BUILDING AN INCOME MACHINE:

ETF COVERED CALLS

AN OPTIONS OVERLAY STRATEGY MAKES DRAFTING A SYSTEM FOR GENERATING INCOME IN LOW-YIELD ENVIRONMENTS EASY.

By Cory Banks

2013 COULD BE A YEAR DEFINED BY INCOME. As the Federal Reserve keeps interest rates at all-time lows for the fourth-straight year, investors are on the hunt for new ways to add yield to their portfolios. Unfortunately, many bring added risks. High-yielding stocks, junk bonds, master limited partnerships—each pays a high yield, but there are concerns about overcrowding, tax and defaults (see page 14 for our favorite high-yield ETFs). Moreover, not every security pays regular dividends, and predicting the amount of yield you're adding can become complex. Luckily, there's another tool available for ETF investors that can not only generate income, but, done right (and that's a big question), can also ratchet down risk.

THE GLORIOUS, TERRIBLE, WONDERFUL, FRIGHTENING WORLD OF OPTIONS

Options are a funny thing. They strike fear into the hearts of many investors, evoking all kinds of bad words: Derivatives. Leverage. Strike price. Bears!

But in the end, what options are is something altogether simple and more benign: insurance.

Options are contracts that give the owner the right to buy or sell an asset at a specific price on a specific date. They come in two flavors:

- **Calls** give you the right (but not the obligation) to buy a security at a certain price on a certain date.
- **Puts** give you the right (but not the obligation) to sell a security at a certain price on a certain date.

Depending on which side of the transaction you're on, they work different ways. If you buy a call option, for instance, you pay a premium for the possibility of upside with no risk. If you sell (or write) an option, you pocket the premium and take on the risk of selling the stock to the call buyer in the future.

HOW DOES THIS TIE INTO INCOME?

Over the years, a small but devoted universe of advisors and ETF managers has evolved that use options to generate income for clients and hedge downside risk. The bulk of them follow what's called a "covered-call strategy," which involves holding a long position in an ETF and selling (or "writing") options on it. Through the call, you are obligated to sell shares of the security at a specific time in the future for a specific price. You forfeit any upside in the security above the strike price of the option. In exchange, you collect a premium. Call options can be written out of the money, at the money or in the money. The farther into the money you write the option, the more expensive it will be—and the more money you, the option seller, can make.

Covered-call strategies (often called buy-write strategies) are not new. Investors have sold options on individual securities for years, with varying levels of success. The biggest issue with these strategies is tied to volatility of single securities. Say you sold a call for $0.50 on a $25 stock (a 2% premium), and in the next week, the company announces an earnings forecast that disappoints the Street. The stock falls 20%, or $5. Your 50 cent premium puts you ahead of straight equity holders, but you still lost $4.50 ($5 drop minus your $0.50 premium).

