Brompton Insights

Choosing the Right Covered Call Strategy

BROMPTON FUNDS

May 9, 2023

Funds in focus: Brompton Enhanced Multi-Asset Income ETF (BMAX), Brompton Tech Leaders Income ETF (TLF, TLF.U), Brompton Global Healthcare Income & Growth ETF (HIG, HIG.U), Brompton European Dividend Growth ETF (EDGF), Brompton Global Dividend Growth ETF (BDIV), Brompton North American Financials Dividend ETF (BFIN, BFIN.U), Brompton North American Low Volatility Dividend ETF (BLOV), Brompton Sustainable Real Assets Dividend ETF (BREA)

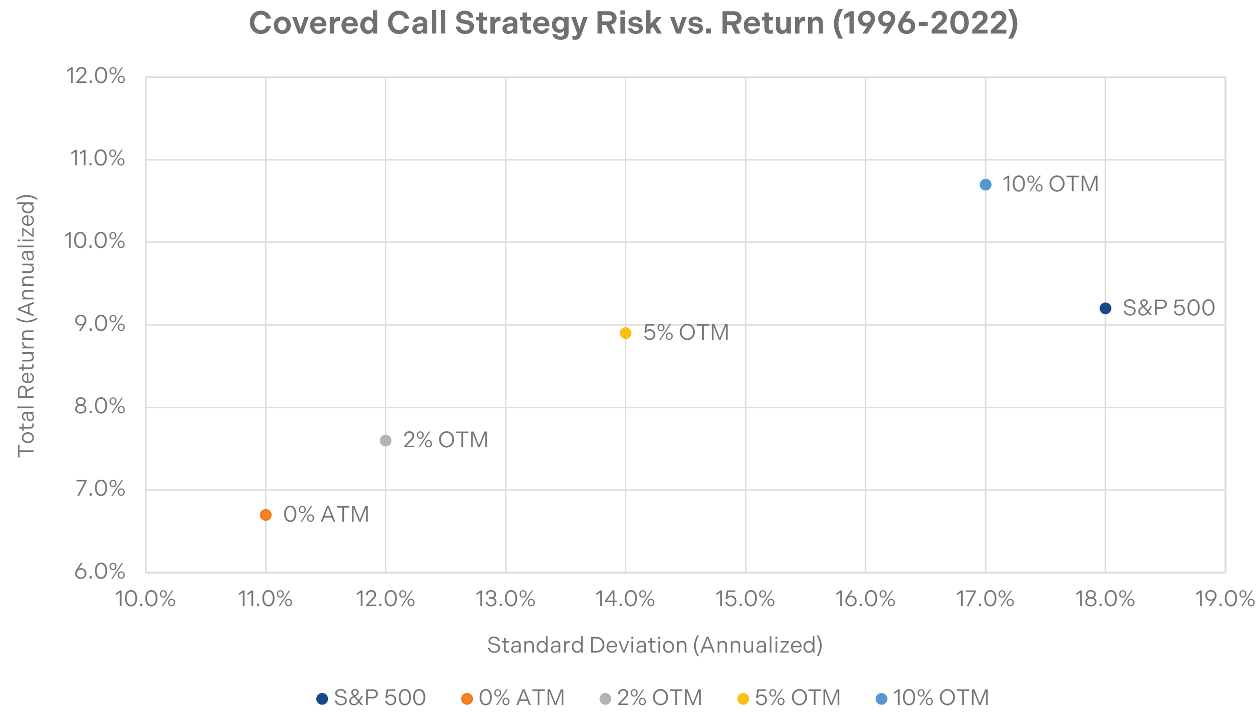
Covered call funds have become popular in recent years as investors look for higher yielding investment strategies to add to their portfolios. A covered call option strategy involves investing in a portfolio of stocks and then selling call options on the same stocks that are held in the portfolio. This strategy allows a fund to generate additional income from the premiums received when selling call options, which reduces the volatility of the portfolio and allows the fund to pay out higher distributions than it would otherwise be able to do. Relative to a traditional equity strategy, certain covered call strategies can have several benefits for an investor:

- Lower volatility
- Higher distributions
- Higher risk-adjusted returns over time
- Potential for higher absolute returns
- Outperformance during flat markets
- Lower drawdowns during volatile markets

However, not all covered call strategies are the created the same. There are a number of key decisions a portfolio manager must make when designing and executing an options strategy. These include:

- whether to write calls on the portfolio as a whole or on the underlying positions in the portfolio;
- whether to write calls At-The-Money ("ATM") or Out-Of-The-Money ("OTM");
- for OTM strategies, determining the moneyness level – how far out of the money to write (e.g. 5% OTM);
- the total size of the overwrite (e.g. 25% of the portfolio) and whether the overwrite level is passive/fixed or active/variable; and
- how much to vary these parameters and whether to make any tactical adjustments based on market conditions.

