INVESTMENT COMMENTARY: Q4 2018

January | 2019

Van Hulzen Covered Call Strategy: A Steady Beacon in an Unsteady Market

First of all we would like to wish you and your family a Happy New Year! Also, we've recently come up with a new symbol for our strategy: **Polaris**

We will explain this later in our commentary. But let's first review 2018….

"Proof is in the Pudding"

This old adage warns us to be patient and weigh actual evidence over someone's slick sales pitch. As we begin our 19th year managing covered call portfolios for our clients, we are pleased to say our proof continues to be in the pudding.

As you know, we have been writing and talking about risk management and downside protection for years, but every once in a while (after periods like Q4), we are proud to pause and reflect on our results. Q4 was a nasty period for stocks, with the S&P 500 losing 13.5% and the technology sector losing more than 20%. Our strategy lost 5.1%.

Our covered call strategy protected our clients against more than 50% of the S&P's losses. For the full year, we turned in a -1.7% return, compared to -4.4% for the S&P 500, -4.8% for the passive covered call index (ticker BXM), and -6.7% for the Hedge Fund Research Index.

2018, A Year full of Craziness"

Below you will find a sampling of this craziness (from David Collum's recent 2018 review):

- Companies doubled their market caps by adding block chain to their name or issuing a cryptocurrency;
- An 18-year-old launched a hedge fund from his bedroom in suburban New Jersey;
- Equities ran 300+% off the lows while the GDP tracked the Great Depression, compounding at 2% per year;
- Value investing strategies have performed in the bottom 1 percentile since 1990;
- The S&P ran 14 months in a row without a monthly loss;
- Blue Apron IPOed at $10 a little over a year ago; it's now at $1.23 and nobody has been indicted?

- Tilray, a cannabis company reporting $28 million in sales, doubled in value in three trading days and rose tenfold in 2 months to a market cap of $20 billion before cutting in half. As Scott McNealy would say, “What were they smoking?”;
- Domino’s Pizza added 35% to a 20-fold, 10-year run aided by a debt-funded buyback program;
- 60% of corporate debt issued by companies in the Russell 2000 is rated as “junk;
- GM pays its investors a dividend yield of 4.1% with negative cash flow;
- Uber has never turned a profit, but it’s about to go public at $120 billion.

And the list continues. As covered call investors, we observe this madness but do not participate, instead continuing our focus on the “tried & true.” Our process has delivered excellent results over 18 years and we do not deviate from this process. Of course, sometimes that means that you have to be patient and wait for an opportunity to arise. Sometimes cash (in the short term) is better than forcing a bad trade.

We believe that opportunity is now. After a 10 year bull market, most economists now expect more of a volatile, sideways moving pattern over the next few years. Our strategy thrives in that environment, capitalizing on volatility to increase yields and downside protection. The average yield over our long term (18 year) track record is 7-8%. But we collect even higher yields when markets are volatile.

Hedge Funds Without a “Hedge” Are Just Funds

Perhaps the most alarming statistic from 2018 is the -6.7% turned in by hedge funds. We were shocked by this number and decided to dig in a little deeper. According to Hedge Fund Research, Inc., not only did the broadest hedge fund index (the Global Index) lose -6.7%, the broadest equity index (the Equity Hedge Index) lost even more (-9.4%).

Given these staggering results, we thought we would spend a moment on the history of the hedge fund category. The first hedge fund was launched by Alfred Winslow Jones in 1949. It was a long/short equity fund and was designed to deliver consistent returns at lower risk. This idea gradually caught on and by the mid-1960s, hedge funds had gained broader popularity. Since then, the industry has been through two boom/bust cycles as some managers strayed from their original objectives, took on too much risk and ultimately blew up during the bear markets of 1973-74 and then 2000-2002. “Chasing the S&P” is often cited as the primary cause of such implosions.

There has been another resurgence in the 2000s, with the number of hedge funds growing from 2,000 in 2002 to over 10,000 in 2015, managing more than $3.2 trillion of client assets (according to the 2016 Preqin Global Hedge Fund Report).

