XA's DiBernardo On Covered-Call Strategies Gaining Ground And Popularity

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Chuck Jaffe, in this episode of The NAVigator podcast interviews Ray DiBernardo, Portfolio Manager of the XAI Madison Equity Premium Income fund. Ray says that covered-call strategies have become increasingly popular of late, as investors want to goose income while reducing market risk. DiBernardo, an analyst at Madison Investments, notes that investors have been intrigued by covered-call strategies for about two decades, but the availability of more options-based strategies through the advent of ETFs has made investors more aware of how to find income-enhancement through covered calls. DiBernardo notes that covered call strategies did well in 2022 when the overall market was struggling, which also has increased their use as a hedge against market risk with the market trading at record highs.

The podcast can be found on AICA's website by clicking here: https://aicalliance.org/alliance-content/pod-cast/

CHUCK JAFFE: We're talking covered-call strategies with Ray DiBernardo, portfolio manager for the XAI Madison Equity Premium Income fund, welcome to The NAVigator. Yes, this is The NAVigator, where we talk about all-weather active investing and plotting a course to financial success with the help of closed-end funds. The NAVigator is brought to you by the Active Investment Company Alliance, a unique industry organization representing the full spectrum of the closed-end fund business from investors and users to fund sponsors and creators. If you're looking for excellence beyond indexing, The NAVigator's going to point you in the right direction. And today we are looking in the direction of covered-call strategies, we're doing it with Ray DiBernardo, analyst and portfolio manager at Madison Investments, which runs the XAI, XAI being for XA Investments, Madison is subadvisor, so it's the XAI Madison Equity Premium Income fund, ticker symbol MCN, and if you want to learn more about the firm and the fund, go to XAInvestments.com/MCN. If you want to learn more generally about closed-end funds, interval funds, and business-development companies, go to AICAlliance.org, that's the website for the Active Investment Company Alliance. Ray DiBernardo, it's great to have you on The NAVigator.

RAY DiBERNARDO: Hi, Chuck. It's great to be with you.

CHUCK JAFFE: Let's start with covered-call strategies, there's a lot of talk about the, I talk with people all the time who are like, "I'm kind of interested in how they work because I'm looking to goose income." I could explain them but I won't do it well, so help everybody understand covered-call strategies and how a covered-call strategy is not every option strategy.

RAY DiBERNARDO: Yeah, covered calls as a strategy have been around for quite a long time but they've kind of varied in popularity, so to speak. In recent years with the advent of ETFs we've had a lot more attention to the strategy, but really prior to a benchmark being created back in 2002, very few people actually used the strategy. It's very labor intensive, you have to pay attention to not only the underlying holdings but all of the options involved and expiration dates and whatnot, so it was sparingly used and there really wasn't a proof statement for what the strategy did. So in a nutshell, you essentially own an asset, in our case it would be a portfolio of stocks, and then you sell call options against these assets and collect option premiums, so you're agreeing to sell your existing assets at a set price for a set period of time and for that you receive a premium, so the strategy generates additional income but you are putting a cap on the upside that you can get from the underlying asset. So it's a total return strategy, it's very conservative, most people understood that even years ago before the benchmark was created, but in 2002 the same gentleman, a Duke University professor was asked to help create a benchmark called the CBOE S&P BuyWrite Index, which simply took the S&P 500 as the underlying asset and wrote a 30-day call option against the asset and rolled that 30-day option every month, and it gave us a good passive representation of what covered-call writing could do. When that occurred, the consultants all came out of the woodwork, big ones like Cowan and Ibbotson, and they all did back-tested studies to see how this strategy help up against the S&P 500. What they found, that over a full market cycle you could get returns that were very similar to the S&P 500, but you got there with significantly less volatility, roughly two thirds the volatility. So you didn't participate fully on the upside, but you also didn't participate on the downside, so a much smoother path to getting similar returns over a full market cycle. That became the proof statement for the strategy, and in 2004 is when you saw a big jump in the number of funds utilizing the strategy, particularly closed-end funds. We happen to be the very first one that was launched using a covered writing strategy in 2004, but after us something like $20 or $30 billion dollars was raised over a two or three year period with some of the bigger hitters coming on board with multiple funds such as Eaton Vance and BlackRock. It had a period of very strong popularity, particularly in the period when yields have come down significantly, we've been in a long period of low interest rates and yield-hungry investors are always looking for an investment that gives them an attractive income stream.

CHUCK JAFFE: They are and traditional covered-call strategies you'd say maybe you're sacrificing some long-term growth from some short-term benefits, that short-term benefit would be better yields right now. Given that, well, we are now in a spot where we're starting to see the rate cycle change, what do we expect from covered-call strategies when we get into a rate reduction cycle?

