefits in today's market environment

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About Ziegler Capital Management, LLC

Asset management firm based in Chicago with a proven history of providing investment solutions for institutions, mutual fund subadvisory clients, municipalities, pension plans, Taft Hartley and individual investors. Ziegler Capital Management is an independent third party subadviser to the First Investors Covered Call Strategy Fund.

Covered Call investing has attracted a great deal of attention from investors searching for lower-volatility equity strategies with an attractive income component. The risk-reducing characteristics of the covered call strategy have produced superior risk-adjusted returns over time relative to a long only approach. This paper begins by discussing why an investor would allocate to a covered call strategy. The second section of the paper describes three different types of covered call strategies: 1) Passive Index-based, 2) Active Index-based, and 3) Active Single-stock.

Why Covered Call?

A Low Volatility Equity Strategy with an Attractive Sharpe Ratio

Equity investors are exposed to a great deal of volatility within portfolios. Although committed to the growth prospects of the equity asset class, many investors may be willing to trade some of this volatility for greater return consistency. Due to the income from the sale of call options, which help stabilize returns, covered call strategies have tended to produce lower beta and lower volatility compared to equities. Despite the lower beta, covered call strategies have historically tended to produce returns similar to equities over the long term, resulting in an improved risk-return profile.

A Supplemental Income Strategy

A covered call strategy allows the owner of an equity security to collect both dividend distributions as well as upfront income from the sale of call options. In today's low rate environment, the income from the call options has become increasingly attractive to yield-starved investors.

Reduced Drawdowns

Investors often consider the sale of the call option as a form of downside protection. As a result of the call premiums, covered call strategies tend to outperform during bear markets, thus reducing portfolio drawdowns. Investors have realized that equity returns can compound to higher returns over time by minimizing the impact of drawdowns. The downside protection is equal to the upfront call premium received.

The Basics of Covered Call Investing

A Low Volatility Equity Strategy with an Attractive Sharpe Ratio

Investors have broad familiarity with the S&P 500 Index, as it is the most widely used equity benchmark in the U.S. Imagine taking the S&P 500 Index and selling a one-month, at-the-

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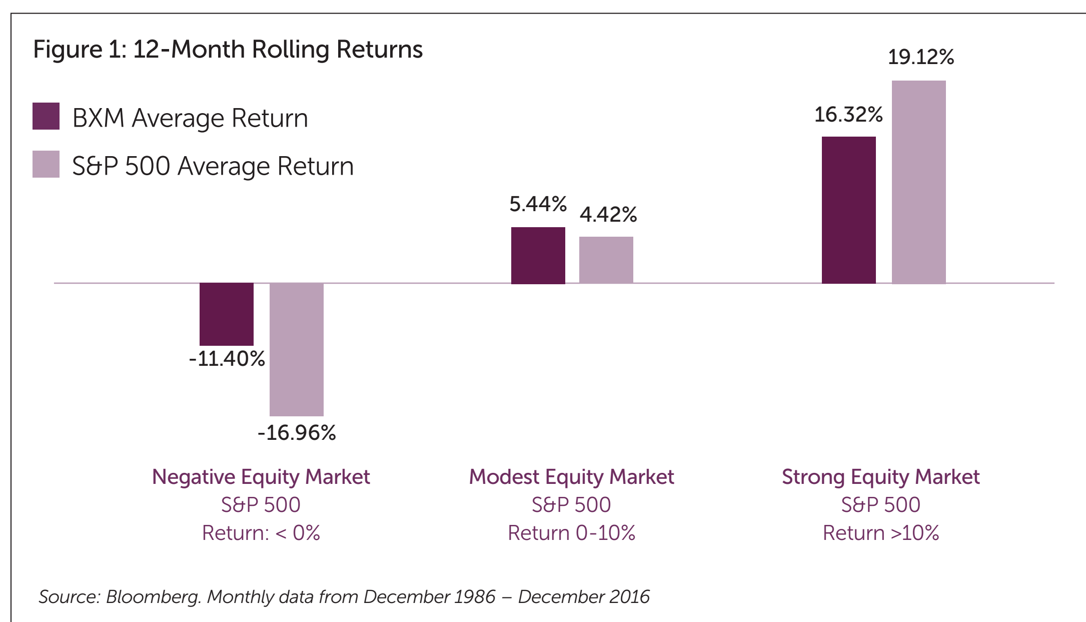
money call option each month. Continuing to hold the S&P 500 Index and selling an index call option month after month would create what's known as the CBOE S&P 500 BuyWrite Index ("BXM Index"). The BXM Index is the most widely used benchmark for covered call portfolios.

