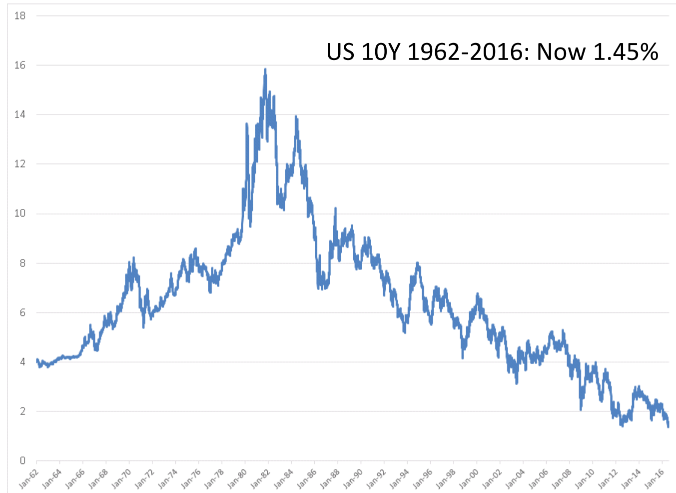
THE QUEST FOR YIELD

August | 2016

An Unprecedented Low Yield Environment

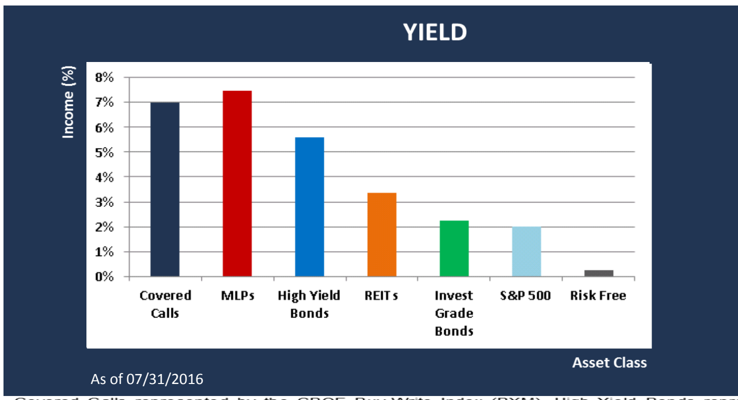
Today's low yield environment has made it incredibly hard to find reliable sources of income without sacrificing quality. Treasury rates have been on a downward trend for 33 years, which has fueled an impressive bull market for bonds. Although the Fed seems committed to its low rate policy in the near term, most economists believe current levels are unsustainable over the long run. This certainly seems true based on the chart to the right. Of course, an increase in interest rates will almost certainly increase the volatility of bond portfolios and cut into investment returns. Diversifying risks will be more important than ever.

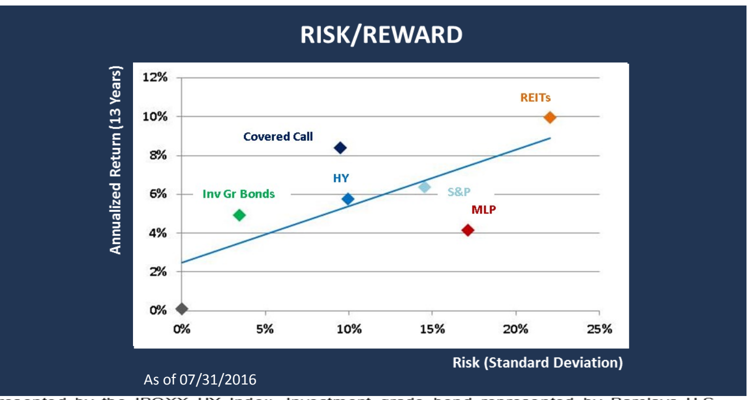


Balancing Risks & Returns

Low yielding investment grade bonds have pushed income-seeking investors out the risk curve in search of attractive yields. They inevitably end up in either high yield (junk) bonds with significant credit risk or in alternative income categories like REITs and MLPs, which carry full equity market exposure as well as interest rate exposure.

More and more investors are considering a high quality covered call portfolio in order to diversify their risks. Covered call strategies can offer investors income of 6-8% without taking significant credit risk (for example, the average credit rating of our covered call portfolio holding is AA, compared to single B for most high yield bond funds). And of course, a covered call portfolio can carry less market risk than long-only stocks. This balanced combination of income and price appreciation is shown below, compared to the other major asset classes.





Covered Calls represented by the CBOE Buy-Write Index (BXM), High Yield Bonds represented by the IBOXX HY Index, Investment grade bond represented by Barclays U.S. Aggregate Bond Index, Long only stocks represented by the S&P 500 index, Hedge Fund index represented by the Credit Suisse Hedge Fund Index, MLP performance represented by Alerian MLP Index, REIT's represented by the DJ US Real Estate Index. Source: Bloomberg, Each of these asset classes has its own set of investment characteristics and risks and investors should consider these risks carefully prior to making any investments. Past performance is no guarantee of future performance. The referenced indices are shown for general market comparisons and are not meant to represent the Fund. Indexes are not available for direct investment.