Unfortunately, this is not a new trend. Hedge funds have been under-performing for many years. But these are smart people, and some of the best trained in the industry. Al Root of Dow Jones decided to survey these managers to see what they learned from 2018. Here are the top four “lessons learned” from the Q4 sell-off:

1. **FOMO.** One of the major themes of 2018 was the Fear of Missing Out (FOMO). Managers too often “chased” the S&P rather than sticking to their process. You can’t just buy dips; you have to sell rallies as well.
2. **Quality matters.** Pay more attention to quality. Leverage, in particular, got managers into trouble. This applies to the debt levels of the underlying investments as well as the strategies themselves.
3. **Bear markets don’t always result in recessions.** According to Barron's, 15 of the 23 bear markets since 1929 were associated with or resulted in recessions. That means that more than one-third of the time, stock declines didn't lead to a broader economic slowdown.

4. **<u>Things can change on a dime.</u>** Of the 23 bear markets referenced above, the average time for markets to drop 20% was about 175 days. This time around, it took the Dow Jones Industrial Average 83 days to hit its Dec 26 low. And more than half of the decline happened over just three weeks.

The Polaris Of Your Portfolio

Don't get us wrong. We do not see ourselves as a hedge fund. We offer more upside than hedge funds. But we do know that our risk profile (as measured by standard deviation) is typically in line with the broad hedge fund index. This makes our strategy a great low-beta equity allocation. And a great complement to your more aggressive equity allocations.

Circling back to our original theme, we see our role as the Polaris of your portfolio. Polaris (also known as the North Star) lies nearly in a direct line with the axis of the Earth's rotation "above" the North Pole—the north celestial pole. Polaris stands almost motionless in the sky, and all the stars of the northern sky appear to rotate around it. Therefore, it makes an excellent fixed point from which to draw measurements for celestial navigation and for astrometry.

For 17 years, we have been serving as the Polaris of our clients' portfolios. And we are looking forward to (at least) 17 more.

High Level Takeaways

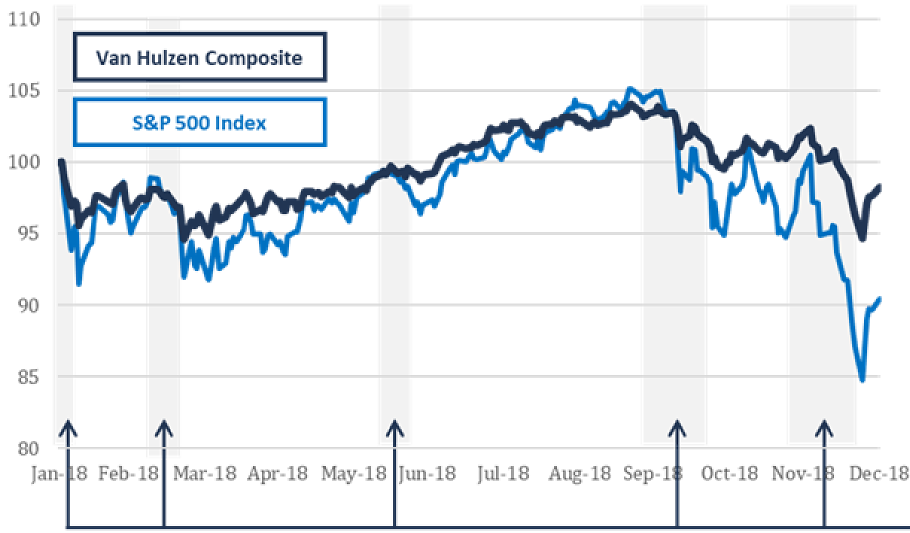
The market environment has changed significantly over the past year:

- Sept 2018 marked the longest bull market on record (number of months);
- 2017 saw a record number of consecutive positive months (calm before the storm) ;
- 2018 has been a different story – Increased volatility has made the market more favorable for covered calls than it has been over the past 4-5 years;
- We are also seeing signs of a potential rotation from growth to value stocks;
- Most economists expect a volatile, sideways moving market for the next several years.

We have a lower risk profile and higher yield than our equity benchmarks:

- For 2018, the composite returned -1.7% (versus -4.4% for the S&P 500);
- For Q4, the composite returned -5.1% (versus -13.5% for the S&P 500);
- We continue to be the leader in downside protection in the covered call category;
- The current portfolio carries approximately 11% annualized income;
- The equity portfolio has a credit rating of single "A".

