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Target Income Solutions: Producing Consistent High Income in Dynamic Markets

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EXECUTIVE SUMMARY

Most investors expect a certain level of current income in their portfolios. They also expect the principal from which income is collected to grow at a rate that exceeds inflation over the long term. Traditionally, fixed income securities are the go-to investment to meet current income needs. However, an environment of rising inflation or low rates can challenge bond growth and put income investors in a tough spot.

Many investors turn to dividend-paying stocks to generate income that may exceed fixed income investments. But these investments come with their own challenges. Stocks that pay high dividends can potentially meet investors' income needs but may have lower-quality business and financial fundamentals compared to stocks that focus on dividend growth. Dividend growth stocks, for their part, may fall short of many investors' income targets on an absolute basis. Collectively, dividend-paying stocks may offer limited growth potential and can go through time periods where the dividend income may be too low to meet investor income needs.

To meet investors' dual need for income and growth, Vest developed Target Income, a distinct solution that seeks to generate attractive current income from both stock dividends and option premia, while also retaining the opportunity to achieve higher total returns than a simple buy-and-hold strategy of high-dividend-paying stocks. Vest believes that a dividend-focused portfolio of stocks lays the optimal foundation for a Target Income Strategy®. On top of this dividend-focused equity portfolio foundation, Vest employs an innovative option strategy that seeks to enhance income by monetizing a portion of the potential upside appreciation of dividend-focused stocks through the sale of call options. As we will demonstrate in this paper, this strategy strikes what we believe is a dynamic balance between income and growth that can potentially deliver an optimal income-with-growth solution.

BACKGROUND

THE INCOME-WITH-GROWTH CHALLENGE

Some investors rely on income from their investments to help pay bills, boost immediate spending, and service long-term liabilities. While this is particularly true for individuals in or near retirement (who would like their investment income to replace their employment income), investment income can be desirable in almost all portfolios.

Because income needs tend to go up over time, it is important that the principal from which income is collected grows at rates higher than inflation over the long term. To achieve this, income investors traditionally utilize fixed income securities, such as fixed-coupon bonds, as a primary source of portfolio income. Historically, these types of bonds provided a significant yield advantage over equities, with equities being primarily held by investors more as drivers of principal growth in their portfolios rather than as solutions for income needs.

Since the global financial crisis in 2008-2009, however, fixed income yields experienced tremendous volatility. Central bank expansionary monetary policy resulted in record-low yields for fixed income investors for over a decade. More recently throughout 2022-2023, central banks embarked on aggressive monetary tightening campaigns to fight inflation. The result has been either extremely low yields that do not produce enough income or a rising interest rate environment that erodes the value of existing fixed income holdings.

Investors have been frustrated by the fixed income markets' inability to produce reliable levels of income, regardless of the direction of monetary policy. Even in an environment where fixed income produces consistently high yields, investors flocking to bonds may have to forego the growth potential of equities. This is precisely the problem that Target Income seeks to solve: striking a dynamic balance between income and growth to deliver an optimal income-with-growth solution.

INCOME FROM EQUITIES: HIGH-DIVIDEND PAYERS VS. DIVIDEND GROWERS

Dividend strategies generally fall into two broad categories: high-dividend payers and dividend growers. Each has its advantages and disadvantages, as shown in Figure 1. Target Income Strategies can leverage an underlying basket of equities consisting of either high-dividend payers or dividend growers. Nevertheless, careful construction of the underlying basket of equities is crucial to a successful Target Income Strategy.

On the one hand, high-dividend payers may have the ability to meet investors' income needs. Many of these companies pay high dividends relative to their stock price because they have lower growth prospects for investing cash internally.[1] As a result, however, high-dividend payers may show lower total returns accompanied by higher volatility,[2] particularly during periods of market turmoil. These stocks also typically have lower-quality business and financial fundamentals compared to dividend growers.[1] Furthermore, strategies based on such stocks may sacrifice benefits of diversification, because these stocks are often concentrated in certain sectors, like energy and utilities. High-dividend payers may also suffer from lower total returns when dividend yields[3] are high simply because the stock price has fallen sharply.

On the other hand, most dividend-growing stocks have increased dividend payments for consecutive years over extended periods. Dividend growers are typically high-quality companies with strong balance sheets, solid fundamentals, stable cash flows[4] and a history of earnings growth. Consistently increasing dividends has been a way for management to signal confidence in their companies' prospects. Relative to high-dividend payers, these dividend-growth companies have a history of total return outperformance, particularly during periods of market turmoil.[1] However, these stocks are often not the highest sources of yield, despite consistently increasing their dividends. As a result, they could fall short of investors' income needs.