By writing call options, investors can modify the risk-return characteristics of the equity asset class, creating a more stable return pattern over time. The premium generated from the sale of call options provides an income component that can help to stabilize overall returns, as shown in Figure 1. Equity investors are exposed to a great deal of volatility within portfolios. Although committed to the growth prospects of the equity asset class, many investors may be willing to trade some of this volatility for greater return consistency.

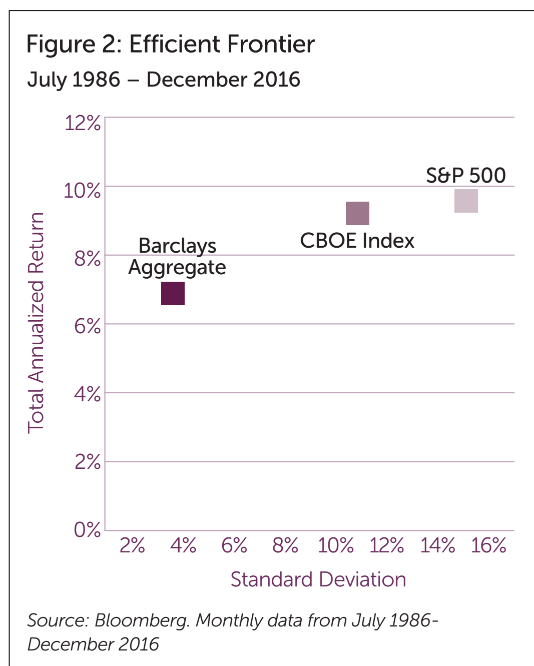


Covered call investing presents investors with the opportunity to experience returns correlated to the equity markets with reduced volatility. The call options can reduce the tails of the equity distribution, resulting in potential outperformance during down markets, but underperformance during strong market rallies. Over a market cycle, covered call strategies have tended to produce equity-like returns with lower beta and lower volatility, resulting in an improved Sharpe ratio. Of course, past performance does not guarantee future results. On the risk-return spectrum, covered call tends to lie between fixed income and equity. As shown in Figure 2, the BXM has been less risky than equities (SPX), but more risky than bonds (AGG), based on monthly data from 1986-2016.

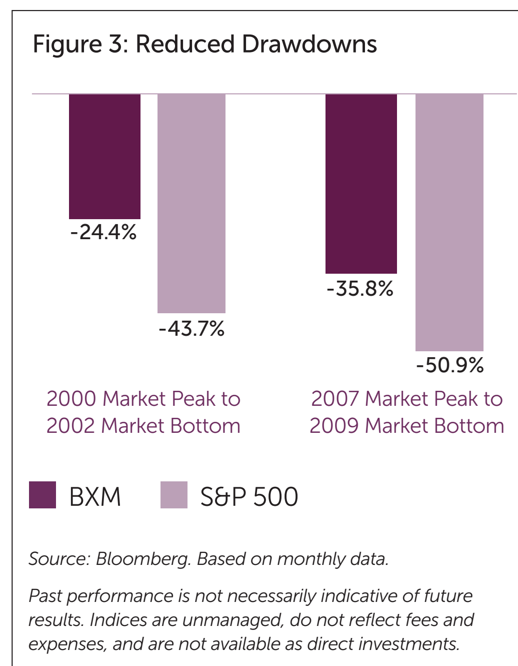
A Supplemental Income Strategy

The call options in the BXM Index help to stabilize equity market returns by providing upfront income to investors each month when the call options are sold. In today's low rate environment, the income from the call options has become increasingly attractive to yield-starved investors.

Although the covered call strategy is a lower-risk equity strategy, it could be an attractive asset class for fixed income investors who desire diversification away from the interest rate risk associated with bonds. While fixed income investments are generally inversely correlated to interest rates — losing value when rates rise — covered call writers may benefit in rising rate environments as the value of the call premiums tend to increase with rising interest rates.



Source: Bloomberg. Monthly data from July 1986-December 2016



Source: Bloomberg. Based on monthly data.

Past performance is not necessarily indicative of future results. Indices are unmanaged, do not reflect fees and expenses, and are not available as direct investments.

However, investors allocating to the covered call would be choosing equity market risks over fixed income duration, or price risk.

Reduced Drawdowns

Astute investors have realized that market returns can compound to higher returns over time by minimizing the impact of drawdowns. Investors often consider the income from the sale of the call option as a partial form of downside protection. As a result of this income, covered call strategies have historically generated impressive results compared to the S&P 500 Index in terms of risk mitigation and volatility reduction, providing reduced drawdowns during bear markets, as shown in Figure 3. For example, covered call strategies that utilize in-the-money call options tend to provide more downside protection, albeit with less upside return potential (lower risk and lower return relative to the BXM Index).