We believe 2018 marked the beginning of a (potentially lengthy) period of elevated volatility. We recommend a continued focus on income and downside protection. Our Strategy has provided strong downside capture throughout the year at less than half the risk.



Five Largest Drawdowns in 2018:

	Composite	S&P 500	Difference
1/31-2/8	-4.4%	-8.5%	4.2%
3/9-3/23	-3.6%	-7.1%	3.4%
6/12-7/5	0.8%	-1.7%	2.5%
9/21-10/29	-4.4%	-9.7%	5.4%
11/7-12/24	-6.9%	-16.2%	9.3%
Average	**-3.7%**	**-8.6%**	**4.9%**

The last time we saw a period of consistently high volatility was the late 1990s-early 2000. We believe the upcoming period will look more like this than the Financial Crisis of 2008-2009 (which was more of an anomaly). A prolonged period of consistently high volatility could be really good for covered call investors.

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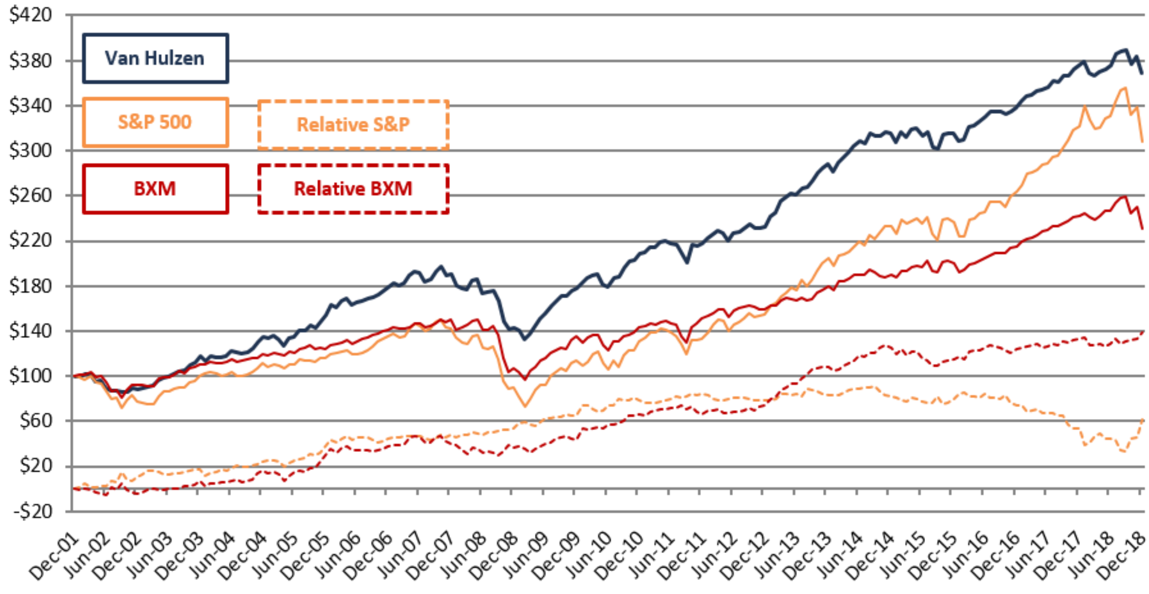
Covered Call Strategy Performance (gross as of 12/31/2018)



Returns (annualized)*	Dec 2018	3M	6M	YTD	1 Year	3 Years	5 Years	7 Years	10 Years	Inception
Van Hulzen (Gross)	-3.7%	-5.1%	-1.6%	-1.7%	-1.7%	5.4%	5.1%	7.9%	9.9%	8.0%
Van Hulzen (Net)	-3.7%	-5.3%	-1.9%	-2.3%	-2.3%	4.8%	4.5%	7.1%	9.0%	7.0%
BXM	-7.7%	-10.8%	-6.4%	-4.8%	-4.8%	4.8%	5.1%	6.2%	8.0%	5.0%
Difference (Gross-BXM)	4.0%	5.7%	4.8%	3.0%	3.0%	0.6%	0.0%	1.6%	2.0%	2.9%

*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.