Animal Spirits Podcast Q&A Transcript

Could you start by giving us a quick overview of The Covered Bridge Fund?

The Covered Bridge Fund is a mutual fund that seeks to provide a higher level of current income than what is available in the fixed income markets today. It is a product that buys large-cap dividend paying stocks that generally have a dividend greater than that of the market or the S&P 500. The fund then sells, or writes, a covered call on approximately half of each position to generate additional income from the option premiums that are received. While it is an equity-based portfolio since its inception it has had less volatility than that of just owning the underlying stocks by themselves. If you look at the beta of the total return of the fund versus the S&P 500 since inception it's about 70% as volatile. Saying that another way, the beta of the S&P 500 is one while the beta of this fund would be .7.

Explain to us what a covered call is?

I think it might be worth starting with the two different types of options in the market and that is calls and puts. In its simplest form a call gives the right for somebody to call (buy) the stock away from somebody at a predetermined price within a predetermined time period. The opposite of that is a put which gives somebody the right to put (sell) a stock to someone at a predetermined price within a predetermined timeframe. Now it gets even a bit more complicated because you can buy puts and calls, or you can sell puts and calls. In general an investor would want to buy a call if they thought a stock was going to appreciate rapidly above a certain price within a certain time and they would want to buy a put if they thought a stock was going lower than a certain price within a predetermined time. Just like in the stock market for every buyer there's a seller and for someone who wants to buy a call believing a stock is going up you can sell a call which essentially is selling away the upside of that stock at a predetermined price. Now you can sell (or write) a call on a stock even if you don't own it which is very dangerous because if the stock goes up dramatically you've sold it to somebody at a low price and you have to buy it back from them at a much higher price. However, if you own the stock already when you sell that call you are writing what is known as a covered call, which is basically using your shares as collateral and saying "hey above this price you can have my stock but you have to pay me a little bit of money in the meantime". So, writing a covered call is basically selling away the upside of an individual name or index at a predetermined price within a certain time. Now, if the stock goes above that stock price you must sell your shares up at that predetermined price missing out on further upside. If the stock does not go above that predetermined price you get to keep the option premium you received and the underlying shares that you own.

What is the trade-off between income and appreciation with covered calls?

The trade-off between income and appreciation with covered calls really comes down to that predetermined price you're willing to let the stock be called away from you, otherwise known as the strike price. You will generally receive a greater amount of income the closer that strike price is to the current market price and less income the higher the strike price is away from the current price. If you get too far away from the strike price that income will be very, very low but the upside will be higher, so it's really determined by how far away the current price is from the strike price. There are a couple of other important inputs to an option price and how much income (or price) you can receive from a call. The first is the length of time before the call's expiration, the longer time period the greater the options worth and thus more income is received. A second and important component to an option price is the volatility of the underlying security. The more volatile the underlying security is perceived to be the greater the option price.

What are the biggest risks involved when writing options like this?

There are really two risks in writing a covered call option, the first is missing out on the upside. As I stated before when you write or sell a call, you're willing to sell the underlying stock at a predetermined price and if the stock goes above that strike price you miss out on that upside. So, in a rising market or a rapidly rising stock price you can have the stock called away from you and you will miss out on the upside from that price. The other main risk is in a declining stock market or sharply declining stock price in that you still participate in the stock's decline; however, you do get to keep that option premium you received thus mitigating some of the downside but if the stock continues to go lower you participate fully in the decline. In other words, you do cushion the downside by the amount of that option premium you keep. One thing I do like to tell people is that when you write a covered call it is the only trade you can do in the market where the moment you put the trade on you make a little bit of money no matter what the stock does. If the stock goes up, you don't make quite as much and if the stock goes down you get to keep the option premium and mitigate a little bit of the downside.

What is the difference between writing covered calls and put writing?

The biggest difference between writing a covered call and put writing is when you write the covered call you own the underlying security which does minimize the risks involved in writing that call. When you write a put, things can get much more complicated. In general, when people write puts, they don't own the underlying security, but they are willing to have a stock put to them at a predetermined price below where the stock is currently trading and receive income for that. If the stock doesn't go down, the stock doesn't get put to them and they get to keep the premium that was received for writing that put. This is a popular strategy in a bull market but can come under severe pressure when you get into a declining market and the stock is going down rapidly. If someone has written a put and the stock gets put to them and continues to go down rapidly they may have to sell that stock at an even lower price, Writing a put without being short the underlying stock carries much more downside risk than writing a covered call.

Is income the main goal here or is there still some room for capital appreciation?

In the case of this fund the main goal is income, but we do allow for some capital appreciation. Many covered call funds in the market tend to focus a greater degree on income and write calls on their entire stock position. In the case of this fund we only overwrite half of each position which should allow for greater upside if the stock goes above its strike price. We could get more income if we over-wrote one hundred percent of every name but by only overwriting half, we generate a good amount of income but also allow for greater upside when stocks are appreciating. It's important to note that when writing covered calls, it is still very important to have the underlying securities go up and not down. Why? because you can write calls repeatedly but if the underlying stock is in a perpetual down-trend you will never make enough option premium to offset that decline.

Why only take out covered calls on half your stock positions?