FIGURE 1: COMPARISON OF DIVIDEND STRATEGIES

DIVIDEND STRATEGY	ADVANTAGES	DISADVANTAGES
HIGH-DIVIDEND PAYERS	• May be able to meet income needs • Stable, firmly established companies	• Lower-quality financials • Lower growth prospects for investing cash • Higher volatility
DIVIDEND GROWERS	• Strong balance sheets, stable cash flows, history of earnings growth • Total return outperformance relative to high-dividend payers	• Lower dividend yields leave the potential to fall short of income targets

In this paper, we examine an emerging new strategy known as Target Income that seeks to generate attractive current income while retaining the opportunity to achieve higher total returns than a reference asset, such as the S&P 500® High Dividend Index, at lower volatility. Target Income Strategies seek to achieve this goal by exploiting the unique properties of call options to monetize the potential upside of stock price moves and overlaying this feature onto a dividend investment strategy.

An underlying portfolio of high-dividend payers versus an underlying portfolio of dividend growers results in a trade-off within the Target Income framework. A portfolio of high-dividend payers may require a smaller portion of the portfolio to be overwritten to achieve the desired income level. Conversely, a portfolio of lower-yielding dividend growers may result in a larger portion of the portfolio to be overwritten to achieve the same desired income level. In either case, Target Income seeks to generate consistently high income with significant upside potential remaining.

Consider a Target Income Strategy that seeks to produce 8% above the dividend yield of the S&P 500, and let's assume a hypothetical dividend yield of the S&P 500 of 1.49% in 2023. This strategy's goal for this year would be to produce 9.49% through a combination of the dividends collected on the underlying basket of stocks, as well as the call premiums collected. Suppose there are two different underlying baskets of dividend-paying stocks: one comprises high-dividend payers with a dividend yield of 4.0% (Portfolio A), and the other comprises dividend growers with a dividend yield of 2.5% (Portfolio B). Assuming all terms are equal on the call options being sold,[5] the high-dividend payers portfolio would need to sell fewer call options to meet the 9.49% target than the dividend-growers portfolio. This smaller call overwrite percentage on Portfolio A leaves potential for greater upside participation, as shown in Figure 2.

FIGURE 2: HYPOTHETICAL COMPARATIVE OVERWRITE AND UPSIDE PARTICIPATION

	PORTFOLIO A (HIGH-DIVIDEND PAYERS)	PORTFOLIO B (DIVIDEND GROWERS)
TARGET INCOME	9.79%	9.79%
DIVIDEND YIELD	4.00%	2.50%
INCOME NEEDED FROM OPTIONS SELLING TO PRODUCE TARGET	5.79%	7.29%
PERCENT OF PORTFOLIO TO BE OVERWRITTEN TO GENERATE OPTIONS INCOME	12%	16%
UPSIDE PARTICIPATION	88%	84%

Compared to a traditional covered-call strategy in which the entire stock portfolio is overwritten (foregoing potential stock appreciation upside), a key advantage of Target Income Strategies is that the income component from calls is written on a relatively small portion of the stock holdings (typically less than 20%), which provides the opportunity for significant upside potential from appreciation in the stock price. Meanwhile, the methodology for stock selection and portfolio construction drives the return and risk features of the strategy. Overall, combining an options overlay with a dividend-based stock selection strategy provides investors an attractive income profile that also has a significant potential growth component.

Before we examine the benefits of using options as a vehicle for shifting potential capital appreciation to income, let us look more deeply at the features of dividends as a basis for stock selection.

PART I. DIVIDENDS AS A BASIS FOR STOCK SELECTION

THE FOUNDATION OF TARGET INCOME STRATEGIES

Selecting an effective portfolio of dividend-paying stocks is not simple. Examining dividend yields alone can result in a portfolio of stocks whose share prices have fallen due to fundamental business concerns about the companies going forward. Instead, careful consideration needs to be applied to the universe of dividend-paying stocks. Stock quality, sector diversification, risk/return profile, performance in rising and falling markets and, of course, dividend yield all need to be factored in and evaluated at the portfolio level.

QUALITY STOCKS

Ideally, effective Target Income Strategies consist of a portfolio of equities that includes companies with strong balance sheets, stable cash flows and a history of earnings growth. Companies with a long history of raising dividends typically have a history of cash flows to support those dividends, as well as sufficient earnings growth to increase them each year.

