INVESTMENT COMMENTARY: Q4 2016

January | 2017

A High Quality Problem

The stock market (S&P 500) has rallied since the November election. There has been much analysis of the sector attribution, with banks leading the way on the reflation trade and industrials and materials stocks surging on hopes of higher infrastructure spending and GDP growth. But less attention has been paid to the quality of the rally.

In fact, it is the lowest quality stocks that have led the charge. According to research by Eric Bush of Gevekal Capital, the top three deciles of stocks with the highest ROE have only returned about 0.4% (in USD) over the past three months, while the bottom three deciles of stocks with the lowest ROE have returned 4.7%.

Similarly, stocks with the lowest sales growth have outperformed stocks with the highest sales growth by nearly 8% in just three months. And lastly, stocks with the highest net debt as a percentage of total capitalization have completely trounced all other stocks during this period as well. The decile of stocks that have the most debt have returned 9% over the past three months while the average return for the other nine deciles is just 1.3%. Stocks with the least amount of debt have fallen by -1.4%. All in all, the rally in developed market equities over the last three months has been clearly led by stocks with the shakiest fundamentals.

Source: Bloomberg. Past performance is not indicative of future results. Shown performance is not meant to represent the Strategy.
Weak Balance sheet index: ISXWBUP - The iSTOXX USA Weak Balance Sheet ex Utilities and Financials Index selects stocks that have an Altman Z-score of less than 2.4 for the past three consecutive years. Strong Balance sheet index: SXAZAL - The STOXX Strong Balance Sheet Index family selects stocks according to their Altman Z-Score, a quantitative measure of the financial and fundamental health of a company. The indices invest in companies with a high probability of not defaulting in the next two years.

The STOXX "Strong" and "Weak" balance sheet indices also support Mr. Bush's conclusions (see below), as does our own research. The bottom decile CFROI (cash flow return on investment) stocks out-performed the top decile stocks by more than 457 basis points over the last 7 weeks of the year (since the election), despite significantly under-performing (as you'd expect) over most other preceding periods. Some market commentators have coined this recent rally a "Dash for Trash."

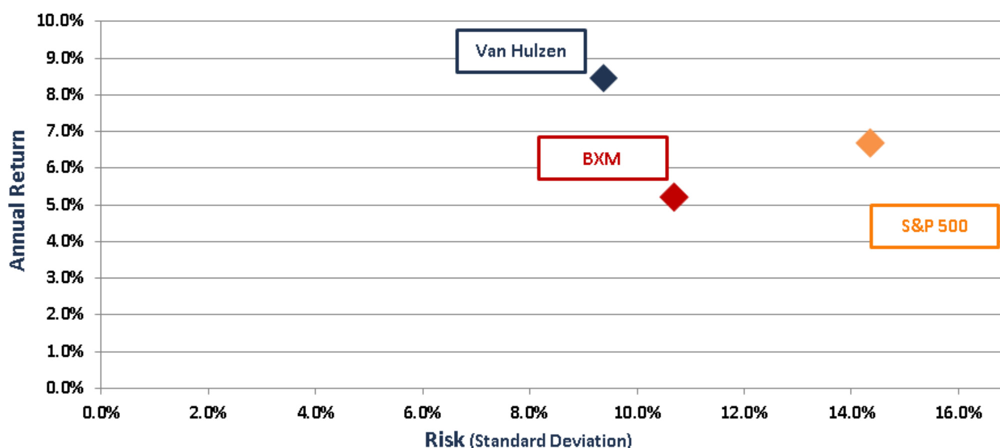
This massive, post-election run-up has made low ROI, over-levered stocks expensive. The strategy is keenly focused on quality. We invest in companies with high ROIs, low debt and sustainable cash flows. We believe what was a high-quality problem last fall has turned into a high-quality opportunity today. History has shown that quality will win in the end.

We also believe we could be looking at a volatile year ahead. The volatility index is sitting at the 5th percentile of all daily readings since 1990 (95% of the time VIX is higher than its current reading of 11.50). We haven't seen levels this consistently low since 2006-2007. We will continue to focus on quality and will continue to sell call options on our stock holdings in order to capitalize on expected volatility, add potential income and potentially protect against market weakness.

Van Hulzen Covered Call Strategy in Review and Outlook

The US election had an impact on every financial market in Q4 of 2016. US Treasury rates rose from their summer low of 1.36% to 2.49% in mid-November. And the sector divergence in the equity markets was enormous, as investors attempted to gauge what four years of Trump policies might look like in just one month. 2016 began with a significant market sell-off (S&P 500 down > 10%). In that period (12/31/15-02/29/16), the SPX lost 5.1% and the BXM lost 2.7%, while the portfolio lost about 1%. The portfolios recovered to 2.4% for Q1, while the S&P had to rally 11% from the February bottom just to make up its losses and achieve a 1.35% return for the quarter. The BXM ended at -0.75% for Q1.

For the following 7 months, the portfolio traded roughly in line with the S&P 500 and BXM. The return (12/31/2015- 10/31/2016) was 5.2% for the portfolio, 4.5% for BXM and 5.8% for S&P 500. It is important to point out, however, that the portfolio achieved this return by taking far less risk. The portfolio did underperform during the last two months of 2016, largely because of our focus on quality and the above-mentioned market dynamics ("low quality" equities significantly out-performed high quality equities during this period). The market's performance was largely driven by financials, materials and industrials. We were underweight to neutral in those sectors and of course have call options on our stocks, limiting our upside during this period.



