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GLOBAL INVESTMENTS

COVERED CALL INCOME

Covered Call Income is a separately managed account investment strategy

Commentary – 6/30/2019

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- After a dismal month of May, the markets came roaring back in June with the S&P 500 up 7%.
- One of the main catalysts for the market rebound was central banks coming to the rescue
- The highly anticipated Trump-Xi meeting at the G20 summit took place at the end of June in Japan and depending on who you ask, the meeting seemed to go over relatively well.

Second Quarter Review

The second quarter for the U.S. stock markets had its fair share of ups and downs giving investors plenty to digest over. For the month of April, several key points played an important role with the markets at or near all-time highs. Earnings season had been well-received with a majority of companies beating estimates. The Federal Reserve seemed likely to hold interest rates steady at its next meeting and with the markets pricing in the next move being a rate cut, monetary policy seemed to have turned from a headwind to a tailwind. Trade uncertainty between the U.S. and China continued to hover in the background. With each passing week there was talk of a potential imminent trade deal but nothing ever evolved. Playing the waiting game can create quite a bit of uncertainty with so many different outcomes of a deal still possible.

Trade tensions between the U.S. and China continued to take center stage and dominant the markets throughout May as volatility rose with the trade rift heating up as well as tariffs threatened against Mexico. China made it very clear that they had every intention of playing the waiting game and won't be forced into a deal. Until the markets see some clarity on trade volatility will loom large. The Crossmark Trading team took advantage of the added volatility in May by strategically placing trades that generated the most option income for an individual month so far in 2019. After becoming significantly more dovish since the January FOMC meeting, the Federal Reserve remained in pause mode. The suggestion that a rate hike could take place still remains a possibility but economic data would have to deteriorate much more through the summer in order for that to come to fruition. The convergence between the markets and the Fed will most certainly contribute to increased volatility over the coming months.

After a dismal month of May, the markets came roaring back in June with the S&P 500 up 7%. One of the main catalysts for the market rebound was central banks coming to the rescue. Faced with weaker economic data, risks to the trade outlook and low inflation led to a key shift towards further stimulus from both the Fed and ECB. Markets will be paying extra close attention to the labor market data in the coming weeks and months. With greater downside risks to the economic outlook and falling long-term inflation expectations, the Fed backed up the recent dovish rhetoric by indicating that eight out of the seventeen members think rate cuts are definitely in play at some point this year. The markets now see the potential of .50bp in rate cuts by the end of the year, which is a sharp contrast to the .50bp increase in rates for 2019 that was expected last year. The markets have been willing to ignore bad economic data with the hope that central bank stimulus would help to avoid a recession. So far the delivery of that stimulus seems very likely to continue the longest economic expansion in history.

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The highly anticipated Trump-Xi meeting at the G20 summit took place at the end of June in Japan and depending on who you ask, the meeting seemed to go over relatively well. It was very doubtful that a trade deal would be reached, however both sides agreed to restart negotiations without the risk of further escalation in tariffs. President Trump lifted the Huawei ban and China through President Xi, agreed to purchase more U.S. agricultural goods. While the lack of escalation averts a worst-case scenario, the ongoing uncertainty with no significant signs of progress on key points in the negotiations will continue to hover over global securities markets.

VIX vs S&P 500 QTD 2019

Source: Bloomberg

The Covered Call Income strategy outperformed the primary benchmark of the BXM in April and June and lagged the BXM for the month of May. Overall the Covered Call Income strategy was slightly behind the BXM index in the 2nd quarter of 2019. The option overlay on the Covered Call Income strategy helped during the month of May from a volatility standpoint, as the trading team was able to execute several different option spread trades that generated additional option income. The Covered Call Income strategy utilizes a sector neutral approach to the S&P 500 sector weights. Implementing this approach takes quite a bit of risk off the table. From an attribution standpoint, the portfolio was led by healthcare and financial sectors. Cerner Corp added +54bp to performance on positive earnings and guidance. The healthcare sector alone added +105bp to performance. American Intl Group (AIG) led on the financial side adding +33bp to performance. The technology sector underperformed for the quarter -83bp. Qualcomm and Intel were down -51bp and -38bp respectively on continued trade pressure with China. A few individual names to touch on that contributed positive performance for the quarter were Wal-Mart +20bp, Coca-Cola +17bp and Starbucks +21bp. On the downside Exxon Mobil as off -24bp for the second quarter.

Covered Call Income: Moving on to the 3rd quarter of 2019

Overall, stocks produced solid gains by the end of the quarter even with a brutal month of May. The trade war between the U.S. and China, low inflation, and news that the Fed is considering cutting interest rates helped alleviate investors' concerns. Being prepared for volatility to make another comeback is a key aspect in regards to the Crossmark Covered Call Income strategy. The Crossmark trading team will continue to monitor volatility with the intent of strategically placing option trades in order to maximize income as we head into the summer months and the third quarter.

Top 10 Model Holdings [1]

Microsoft Corp.
United Technologies Corp.
Pfizer, Inc.
Coca Cola Co.
Abbott Labs
Nike, Inc.
Starbucks Corp.
Exelon Corp.
Intel Corp.
AT&T, Inc.

% of Total Portfolio: 34%

About Covered Call Income

Covered Call Income strategy is designed for investors who want equity market participation with enhanced income potential. This approach is appropriate for investors looking for higher yields, capital appreciation and reduced risk levels.

Writing call options to generate income and to potentially hedge against market declines by generating option premiums involves risk. These risks include, but are not limited to, potential losses if equity markets or an individual equity security do not move as expected, and the potential for greater losses than if these techniques had not been used.

[1] Model Portfolios are based on a hypothetical account managed during the current quarter. Actual characteristics and income may differ materially from model. As of 6/30/2019.

Definitions

“Up and Out” – This occurs when the original call option is repurchased and another call option is sold. The new option is sold with a higher strike price and a later expiration date than the original option.

“Rolling Down” – This involves buying back the current call option and selling another call option with the same expiration date. The only difference between the two call options is the strike price. In this case, the new option has a lower strike price.

“At-the-Money” – Options with a strike price, or exercise price, equal to the price of the underlying asset. Theoretically, these options have a delta around 50%.

“In-the-Money” – Options with a strike price, or exercise price, lower than the price of the underlying asset. These options have a theoretical delta greater than 50%.

“Out-of-the-Money” – Options with a strike price, or exercise price, greater than the price of the underlying asset. These options have a theoretical delta less than 50%.

“Delta” – One of the “Greeks” derived from the Black-Scholes model for option pricing. Theoretically, it states how much the price of the option will change given a $1 change in the price of the underlying asset. It is also commonly referred to as the “hedge ratio.”

Our Firm

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Options are not suitable for every investor. Writing call options to generate income and to potentially hedge against market declines by generating option premiums involves risk. These risks include, but are not limited to, potential losses if equity markets or an individual equity security do not move as expected, and the potential for greater losses than if these techniques had not been used. If the market price of a security increases, a call option written against that security limits the gain that can be realized. And, there are significant differences between the securities and options markets that could result in an imperfect correlation between these markets, causing a given transaction not to achieve its objectives.

All investments are subject to risk, including the possible loss of principal. Past performance does not guarantee future results.

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