DIVERSIFICATION

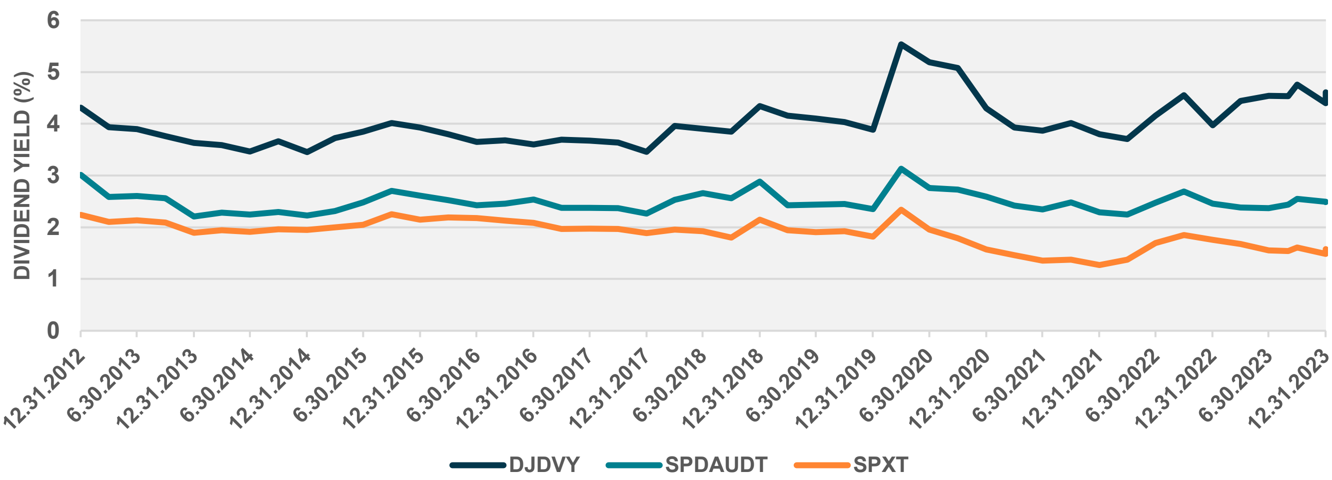
Another key feature of effective Target Income Strategies is having a high degree of stock and sector diversification within the portfolio. An equal-weight approach is preferred, as it is important to not have a portfolio that is too dependent on a few large holdings for performance. Some sectors, like energy, telecommunications and utilities, tend to have high dividend yields, but they must be considered cautiously to ensure that their growth prospects remain strong. At the very least, a portfolio consisting of underliers from traditional high-yielding sectors should be balanced against underliers that have demonstrated consistent dividend growth.

DIVIDEND YIELD

Dividend yield is not the primary stock selection criteria for building an effective underlying portfolio for a Target Income Strategy, as the total income will be greatly enhanced by the partial call overwrite. Instead, one should seek to find a balance between high-yielding stocks and stocks that have demonstrated dividend growth. The result is a portfolio ripe for Target Income: an underlying portfolio with solid dividend yield and modest overwrite percentage, maintaining appreciation potential in times of positive market returns.

For illustrative purposes, we will be using the S&P 500 Dividend Aristocrats Index[6] (SPDAUDT) as a representative portfolio of dividend growers, and the Dow Jones U.S. Select Dividend Index[7] (DJDVY) as a representative portfolio of high-dividend payers. Their yields over time are shown in Figure 3, along with the S&P 500 Total Return Index (SPXT).

FIGURE 3: DIVIDEND YIELD OF DJDVY, SPDAUDT, SPXT



Source: Bloomberg

RETURN AND RISK

In addition to considerations for stock quality, diversification and dividend yield, one should also seek a portfolio that has an attractive risk/return profile. Specifically, the portfolio should target dividend growth stocks that have demonstrated strong performance relative to risk. Again, using the S&P 500 Dividend Aristocrats Index as a sample portfolio for dividend growers, we observe higher returns with lower portfolio volatility over the long term. The Dow Jones U.S. Select Dividend Index, our sample portfolio for high-dividend payers, generally has lower returns accompanied by higher portfolio volatility, as seen in Figure 4.