Over the last decade, as investors have sought opportunities to earn both consistent returns and income, covered calls have gained in popularity. Institutional investors and investment advisors alike are embracing the strategy as part of a diversified equity allocation. However, as the market becomes more familiar with covered call strategies, investors continue to gain an understanding of the nuances between approaches.

History of Covered Calls

Over 30 years ago the Chicago Board of Options Exchange (CBOE) and Standard & Poor's (S&P) created the standard for covered call benchmarks known as the CBOE S&P 500 Buy-Write Index (BXM). The BXM Index is designed to track the performance of a hypothetical buy-write strategy on the S&P 500 Index (for more info, see (www.cboe.com/micro/bxm/introduction.aspx). Several high-profile studies have helped to bring covered calls to the forefront of equity allocation discussions as well.

The CBOE website references three studies in particular from the past 10 years that look at the risk-return dynamics of covered calls. All three firms conducting these studies (Callan Associates, Ibbotson, and Asset Consulting Group) concluded that over the time period studied, a passive buy-write strategy had a superior risk-return profile over long-only equities, achieving similar long term returns at significantly lower risk. And while a passive buy-write strategy (index replication) indeed has solid relative characteristics, an active buy-write strategy has the potential to further improve the outcome. Yet the active application of buy-write strategies can differ significantly in both process and outcome. In short, not all covered call strategies are created equal.

The Nuance of Covered Call Investing

Most simply defined, a covered call position is the ownership of equity shares of a corporation whereby the owner then offers to sell his shares to another investor at a higher price in the future. For this offer, the owner receives income from the call option buyer. At Van Hulzen a covered call strategy is inherently an equity strategy (but with an advantaged risk profile) which by default should require a diligent investment manager to be proficient in fundamental analysis. It is for this reason that the designed investment process around disciplined cash flow fundamentals. The first priority is to construct a high quality equity portfolio. The managers then turn to the option market as the *second* step, in order to add incremental yield and potentially add downside protection.

However, most covered call strategies are designed to primarily focus on the collection of call option premiums and to derive their return solely from the implied volatility embedded in the option price. These types of strategies generally include theta capture (time decay capture), over-writing (writing more calls than underlying shares, beta-seeking (find high beta stocks), and leveraged players (the use of margin). As a result, the manager's core competency in these strategies tends to be in the modeling of implied volatility versus actual volatility, not in whole or in part in fundamental equity analysis. The inherent challenge we see in these strategies is that they seek to profit from a portfolio constructed on option-based inputs and generally fall apart in periods of distress and market declines. Index replication studies show the value of including covered calls in an equity allocation. Active managers who focus on a strong fundamental process can extend that value further and even improve it. But beware the option-based volatility strategies calling themselves covered calls: They might be better suited to limited partnerships and option derivatives.

Van Hulzen Covered Call Strategy: The Strategy invests in large cap companies that the portfolio managers expects to produce strong return on investment , pay regular dividends, have below-average leverage, attractive valuations, and a consistent shareholder value-oriented track record. The Strategy predominantly invests in dividend-paying companies and uses call options in an attempt to create incremental income and reduce portfolio volatility. The Strategy seeks to make income a more significant component of the total investment return and targets long term risk-adjusted returns versus long-only equities. The goal is a portfolio that generates a higher than average annual income with a target of 6-8% annual income.

Van Hulzen Asset Management offers its covered call capabilities in separately managed account format, as well as through a mutual fund.

More information on the fund: www.ironhorsefund.com

Covered call investors typically fall into two groups:

Equity investors: Because equities are the highest returning asset class, most investors see them as an important allocation. However, with the market at new highs, the outlook is more uncertain and volatile than ever. Covered calls are a nice way to stay invested in equities but to take a more cautious approach by focusing on income and downside risk management. The call premiums received in a covered call strategy supplement the dividend income, and increase total portfolio yield dramatically. These strategies are a good way to meet long term goals and sleep a little better at night during market pullbacks.

Fixed income investors: Today's low yield environment has made it incredibly hard to find reliable sources of income without sacrificing quality. And on top of that, interest rates stand poised to rise over the near to intermediate term, which will almost certainly increase the volatility and cut into the returns of this asset class (as we saw in 2013). With treasury yields at all-time lows and investment grade corporate bonds yielding 2-4% compared to their historic range of 4-7%, income-seeking investors are having to move out the risk curve to find attractive yields. They inevitably end up in either high yield (junk) bonds with significant credit risk or in alternative income categories like REITs and MLPs, which carry fully equity market exposure as well as interest rate exposure. A high quality covered call portfolio can offer investors income of 8-10% while also significantly reducing market exposure. Combining one of these strategies with a high quality, short duration bond ladder (3-4 year duration, for example) can further reduce volatility and provide a weighted average portfolio yield of approximately 5-7%.

Covered Calls in Summary

Wherever you stand as an investor, the consideration for a covered call strategy is both widely researched and supported. The current market environment has brought such strategies ever more into the spotlight as a potential solution for income seeking, risk conscious investors. As the saying goes, "The pessimist complains about the wind; the optimist expects it to change; the realist adjusts the sails." How are you adjusting your sails?

VAN HULZEN ASSET MANAGEMENT

Investment Committee

4370 Town Center Blvd Suite 220, El Dorado Hills, CA 95762
Tel: (916) 608-4284 | Fax: (916) 608-4296
www.vaminstitutional.com