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# COVERED CALL INCOME COMMENTARY

## Third Quarter Review 2018

Second quarter earnings season proved to be very strong throughout the month of July as almost 90% of companies beat expectations. The strength of corporate earnings was enough to send equity markets higher across the board. The S&P 500 gained nearly 4% in July and good economic news also propelled the 10-year US Treasury yield to 3%. Consumers also remained optimistic about the near term future of the markets as retail sales grew over 6% year over year for the month of June. That percentage being the fastest pace of spending growth since 2012. Corporate confidence and strength in the markets was also observed in the labor market as jobless claims hit a level not seen in over 4 decades. The Fed continued to seek some kind of balance within the markets in June.  Interesting rhetoric coming out of the Fed seemed to show that future moves will be more reactionary to economic developments, which will more than likely produce more volatility in the markets.

Historically, the month of August had been one of the worst performing months of the year. Investors were faced with new U.S. sanctions against Iran, relationship strains between the U.S. and Turkey and the continued deterioration of trade talks surrounding the US and China. Most equity markets and risk assets sold off, with one exception being the S&P 500 which was up once again on strong investor sentiment and a lack of inflationary concerns. Consumers continued to benefit from the tailwinds provided by fiscal reform. Even though U.S. stocks hit all- time highs in the month of August, the sectors leading the charge were more defensive in nature. Telecom, utilities and healthcare outperformed while materials, energy and industrials underperformed for the month. Trade rhetoric was once again at the forefront in August with the U.S. and Mexico announcing an agreement with the hopes that Canada would soon come to the table. Trade talks with China appear to have stalled in August.

U.S stock indices continued to hit record highs in September, but investor sentiment towards the end of the month portrayed a less bullish market environment. There were quite a few developments below the surface that warranted some caution in the markets. Leading sectors, such as technology, have shown definitive signs of weakness which could represent a shift away from sectors that are perceived as high risk. On the other hand, industrial stocks have surged bolstered by the weak dollar and the 10-year Treasury yield moving above 3%. The Fed raised rates as expected and removed the word “accommodative” from its rhetoric and also hinted at another hike in December. Trade disputes with China continued to be at the forefront in September as the Trump administration announced an addition of 10% on tariffs of $200 billion worth of Chinese goods. The markets had initially feared a 25% tariff

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with the Chinese response being very strong. Instead, the tariffs implemented on Chinese goods went into effect on September 24th at 10% and then rising to 25% on January 1st 2019. The news being better than expected contributed to stronger performance in global stocks relative to U.S. markets.

**VIX vs S&P 500**


Source: Bloomberg

The Covered Call Income strategy ever so slightly lagged the primary benchmark of the CBOE S&P 500 Buy Write Index (BXM) in July and August and outperformed the index in September and the third quarter overall. The S&P made a decision at the end of May to discontinue support for the primary benchmark of the S&P Covered Call Index. The Crossmark Investment Committee decided to revert back to the BXM as the primary benchmark for the Covered Call Income strategy starting in June. The BXM was the original benchmark for the strategy since inception in August of 2005. From an attribution standpoint, the strategy was affected in the following ways in regards to the S&P 500 sector breakdown:

- Owning Lowes Cos. (LOW) and Microsoft (MSFT) in the third quarter provided a boost to performance as those stocks were up 20.72% and 16.43% respectively.
- Starbucks (SBUX) rebounded after a lackluster second quarter and was up 17.17% for the third quarter.
- General Motors (GM) was a drag on performance for the quarter on weak car sales and was off 13.60%.
- Microchip Technologies (MCHP) had poor earnings results and was down 12.86% for the quarter.

## Looking ahead to Q4

As we press on towards the end of the year, there is wide ranging concern surrounding the markets should trade disputes drag on or potentially escalate. Earnings season is rapidly approaching and with estimates for S&P 500 year over year earnings growth at over 20%, the bar has been set extremely high. This could prove daunting for companies to beat levels this high. Earnings growth will most certainly be at a lower rate in 2019. All that being said, the economy continues to look strong, earnings growth remains a support for stocks and a healthy corporate outlook is boosting consumer sentiment through job growth and consumer confidence. The mid-term elections in November will definitely be worth keeping an eye on as continued uncertainty surrounding the markets will provide for more volatility. Look for the Crossmark Covered Call Income team to strategically place trades in order to generate additional income while using volatility to the strategies advantage.

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| Top 10 Model Holdings [1] | Weight |
|---|---|
| 1. Visa, Inc. | 4.09% |
| 2. Abbott Labs | 4.00% |
| 3. Oracle Systems Corp. | 3.51% |
| 4. Nike, Inc. | 3.46% |
| 5. Activision Blizzard, Inc. | 3.40% |
| 6. Cisco Systems, Inc. | 3.32% |
| 7. Intel Corp. | 3.22% |
| 8. Gilead Sciences, Inc. | 3.16% |
| 9. Delta Air Lines, Inc. | 3.15% |
| 10. Coca Cola Co. | 3.15% |
| Total of Portfolio | 34.46% |

[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 9/30/2018.

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."

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 calls on securities held in the portfolio maximizes the gains that can be realized if the price of a stock increases, and investing in equity securities involves market risk, including the possible loss of principal.

**About Crossmark's 30 Year History**

Crossmark Global Investments is an innovative investment management firm. We provide a full suite of investment management solutions to institutional investors, financial advisors and the clients we serve. We have a multi-decade legacy of specializing in values based investment strategies for clients. Founded in 1987, the firm is headquartered in Houston, Texas and manages approximately $5.2 billion in AUM.

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