FIGURE 4: SPDAUDT GENERALLY OUTPERFORMED DJDVY WITH LOWER VOLATILITY (AS OF 12/29/2023)

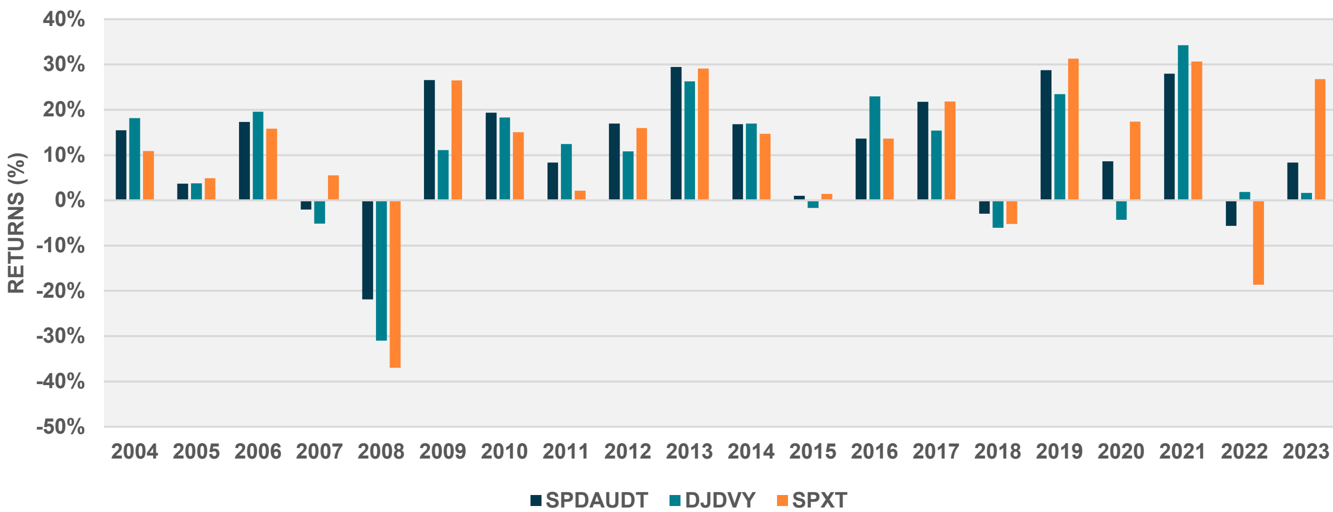
	RETURNS (ANNUALIZED)		
	SPDAUDT	**DJDVY**	**SPXT**
3 YEAR	8.62%	11.16%	10.00%
5 YEAR	12.25%	10.05%	15.69%
10 YEAR	10.67%	9.26%	12.03%
15 YEAR	13.83%	11.51%	13.97%
20 YEAR	10.60%	8.29%	9.69%
	VOLATILITY (ANNUALIZED)		
	SPDAUDT	**DJDVY**	**SPXT**
3 YEAR	15.28%	16.50%	17.59%
5 YEAR	20.19%	22.53%	21.30%
10 YEAR	16.61%	17.88%	17.73%
15 YEAR	17.15%	18.16%	18.33%
20 YEAR	17.99%	19.76%	19.12%

Source: Bloomberg

PERFORMANCE IN RISING AND FALLING EQUITY MARKETS

The last consideration for an underlying portfolio of equities within a Target Income Strategy is its performance under various market conditions. Both dividend growers and high-dividend payers perform relatively well under severe bear market scenarios like 2008 and 2022. This outperformance during strong bear markets is largely due to the resiliency of the stocks that compose the respective indexes. Moreover, the S&P 500 Dividend Aristocrats Index is frequently able to keep pace during strong bull markets like 2009, 2013 and 2017, as seen in Figure 5.

FIGURE 5: CALENDAR-YEAR RETURNS FOR SPDAUDT, DJDVY, SPXT (AS OF 12/29/2023)



Source: Bloomberg

Now that we have reviewed the potential benefits of a dividend-based stock selection strategy, let us examine how options are used to generate income from the potential capital appreciation of stocks. In the next section, we explain how options remodel portfolios to higher income levels, and how strategy design choices influence both the level of income and the potential growth component of returns.

PART II. OPTIONS OVERWRITING

GENERATING INCOME BY MONETIZING THE UPSIDE POTENTIAL OF STOCKS

MOVING BEYOND DIVIDENDS WITH OPTIONS

Many of us have benefited from a remodeling or home improvement project. We may love our home for its location, school system, design, yard or other features. At some point, however, we may need to make changes, such as building an in-law suite, upgrading the kitchen or bathrooms, or finishing a basement, to better meet the needs of the family and improve the home's utility. Investment strategies, like houses, can be “remodeled” to better match investment goals. Instead of drills, hammers and nails, the remodeling tools for investments are options, which adapt investments to achieve a preferred combination of income and growth without disturbing other parts of the portfolio.

Options are contracts that give an investor the right, but not the obligation, to buy or sell a security or other financial asset (reference asset) at a predetermined price (strike price) on or before a specific date in the future (exercise date). In the case of a call option, the buyer pays an upfront premium and acquires the right to a stock’s future returns above the strike price. The seller, on the other hand, gives up the right to the stock’s future returns above the strike price in exchange for upfront premium income. Options thus confer on a stock owner the unique ability to convert a stock's uncertain future returns into certain upfront premium income.