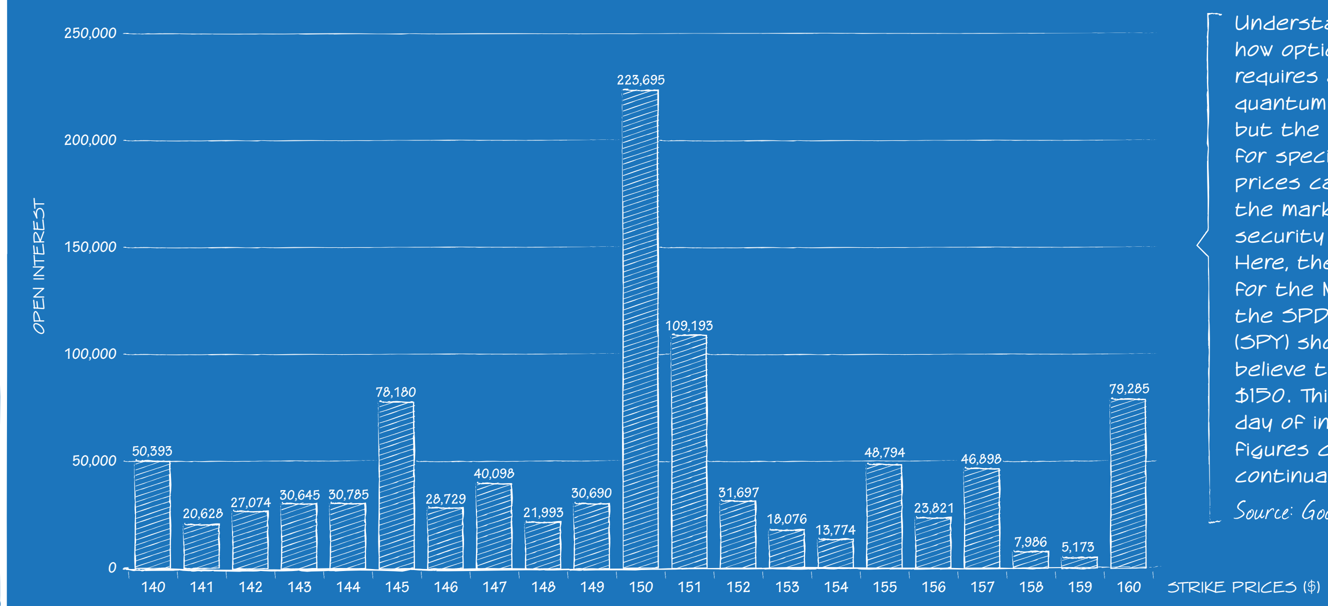
ETFs make this a much stronger strategy by eliminating single-stock risk. And the history looks pretty good: According to the Chicago Board Options Exchange (CBOE), selling options on the S&P 500 has reduced your volatility by one-third, on top of increasing your return. The group's BXM index, for example, tracks the performance of monthly covered-call options on the S&P 500. The index writes its options at the money, unlike many traditional options overlay strategies that use out-of-the-money options. That means the index caps gains from rising markets much sooner than normal, and underperforms in strong equity markets. During falling markets, however, the index consistently outperforms, thanks to the income buffer.

There are a few ETFs that track the CBOE benchmarks, including the PowerShares S&P 500 BuyWrite Portfolio (PBP) and AdvisorShares' STAR Global Buy-Write ETF (VEGA). Or you could go the ETN route with iPath's CBOE S&P 500 BuyWrite Index ETN (BWV). For investors looking for more customization, however, a do-it-yourself strategy can work too.

Putting together an options "overlay" is surprisingly simple. Kevin Simpson, portfolio manager at Capital Wealth Planning in Naples, Fla., explains that only the cream of the ETF crop have enough volume for robust options markets. Simpson's team uses big funds like the SPDR S&P 500 ETF (SPY), the iShares MSCI Emerging Markets ETF (EEM) or the iShares Russell 1000 ETF (IWB), holding long positions while writing 30-day calls out of the money.

Sound complicated? It's not. It is, however, a change for most advisors, and requires a disciplined monitoring process. "It does require a lot of time, especially because we're selling covered calls on a monthly basis," Simpson explained. "But that doesn't make it any more sophisticated. I think anyone could run a strategy like this."

OPEN INTEREST ON SPY CALLS FOR 1/10/2013



Understanding exactly how options are priced requires a Ph.D. in quantum economics, but the open interest for specific strike prices can indicate how the market thinks a security will perform. Here, the open interest for the March 13 call on the SPDR S&P 500 ETF (SPY) shows that most believe the fund will hit $150. This is just one day of interest—these figures change on a continual basis.