Types of Covered Call Investment Strategies

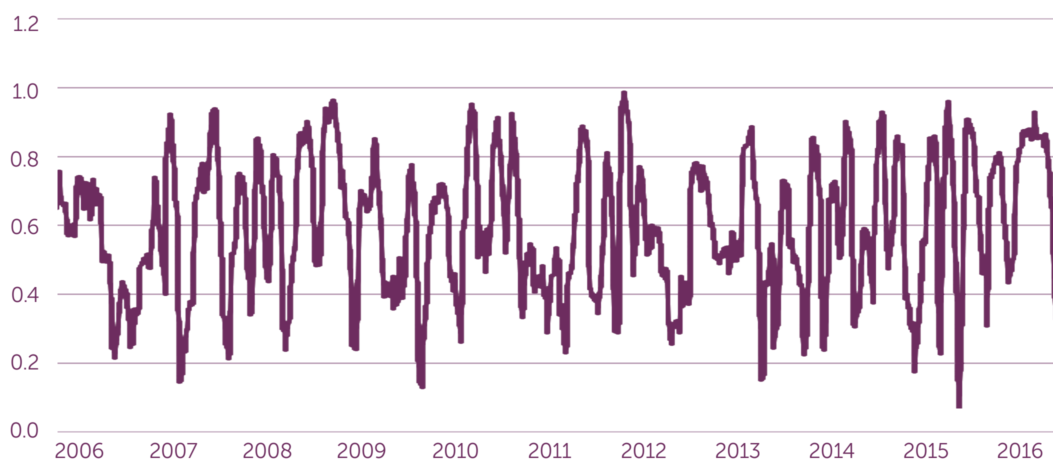
1) S&P 500 Index with passively managed Index options (the BXM Index)

Although the passively managed covered call strategy of the BXM Index has produced attractive risk-adjusted returns, the strategy has some limitations:

- It is restricted to only one call option (a one-month, at-the-money call option), regardless of the market environment. Market valuations and implied volatility characteristics change throughout the economic cycle. While the one-month contract duration of the BXM tends to optimize the call option's time-value decay in common markets, the BXM is unable to take advantage of spikes across the entire term- structure of implied volatility by opportunistically selling longer duration options. There are periods when a one-month, at-the-money call option is the optimal strategy, but the majority of the time it is not. For example, when implied volatility and call premiums are elevated, it can be advantageous to "lock-in" the elevated call premiums for longer than one month. This can only be done by selling longer-term options, such as a 3, 6, or 12-month call option. The BXM would not be able to make such an adjustment to its call option portfolio.

- Although there are approximately 252 trading days in any given calendar year, the BXM sells call options on only 12 of those days. This creates substantial risk for the BXM. Its returns are overly dependent upon the market characteristics on those 12 days. For example, if call premiums happen to be below average on those 12 days, the BXM will generate lower call income. An active manager, on the other hand, can avoid those below average days and sell more call options during the inevitable periods of higher implied volatility that occur throughout each year. At a minimum, an active manager can sell call options more regularly throughout the year, resulting in a more diversified portfolio.
- Because of the single option strategy, the BXM's entire option portfolio expires at the same time. As the call portfolio approaches expiration, the delta of the entire call portfolio can swing wildly. Although the BXM has an average beta often quoted at two-thirds of the S&P 500, because the BXM utilizes 30-day options, the swings in delta occur every month, leading to an unstable beta in relation to the S&P 500 Index (See Figure 4). This major flaw has a simple solution. A more optimal strategy staggers the option expirations throughout the year so the entire portfolio is not expiring at the same time.

Figure 4: BXM Beta to SPX (Rolling 30-Day)



Source: Bloomberg. Based on daily data. 12/31/16.

Overall, the passive BXM does not have a diversified option portfolio. Actively managed call option strategies are able to choose a broader array of exercise prices and expiration dates, thereby creating a more diversified call option portfolio relative to the passive, single-option strategy of the BXM.

2) S&P 500 Index with actively managed Index options

To avoid the problems associated with the BXM Index, covered call investors can utilize S&P 500 Index investing with actively managed Index call options. This option strategy can include additional expiration dates and exercise prices, moving one step closer to a more diversified call option portfolio. However, this strategy limits the covered call investor to a single underlying security, the S&P 500 Index. While this may reduce stock selection risk, it also limits call premiums. Historically, call premiums on the S&P 500 Index tend to be quite low, particularly for short-term options, when compared to higher premium individual stock call options (See Figure 5). Due to the lower income, Index call options tend to produce only minimal downside protection while capping upside participation at low levels.