Investors holding a basket of stocks may repeatedly sell call options on a portion of the stockholding to convert some of the future returns into upfront premium income, while preserving most of the return potential of the price appreciation of the stocks. This approach can work well with strategies that select stocks based on their potential for capital appreciation. The premium income collected from the options sold, combined with the dividends from the remaining stocks, may become a source of high current income.

TARGET INCOME: A RULES-BASED SOLUTION

This income-enhanced strategy can be incorporated into a rules-based approach that produces consistent income each year. Such "remodeling" shifts a portion of the base portfolio's total returns into income. This is accomplished by "writing" (or selling) weekly or monthly call options on a small portion of each stock position to convert a portion of the stocks' total returns into income. This is known as a partial covered-call strategy.[8]

The specific goal of Target Income is to generate consistent income from option premia, along with stock dividends. Specific target income amounts can be set at any level. (Historically, Target Income goals are set at 8% to 10% above the dividend yield of an underlying index, as this has proven to be what we believe is the ideal balance between current income combined with potential upside participation.)

WRITING COVERED CALLS

Covered-call writing is an established means of capturing some of the potential capital appreciation of stocks in the form of upfront premium income. By selling a call option on a stockholding, the investor receives a premium in exchange for foregoing the stock's upside returns above the option strike price over a specific time horizon. In effect, this strategy transforms potential capital returns above the strike price into a known level of income at the start of each period. The premium income received from repeatedly selling calls that expire each week or month can be significant on an annual basis. However, some of this income is offset by limited upside returns on the portion of each stockholding that is "covered" with options.

Some basic principles of option pricing are relevant to the design of a covered-call strategy with an income target. Specifically, when choosing to implement covered-call writing, an investor can select the strike price of the options sold, the portion of the stock position to be overwritten, and the term of the options sold.

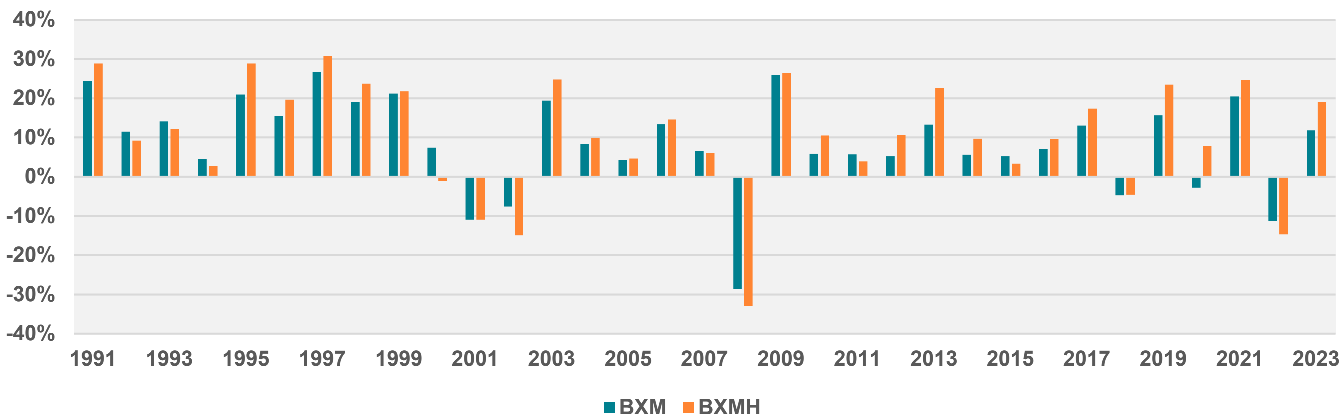
FIXED VS. VARIABLE PARTIAL OVERWRITE

Some widely followed indexes of covered-call strategies, such as the Cboe S&P 500 BuyWrite Index (BXM),[9] incorporate writing call options on the full stock position. This index sells monthly at-the-money calls using S&P 500 Index options, with the S&P 500 Index serving as the underlying portfolio of stocks. A 100% overwrite allows maximum capture of the option premium but limits upside returns on the entirety of the stock holdings, making the strategy geared more toward income at the expense of growth.

In addition to BXM, Cboe also produces the Cboe S&P 500 Half BuyWrite Index (BXMH), where only 50% of the portfolio is overwritten. Both indexes have a long history, which allows for a deep comparison and demonstrates the value of partial overwriting, especially during strong bull markets.