Overall, the portfolio return was approximately 60-65% of the S&P 500, while taking only about 50% of the market risk. This is in line with what we would expect from a covered call portfolio. The graph on this page shows the return relative to risk taking stayed strong through the whole track record. We sometimes refer to our covered call strategy as a "singles and doubles" strategy. We emphasize quality and do not chase the flavor of the month. And we manage our downside risks very carefully. This discipline has allowed us to achieve the best ranked downside capture among our comparable peers, according to the PSN database, with an upside capture in-line with our peers.

To summarize:

- Risk adjusted results show how the benchmarks performed if they had the same risk as the portfolio;
- The portfolio is equal to 56% of the stock market risk (SPX) and equal to 92% of the "buy write" index (BXM);
- Over the last year, the portfolio has produced 62% of the SPX return and 96% of the BXM return;
- This shows that the active managed portfolio has added value relative to a passive index portfolio.

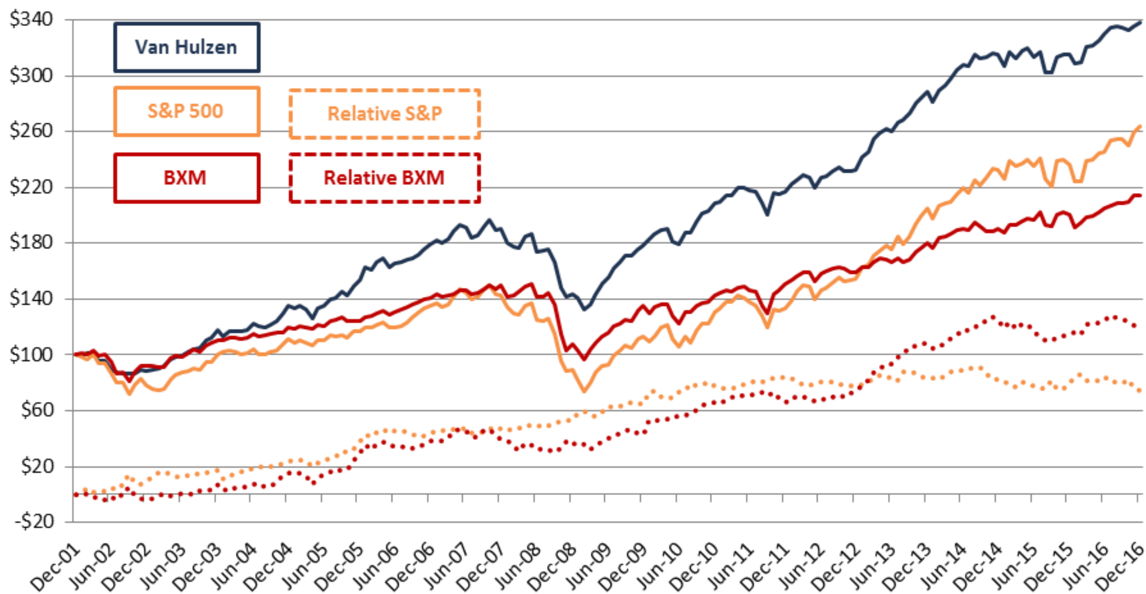
Our investment process is focused on finding undervalued high quality stocks and selling call options to potentially enhance the total return and risk profile on each position. We believe that equity markets are likely to experience heightened volatility in the coming years. As covered call investors, we welcome back this higher volatility as it makes the total return performance less dependent on price appreciation.

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

Covered Call Strategy Performance (gross as of 12/31/2016)



Returns (annualized)*	Dec 2016	3M	6M	YTD	1 Year	3 Years	5 Years	7 Years	10 Years	Inception
Van Hulzen (Gross)	0.9%	1.1%	2.5%	7.2%	7.2%	5.5%	9.2%	9.6%	6.6%	8.5%
Van Hulzen (Net)	0.9%	0.9%	2.2%	6.6%	6.6%	4.9%	8.4%	8.6%	5.6%	7.5%
BXM	0.1%	2.6%	4.5%	7.1%	7.1%	6.0%	7.2%	6.8%	4.3%	5.2%
Difference (Gross-BXM)	0.8%	-1.6%	-2.0%	0.2%	0.2%	-0.5%	2.0%	2.7%	2.3%	3.2%

***Inception date : 12/31/2001. Figures greater than one year are annualized. Van Hulzen returns represent actual returns from composite of accounts**

Note: There is no assurance that the Strategy will achieve its investment objectives. Writing call options can result in an option exercise and may cause shares to be "called away" and sold. The use of covered call strategies does not ensure profits or guarantee against losses. Past performance may not be indicative of future results.

The foregoing content reflects the opinions of Van Hulzen Asset Management and is subject to change at any time without notice. Content provided herein is for informational purposes only and should not be used or construed as investment advice or a recommendation regarding the purchase or sale of any security. There is no guarantee that these statements, opinions or forecasts provided herein will prove to be correct. Past performance is not a guarantee of future results. Indices are not available for direct investment. Any investor who attempts to mimic the performance of an index would incur fees and expenses which would reduce returns. All investing involves risk including the potential for loss of principal. There is no guarantee that any strategy will be successful. *The CBOE S&P 500 BuyWrite Index (BXM) is a benchmark index designed to track the performance of a hypothetical buy-write strategy on the S&P 500 Index. The BXM is a passive total return index based on (1) buying an S&P 500 stock index portfolio, and (2) "writing" (or selling) the near-term S&P 500 Index (SPXSM) "covered" call option, generally on the third Friday of each month. The S&P 500 Index consists of 500 stocks chosen for market size, liquidity, and industry group representation. It is a market-value weighted index (stock price times number of shares outstanding), with each stock's weight in the Index proportionate to its market value. It is widely used as a benchmark of U.S. equity performance. It is not possible to invest directly in an index. FPAC-0380-16*