It is important to keep these factors in mind when assessing a covered call strategy, as changes to these parameters can have a significant impact on the risk/return profile of a portfolio. For example, simply changing the moneyness level at which calls are written will impact the amount of options premiums received, which in turn will impact the risk/return profile of a strategy. Our sense is that investors typically believe that more premiums lead to higher distributable income; however, generating higher premiums by writing closer to the money also means sacrificing more of the upside when markets move higher, which reduces total returns. This is shown in the chart below, which looks at the returns of a hypothetical S&P 500 covered call strategy from 1996-2002 based on the moneyness level at which calls are written.



Source: Goldman Sachs Global Investment Research as of March 17, 2023

In our view, there are three key takeaways from this analysis:

1. All of these covered call strategies have a better risk-adjusted return (Sharpe ratio) than the underlying benchmark.
2. A covered call strategy reduces the volatility of the portfolio, and the magnitude of this reduction is a function of the premiums written. In other words, an ATM strategy brings in more premiums than an OTM strategy and therefore reduces volatility by a greater amount.
3. Generating higher option premiums by writing closer to the money does not lead to higher absolute returns. Therefore, a strategy that writes at-the-money calls and pays out all of the premiums received as a distribution, is at risk of a declining NAV over time, which would eventually lead to the need to cut the distribution.

In conclusion, we believe that covered call strategies are a great way for investors to gain exposure to the equity market with lower volatility and higher distributions than may otherwise be available. Covered call strategies also provide investors with the potential for enhanced risk-adjusted returns. However, the devil is in details, and investors should be aware that writing for higher option premiums does not always result in higher absolute returns. In our view, the sweet spot is an active strategy that writes ~5-10% OTM, but this may vary depending on the risk profile of the underlying portfolio.

Brompton's Approach

Brompton's covered call funds offer investors exposure to a portfolio of large capitalization equities and are designed to provide regular distributions, the opportunity for capital appreciation and lower volatility than would otherwise be experienced by holding the same portfolio of equities directly. By using a covered call strategy, Brompton can draw on three main sources of potential total return for the fund: (i) capital appreciation of the underlying equities in the portfolio; (ii) dividend income from the portfolio; and (iii) premiums earned from writing call options.

As discussed above, a variety of factors can impact the risk/return profile and overall success of covered call strategies. Brompton's portfolio management team carefully selects and manages both the underlying equity portfolio as well as the call options, while also considering how these two components might perform under various market conditions. The construction and management of the covered call option strategy is a complex and dynamic process that is difficult and costly for individual investors to replicate in their own portfolios.

Brompton takes an active approach to covered call writing with the aim to maximize total return. We determine what percentage of the portfolio and which equity securities to sell call options on based on market conditions and our investment outlook. We may write calls on a lower percentage of the portfolio in rising or low volatility markets to capture more market appreciation for the fund's portfolio, or a higher percentage in declining or high volatility markets to generate more option premium and provide a cushion against a market decline.

Under current market conditions, Brompton typically writes covered call options that are short dated (1-2 months expiry). Writing short-term call options can increase the likelihood that the options expire without being exercised, thereby allowing new calls to be written on the same underlying securities and potentially generating more premiums. In addition, Brompton will often write out-of-the-money calls to allow investors to participate in the upside potential of the underlying securities to a greater extent than do at-the-money calls. An out-of-the-money call sets the strike price above the market price allowing the fund to capture capital appreciation upside plus the option premium.

Brompton Covered Call ETFs:

Fund	Ticker	USD Unit	Holdings
Brompton Enhanced Multi-Asset Income ETF	BMAX		Large Cap Equities, U.S. Pref Shares, Split Corp. Pref Shares
Brompton Tech Leaders Income ETF	TLF	TLF.U	Large Cap Tech
Brompton Global Healthcare Income & Growth ETF	HIG	HIG.U	Large Cap Healthcare
Brompton European Dividend Growth ETF	EDGF		Large Cap Dividend Growers
Brompton Global Dividend Growth ETF	BDIV		Large Cap Dividend Growers
Brompton North American Financial Dividend ETF	BFIN	BFIN.U	Large Cap Financial Services
Brompton North American Low Volatility Dividend ETF	BLOV		Large Cap Low Volatility
Brompton Sustainable Real Assets Dividend ETF	BREA		Large Cap Infr/REITs/Utilities

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VALUE

INTEGRITY

PERFORMANCE

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