Figure 6 compares annual returns of the indexes going back to 1991. Overall, BXMH outperformed by an average of 1.87% per year. In the 33 years provided, BXMH outperformed BXM 66% of the time, by an average of 4.35%. BXMH underperformed 33% of the time by an average of 3.08%. Naturally, BXMH tends to outperform during up markets, while BXM tends to outperform during down markets. Importantly, BXMH's outperformance in bull markets is due to upside participation remaining. Upside participation is a key feature of partial call overwriting that Target Income seeks to capitalize on.

FIGURE 6: FULL OVERWRITE (BXM) VS. PARTIAL OVERWRITE (BXMH), 1991 - 2023



Source: Bloomberg

Target Income seeks to balance a specific income level while maintaining significant potential for growth. This is achieved by executing a variation of Cboe's benchmark call overwrite strategies. Instead of implementing a call overwrite on 100% of the portfolio (as BXM does) or even 50% of the portfolio (as BXMH does), a much smaller overwrite, such as 15% of the stockholding, is sufficient to produce high levels of income while maintaining significant upside. A 15% overwrite benefits from participating in 85% of the upside of the stock holding beyond the strike price. However, with a fixed portion of the portfolio overwritten, the premium income collected from the sale of call options will vary over time. Typically, during times of higher volatility, the premium income collected from the sale of call options is higher than during times of lower volatility.

A common criticism of covered-call strategies is their historic underperformance in oscillating markets. However, this critique is more appropriate for full overwrite strategies. Strategies that employ 100% overwrite forgo the entire upside, thereby never participating in market recoveries in oscillating markets and leading to a slow decrease in portfolio value. Partial call overwrites, especially ones where the overwrite is relatively small, do not suffer as severely in oscillating markets, as Figure 7 demonstrates.

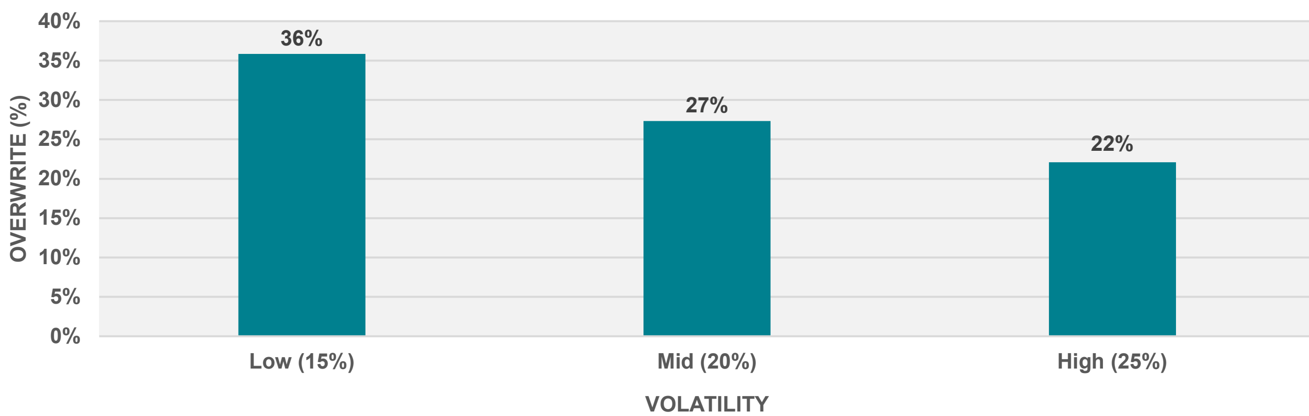
FIGURE 7: COMPARATIVE RETURNS FOR VARIOUS OVERWRITE STRATEGIES

COVERED-CALL SCENARIOS	STARTING VALUE	PERIOD 1	PERIOD 2	PERIOD 3	PERIOD 4	PERIOD 5	PERIOD 6	ENDING VALUE	END RETURNS
UNDERLYING INDEX	**100**	**10%**	**-10%**	**10%**	**-10%**	**10%**	**-10%**	**97**	**-3%**
15% OVERWRITE	100	8.5%	-10%	8.5%	-10%	8.5%	-10%	93	-7%
50% OVERWRITE	100	5%	-10%	5%	-10%	5%	-10%	84	-16%
100% OVERWRITE	100	0%	-10%	0%	-10%	0%	-10%	73	-27%

Target Income Strategies are designed to deliver a specific level of income. The objective of targeting a stable level of income can (in our view) be best achieved by varying the portion of the stock position that is overwritten in response to changes in the prices of the call options related to shifts in volatility. So, during times of higher volatility (when call option prices are high), a strategy targeting a specific amount of income can reduce the portion of the stock position that is overwritten, resulting in a higher participation in the appreciation of the stock above the strike price. Conversely, during times of subdued volatility (when call option prices are low), the strategy overwrites a higher portion of the stockholding to achieve the income target, thus limiting the growth potential to a greater degree. Target Income Strategies vary the size of the stock position overwritten periodically in response to market conditions. In doing so dynamically, these strategies continuously strive to achieve their income target while allowing the balance of the stock portfolio to deliver growth.