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3) Single-Stocks with actively managed single-stock call options

Up to this point, the paper has focused on index-based covered call strategies, where an investor holds the S&P 500 Index and writes index call options for income and downside protection. Now let's consider a covered call strategy in which the investor owns a portfolio of 30-50 individual equities and sells call options on those individual securities. What are the differences?

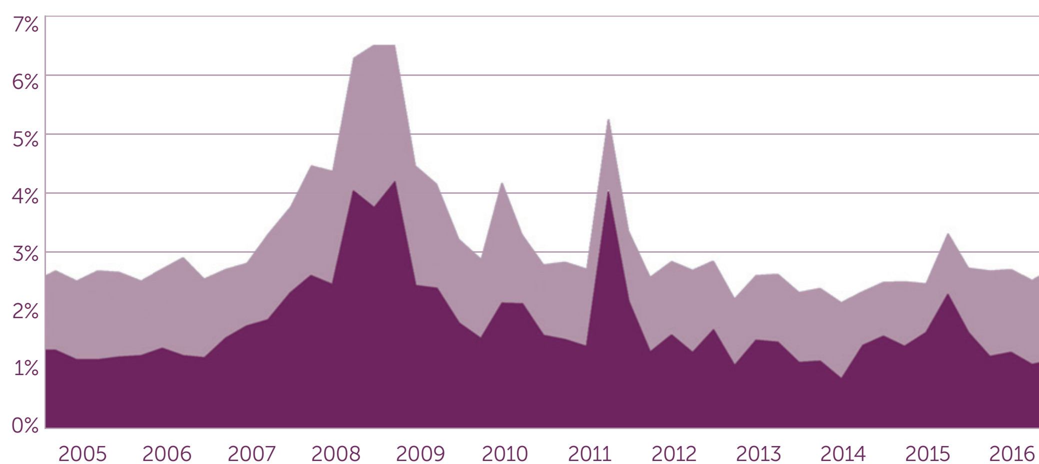
More Call Option Candidates

While Index-based managers are limited to one underlying security, single stock covered call managers have many underlying securities and, as a result, many more call option candidates. Expanding the universe of call options creates opportunities for an actively managed portfolio of single- stocks to generate alpha by scouring the entire volatility term structure of each equity to find call options with attractive premiums. By definition, there will be many more attractive call options when there are more underlying securities. Investing in an Index-based covered call strategy is like searching for a new car at a dealership with only 10 cars for sale, whereas a single-stock covered call portfolio is more like a dealership with 1,000 or more cars for sale. There will be many more cars with attractive characteristics and prices to choose from at the 1,000 car dealership. This greater spectrum of potential call options provides more opportunities for single stock covered call strategies to add alpha.

Greater Flexibility

When call premiums on the S&P 500 are below average, Index managers are not able to switch to a different underlying security. They are stuck with the S&P 500 Index. In contrast, single-stock covered call mangers have the flexibility to invest in a different underlying security with higher call premiums. This is another source of alpha when compared to less flexible, Index-based covered call strategies.

Figure 5: Single-Stock Call Options Tend to Provide Consistently Higher Premiums



Source: Bloomberg. Based on daily data. 12/31/16.

Higher Premiums

Call option premiums on single-stocks tend to be consistently higher than Index-based premiums. Individual equities have inherently richer call option premiums because the S&P 500 Index's broad diversification reduces the overall implied volatility of the Index call options. This provides single-stock option sellers enhanced premium generation compared to Index managers. Over the past ten years, single-stock call premiums have been consistently higher than index-based call premiums, as shown in Figure 5, resulting in more upfront income for investors. This tailwind from call income is another compelling reason to choose single-stock covered call over Index-based solutions.

Conclusion

Covered call strategies have attracted a great deal of attention from investors searching for lower-volatility equity returns with an attractive income component. By selling call options, investors can generate income and reduce the risk profile of the equity asset class, thereby creating a more consistent return pattern over time. These characteristics have historically produced superior risk-adjusted returns relative to the S&P 500 Index.

Actively managing the covered call strategy can provide significant benefits relative to passive Index-based strategies. Index options tend to generate lower call premiums, which results in less downside protection. Index managers also have a limited number of call options to choose from, being limited to only one underlying security. The single- stock covered call strategy can provide a greater spectrum of potential call options, with flexibility to switch to more attractive underlying securities. Single-stock call options also typically generate more upfront income, making it a compelling choice for investors. Please note that the Fund can be managed differently than outlined in this piece. In addition, note that the Fund's strategy is expected to underperform equity markets during periods of sharply rising equity prices. The risks associated with an investment in the Fund include American Depository Receipts Risk, Call Options Risk, Dividend Risk, Exchange-Traded Funds Risk, Market Risk, Mid-Size and Small-Size Company Risk, Security Selection Risk, High Portfolio Turnover Risk, and Tax Risk.

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