RAY DiBERNARDO: Well, it gets right back into the sweet spot for covered-call strategies that we were in prior to yields starting to go higher. Again, taking a look back in time, in the seventies and eighties when these funds started to come on board, there were a dozen or so funds back then, they were competing in a yield world where the 10-year Treasury started the eighties at around 8% and spiked early and then ended the decade around 8%. Since that time, yields have continually dropped, and then we got in that period of close to 0% rates and this is where covered strategies really offered investors a significant bump up in yield potential. We've now seen yields pop again more recently, and the 10-year over 4%, but they are now looking like they'll be starting to trend down, so even at 4% or even 5% yields, on an after-tax basis, the strategy's still very attractive, but it certainly becomes more attractive to investors as yields come down. So I would expect that if yields continue to slide lower, starting with the short end and the Fed continuing the cutting process, the 10-year will probably be dragged slightly lower and that will just make the covered writing strategy more attractive to more investors. I think it's a very positive thing, from an option perspective, that change in interest rates doesn't really impact option premiums all that much, so we're not worried about that, but the overall strategy will become more and more attractive.

CHUCK JAFFE: Covered-calls and option strategies generally have been considered more attractive because of the advent of ETFs, you mentioned that in passing as well, but with the advent of ETFs we've seen a lot of different strategies, so in your fund you are using single-stock call options, in other funds they will use index options. Is there a benefit or a drawback to going with the single stocks as opposed to the indexes?

RAY DiBERNARDO: In our view there are two significant positives to using single-stock options. Now the reason that we structured our strategy in this manner, and there are many different ways to run a covered writing strategy, using index options is totally fine, it provides an umbrella coverage to an underlying portfolio of stocks, but generally, the premium you can receive from a single stock option is higher than you would get from S&P 500 call option with similar expiration and similar out-of-the-money-ness. And the reason for that is that a 500-stock index, a lot of the volatility is diversified away, whereas even with a very high-quality stock, you can get more volatility because you're dealing with a single company. So for example, the only two stocks in the S&P that have an AAA balance sheet, so we consider it a very, very high-quality company, Microsoft and Johnson & Johnson, both have significantly higher implied volatility than the S&P 500, so as a result you can get higher option premiums. So that's the first benefit, higher premiums. Secondly, because we start our process by building a stock portfolio, a very high-quality one, then we can utilize single-stock options and tailor the characteristic of each option to our view of each underlying stock. If we were to use index options, we would get the same coverage across the whole portfolio, but there could be some stocks where we would prefer to be further out of the money or closer to the money depending on our near-term outlook on the company, so it gives us a lot more flexibility to tailor the portfolio the way we want to see it. It does become more labor intensive that way because we're now dealing with many, many options as opposed to just one or two, and that's why it makes more sense to do this in a fund option for investors than to try to do it themselves.

CHUCK JAFFE: Taking that one step further, what are the benefits of owning a covered-call strategy in a closed-end fund, beyond the modest discount for example that your fund trades at, are there specific benefits that you believe an investor gets by holding it in a closed-end fund as opposed to going and buying one of those ETFs?

RAY DiBERNARDO: I think investors buying the strategy in a pool vehicle is a very good way to accomplish getting access to the strategy. As I said, the labor intensity can be significant, particularly if you're using single-stock options. With the closed-end vehicle we're really not worried about flows, with ETFs or regular mutual funds you can have significant inflows which would have you investing potentially at the wrong time, because as well know, investors tend to go to strategies later than they should and you probably get a lot of money flowing into the fund when you least want to invest it, and similarly they might want to be selling and flows leaving the fund at a time when you should be actually reinvesting at lower prices. You don't have that concern in a closed-end fund because you don't have those constant daily flows to deal with, and you can get much more consistent performance regardless of the overall market conditions.

CHUCK JAFFE: Covered-call strategies are not for everybody. I mean, the basic advice always is if you don't understand it, don't buy it, and there will be some folks who hear us on this discussion and maybe fast forward or what have you because it can be tough on the covered calls, but how are you seeing these funds be used, and your fund as well? When you're hearing from advisors, et cetera, where are they positioning this in their portfolio, and where would you want them to position your fund in their portfolio so that they're getting what they really expect?

RAY DiBERNARDO: I think generally over time and because yields have been so low in competing products for so long, the majority of investors are looking at the strategy as an income enhancer, and that is I would say the vast majority of investors in our fund, and probably all other covered-call strategies are doing that, but there's also a hedging component to this as well. Now the market has been an on incredible tear since the Great Financial Crisis with only the odd hiccup here and there, so investors have gotten used to markets going up more than they're going down, and so they're not interested in a hedge when the markets are going up, they want to fully participate, so the strategy gives them income when they're looking for income. But in a year such as 2022, when the market was down 18%, covered-call strategies performed very well, in fact, MCN was up 5% in that down 18% market, so all of a sudden you have investors that are now pricking their ears up and looking at the strategy as a good hedge. So for people that think that the market is getting too expensive, we believe that's true as well, some investors may look at these strategies as a way to reduce the overall beta in their equity allocation, so take some long equity, long-only equity money, move it into something that is still in the equity field but has a lower beta, and that's where covered call can give you more of a downside protection or more of a hedge in case the market does come down. But ultimately, the greatest reason for investors being in this space is the income, and the hedge is just a nice thing to have to go along on the ride.

CHUCK JAFFE: Ray, great stuff, we have enjoyed taking the ride with you. Thanks for joining me on The NAVigator.

RAY DiBERNARDO: Thanks, Chuck. Thanks for having me on.

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