To gain insight into how a Target Income goal such as 8.0% per year translates into varying the stock overwrite percentage depending on volatility conditions, consider hypothetical call options with one month to maturity, assuming a range of volatility conditions. Figure 8 shows the percentage of the portfolio overwritten with a Target Income of 8.0% per year (0.67% per month), with hypothetical "at-the-money" (ATM) call options and one month to expiration. We also assume annualized volatility levels typically found in stock options—15%, 20% and 25%—a 5.0% risk-free rate and a 1.79% dividend yield.[10]

FIGURE 8: PERCENTAGE OF PORTFOLIO OVERWRITTEN: ONE-MONTH ATM CALL OPTION TO REACH AN 8.0% ANNUAL YIELD



Source: Bloomberg

Notice how the percentage overwritten is lowest (22%) in the higher-volatility regime, when option premiums expand with volatility expectations, and is highest (36%) in the lower-volatility regime example.

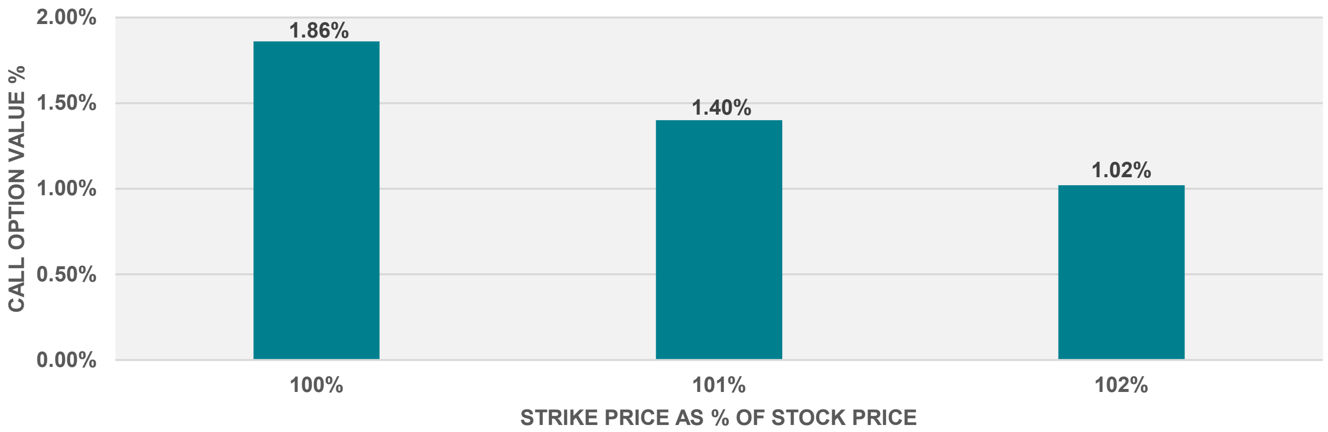
SELECTION OF STRIKE PRICE

The lower the strike price is relative to the stock price at the time the stock position is overwritten, the higher the call option premium. The selection of the strike price is a trade-off between maximizing the upfront premium by selling away all the potential upside or allowing for some upside appreciation before the strike price is hit. When an option's strike price is the same as the stock price, the call option is said to be "at the money" (ATM). When it is higher than the stock price, it is called "out of the money" (OTM). The time premium or income available for limiting upside is highest for ATM call options. Target Income prefers that all call options sold are ATM, which provides sufficient income to reach the target while allowing for only a small portion of each stock position to be overwritten.

Figure 9 shows the difference in call option values between an option with one month to expiration that is ATM (strike price is 100% of the stock price) versus a call option that is OTM (strike price is 101% and 102% of the stock price).

In exchange for allowing for 2% return before limiting upside, the OTM call option premium is reduced by almost half from 1.86% to 1.02%. Therefore, for the OTM call option to generate the same amount of target income as an ATM option, the portion of the stock position covered with 2% OTM calls would need to be almost twice as large as it would be with an ATM option. A similar effect occurs for ATM call options with one week to expiration, where the premium drops from 0.90% for an ATM option to 0.49% for an option that is 1% OTM.

