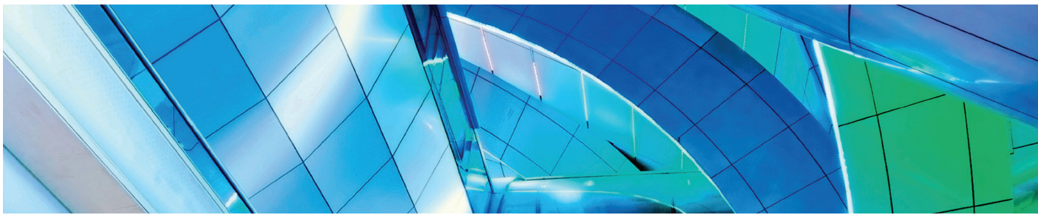
SYZ WEALTH MANAGEMENT



FOCUS

December 2016

A COVERED CALL STRATEGY FOR AN EXTRA ICING ON THE CAKE

HIGHLIGHTS

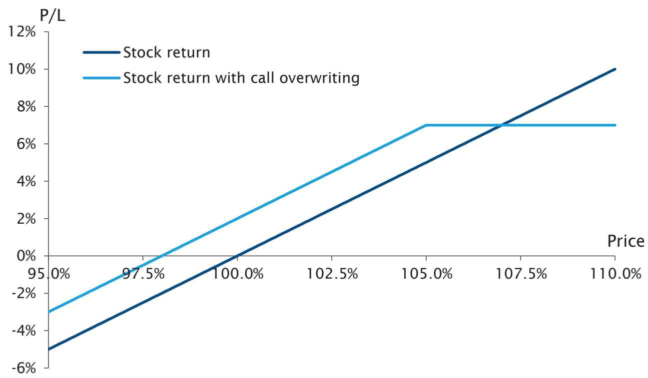
In the current yield chasing environment, investors are looking for strategies able to offer additional income sources to supplement the anemic coupons earned on bonds. High dividend paying stocks are a good starting point, as they fit this need within global equities. Combining a dividend style with a tailored covered calls strategy further enhances the attractiveness of high dividend investing through added income generation and improved risk profile.

Roberto Magnatantini
Global Equities Expert

"Covered calls are an efficient and straightforward strategy to earn additional income complementing an equity portfolio of dividend-paying stocks."

Consider a stock that a portfolio manager has a positive long term view on, but short term upside might be challenged due to overall market conditions or a stock specific reason. Selling the stock might prove being suboptimal, as it would add unnecessary turnover and trading costs. Alternatively, the portfolio manager could write a call option on the stock, pocketing upfront premium for the option sold, while keeping the holding in his portfolio.

Typical payoff of a covered call strategy



Source : Bloomberg, SYZ Asset Management

At maturity of the call option, if the underlying stock trades below the strike price, the option expires worthless and the income received upfront compensates for the lack of upside potential of the underlying. Should the stock price be higher than the strike of the call at expiry, the portfolio manager must deliver the underlying at the strike price, hence losing the upside on the stock. However, the premium received initially is kept. Identifying the names on a portfolio that are good candidates for call overwriting is therefore of utmost importance for the implementation of such a strategy.

In addition to the extra income generated, call overwriting has the desirable effect of reducing the volatility of a long-only portfolio and provides a cushion during difficult times. Moreover, it is the general risk profile that is slightly changed through an improved sharpe ratio. The Chicago Board Options Exchange (CBOE) has created two distinct indices, namely BXY and BXM, to proxy the performance of a systematic covered call strategy. While BXM is a passive total return index based on buying a S&P 500 stock index portfolio and writing near term at-the-money covered call option, BXY applies the same methodology except that the strike of the option sold is 2% out-of-the money. Over a full market cycle, the strategy would have delivered improved risk adjusted returns compared to the S&P 500 index (see below, periods I and II), although the strategy would have underperformed during strong bull markets, such as the 2012-2013 (period III).

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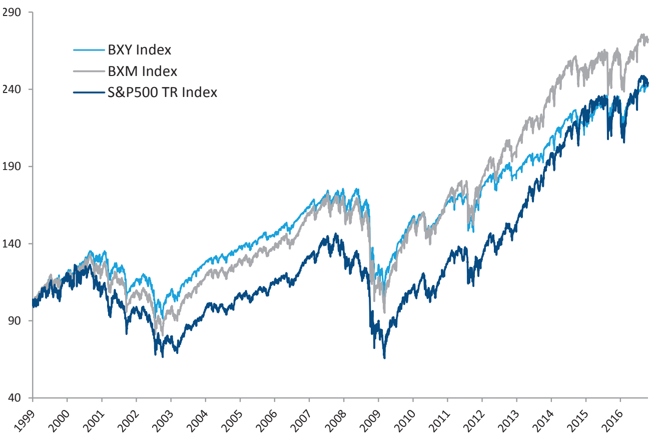
Systematic covered call strategy indices



Source : Bloomberg, SYZ Asset Management

Calls overwriting therefore add desirable features to a high dividend strategy through a triple bottom-line impact in the form of dividend income, option premium proceeds and capital appreciation – all the while aligning the portfolio for a long-term capital gains and sustainable income.

	Period I Jan 2005-Dec 2006			Period II Jan 2008-Dec 2009			Period III Jan 2012-Dec 2013		
	S&P500 TR	BXM	BXY	S&P500 TR	BXM	BXY	S&P500 TR	BXM	BXY
Annualized Returns	10.2%	10.6%	8.7%	-10.1%	-4.1%	-4.8%	24.0%	15.5%	9.2%
Volatility	10.2%	8.7%	6.5%	34.9%	27.5%	25.7%	11.9%	9.9%	7.6%
Sharpe ratio	1.01	1.22	1.33	-0.29	-0.15	-0.19	2.01	1.57	1.22

Source : Bloomberg, SYZ Asset Management