Source: Google Finance

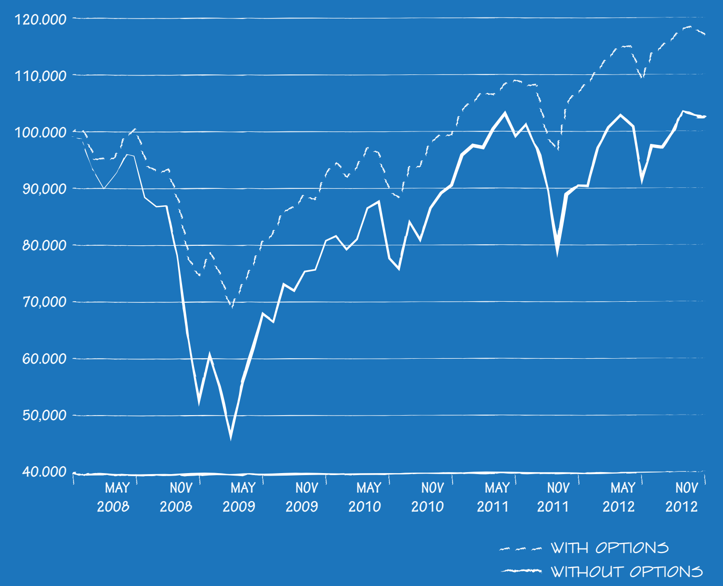
THE REAL EFFECT OF OPTIONS ON A PORTFOLIO

Just how much benefit can you get from an options overlay strategy? According to Main Management's Luke King, quite a bit.

The San Francisco firm manages a buy-write strategy on a portfolio of four exchange-traded funds: SPDR S&P 500 (SPY), iShares MSCI Emerging Markets (EEM), iShares MSCI EAFE (EFA) and iShares Russell 2000 (IWM). Based solely on its price return, the portfolio lost 5.3% in 2011. But King says the combination of options premiums and dividends, when reinvested in the strategy, actually added 10.1% to the portfolio's total return, so that clients in the strategy gained 4.73%.

According to King, the options strategy helped significantly in the face of 2011's overall down market because options, as an asset, tend to be uncorrelated to the equities markets. As volatility increases and the markets fall, the premiums on options sold through Main Management's overlay can dramatically increase. That acts as a cushion against turbulent market conditions, or they can be paid out as a distribution to the client.

PORTFOLIO PERFORMANCE
WITH & WITHOUT OPTIONS



Sources: Main Management, Bloomberg

Even from a logistical standpoint, it's easier: Rather than managing options for hundreds of individual stocks, you can sell and manage options on a handful of securities that contain exposure for thousands of firms. That's likely one reason why options markets on ETFs are so robust: While strike prices on individual securities often move in $5 increments, ETF options have strike prices that are much more granular, often set at $1 increments. That gives investors a level of precision not available elsewhere.

"Especially in the institutional and pension worlds, we already own SPY," Simpson said. "We're not taking additional risk by selling covered calls on it, but we are generating additional income."

The idea here is to sell—and manage—options across a wide range, if not all, of your portfolio. The value to your clients is easy to see: an additional stream of income for their investments.

Or is it?

INCOME OR RISK MANAGEMENT?

Jeff Wycoff of San Francisco's Fort Point Capital says his firm doesn't focus on the income portion of the options overlay, but rather it functions as a way to manage volatility. "When people talk about yield enhancement, they're talking about being long SPY and shorting call options against it," he said. "But this is an important nuance. That's not yield enhancement—you're taking premiums for giving up some upside."

According to Wycoff, the distinction is based on business decisions, not investment goals. "Calling it income generation or yield enhancement is a marketing device," he said.

That doesn't mean the strategy is bad; rather, that income is a secondary focus, according to Wycoff. "We see it more akin to what insurance companies do, instead of income generation," he said. "What these strategies allow you to do is, because they reduce the volatility of the positions that you sell options against, it allows you to hold more of that asset than you would in other optimized portfolios."

Fort Point is careful to make a distinction between how it uses covered calls and how others may market them. "We want to be very careful about calling it yield enhancement," Wycoff said. "In fact, that can set the table poorly if the markets are up and clients say, 'Wait, I'm not as up as the markets!'" Instead, the firm positions its use of options as beneficial to the total return of its portfolios, reinvesting the options premiums to increase gains.

Whether you're looking to manage volatility, top up total return or just add an additional income stream, it's clear these options strategies can be considered for pretty much any business model. The Fed has indicated interest rates will stay at these all-time lows for the foreseeable future, and clients are looking for answers to the yield quandary.

"When you look now at a 10-year Treasury that's paying 1.6 or 1.8% yields, that's not attractive yield for anyone," said Simpson. "You have to consider options in any kind of income strategy moving forward."