There are two reasons we write covered calls on half of each of the stock positions. The first reason is the underlying holdings are stocks and over time we all know the stocks generally go up in price, and I've never really understood why people would go long a stock and sell away 100% of the upside. In the case of the fund though I am willing to sell away half of the upside to generate income into the portfolio. The second reason is important when it comes to covered call funds and the failure of an option overwrite strategy. When you're writing a covered call, you're selling away the upside and taking in call premium so when the market or the stock goes down consistently, you're making a little bit of money each month. Think back to 2008 when the market was declining month after month and if you had sold covered calls in that environment. You would have made a little bit of money month after month but when the market changed direction the up-side move was substantial and if you had sold away the upside on 100% of your positions your return would have been capped near the lows. So imagine saving a little bit of money, saving a little money, saving a little money, and then boom you miss out on a big upward-move that you don't participate in. If the market keeps moving higher you never have the opportunity to earn that back. In the case of this fund you always have half of the portfolio that is available to recover and capture some of that significant upturn.

What happens when a stock gets called away from the portfolio?

When a stock is called away from the portfolio it is because it has run up in price and is now above the strike price. In most cases we let the security get called away and then have a decision to make, do we buy the stock back and write a new call option, do we use the proceeds to purchase another new name in The Fund, or do we add to an existing position. This is really handled on a stock by stock basis evaluating the return potential of the name that was called away versus all other opportunities both inside and outside of the current holdings.

Where does this strategy fit within a portfolio? Is this more of an alternative strategy that tries to straddle the line between stocks and bonds?

This fund is in the alternative space. Morningstar has placed it in the alternative category and more specifically in the "option based" category. Now where it fits in a portfolio is really in any portfolio that needs income. In today's market fixed income securities are returning or yielding somewhere between two and three percent depending on how far you are on the curve or the credit quality you're willing to purchase. Since the inception of this product an investor has received a higher income stream when you combine the dividends of the underlying securities with the call premiums that are being taken in. Now this income stream is not a tax advantaged income stream in that the dividends received are passed through at the dividend tax rate and the call premiums and any capital gains are taxed as ordinary income. So, we think this fund fits great in a non-taxable account but can also be used in a taxable account for people that are looking for income that can't be earned in a fixed income type security today.

How do advisors explain this to their client?

When it comes to explaining this strategy to advisers it can get complicated. I try to keep it simple so the advisor can then explain it to their client. I start with the concept of what we own as underlying securities which are large-cap dividend paying stocks. I tell people that if you look at the portfolio most individuals would recognize 90% of the underlying names as companies that we own. When it gets to the covered call portion of the portfolio, I try to keep it simple and going back to that explanation of what a covered call is. Selling a stock to somebody at a predetermined price and getting a little bit of money or income to sell away that upside. I really keep it simple, large-cap dividend paying stocks and selling away half of the upside to generate some additional income.

What is the best environment for this type of strategy? What's the worst?

The best environment for this fund is still a market that moves higher, and one in which large-cap dividend paying stocks are in favor. The fund should also do well in what I would call a flat but volatile market where stocks are moving up and down month to month. You are taking in the option premium and the stocks aren't getting called away from you month after month, but the stocks are not going down much either. The worst environment is an environment where you have a very significant decline that lasts a short period of time because the only protection you really have is the amount of the call premium that you take in. If the calls are providing a percent to a percent and a half but the underlying is declining 8 to 10% that month you are still losing money. While the strategy still works you are only providing a cushion to the downside. Overall there is less risk in this portfolio than that of just owning the stocks by themselves because you still take in the premium from the options that you're selling.

How is the strategy managed? Is it using indexes, are there individual stocks?

The strategy is run using individual securities, not index options. The main reason for using the individual securities is that the premium received on an individual stock versus an index is greater. The three main components of an option price are the time (days to expiration), the difference between the current price of the stock and the strike price of the option, and the implied volatility of the underlying stock. When you write an option on an index the implied volatility of the option on that index is much more diversified than that of an individual security and therefore worth much less. Writing an option on an individual stock which has higher implied volatility gives you much higher option premium income in the portfolio. By using individual securities this product can generate as much income from option premiums by only overwriting half of each position as many other option writing funds that use index options generate by overwriting 100% of the positions.

We heard you received a patent on Rules Based Risk Management. Can you tell us about the patent and what it covers?

Yes, when I was at a previous firm, I did some work creating a closed end fund that had an option overlay strategy on top of underlying securities. In that case it was an index overlay but the concepts hold true to any strategy. The patent was based on the VXN which is volatility index on the NASDAQ 100 and basically has rules on when you should and shouldn't use an option overlay strategy based on certain levels of The VXN index. Without getting to into the weeds the basics are these. There is a sweet spot when writing options and that is when volatility is within a certain range. When volatility is at extremes either at the high side, or the low side, it is not as advantageous. It really becomes important when the volatility index is spiking to the high side because it generally corresponds with the sharply downward moving market. While you can get a great deal of option premium because the implied volatility is so high and the option price reflects that, it's exactly when you shouldn't be tempted to sell away that upside because the underlying security is so depressed in price a substantial move to the upside could be missed.

The S&P 500 Index is an unmanaged composite of 500 large capitalization companies.

Beta describes how the expected return of a stock or portfolio is correlated to the return of the financial market as a whole. A Beta greater than 1.00 indicates the portfolio is more volatile than the market, and a beta less than 1.00 indicates the portfolio is less volatile than the market