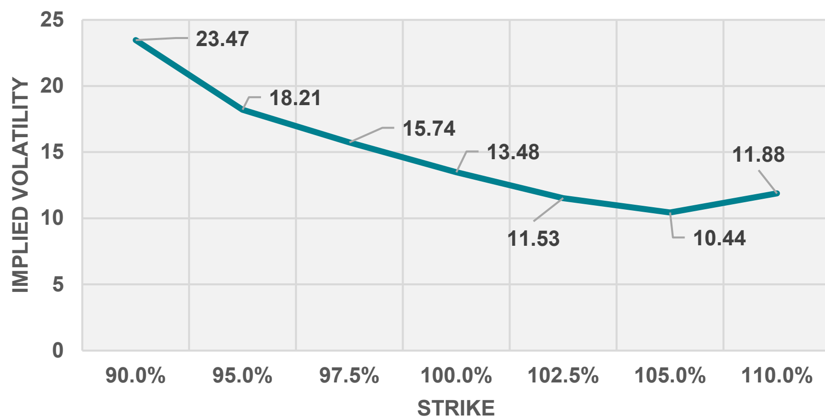
FIGURE 9: MONTHLY ATM CALL OPTION VALUES BY STRIKE PRICE AS A PERCENTAGE OF THE UNDERLYING PRICE



Source: Bloomberg

Lower struck call options have higher premiums due to the moneyness of the option. In addition, ATM call options have higher implied volatilities than OTM call options, which also translates to higher option premiums. This is known as the "volatility smirk" due to the shape of the volatility surface when volatilities are plotted by strike, as in Figure 10. Target Income Strategies seek to extract value out of the volatility smirk by selling ATM call options due to their high implied volatilities relative to OTM call options.

FIGURE 10: S&P 500 IMPLIED VOLATILITY FOR VARIOUS STRIKE PRICES WITH ONE MONTH TO EXPIRATION



Source: Bloomberg

SHORT-TERM VS. LONG-TERM CALL OPTIONS

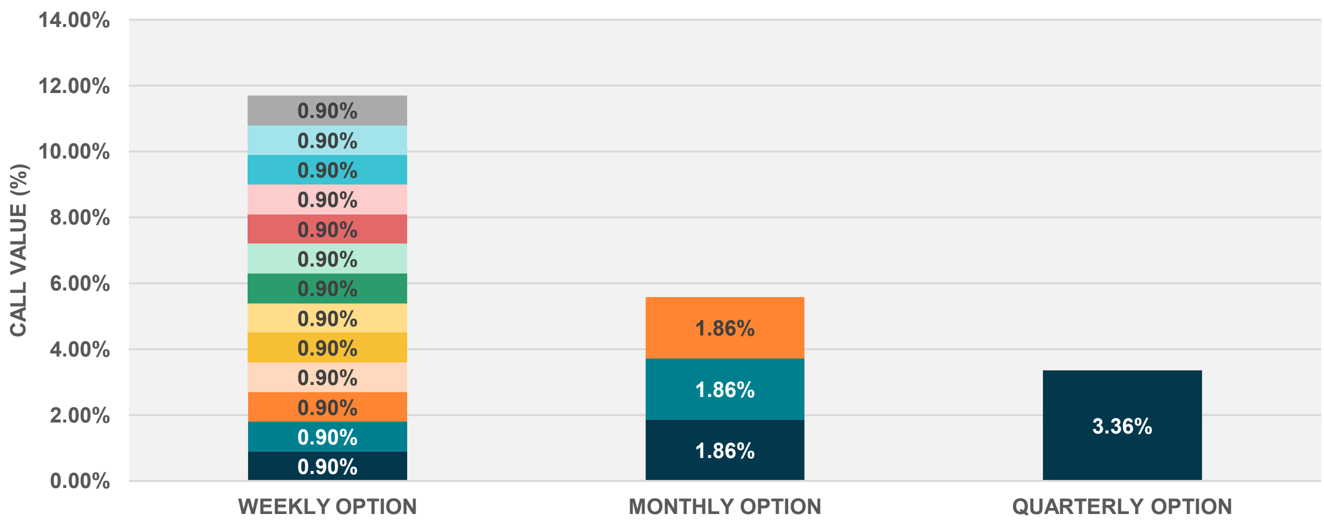
The choice of the term (time to expiration) of the option used for overwriting is also very important. An investor selling weekly options against a stockholding will be compensated 52 times a year for the risk that the stock moves above the strike price at the end of each week, compared with four times a year for an investor selling quarterly call options.

Using short-term options like weekly or monthly options can lead to a greater income opportunity as the investor agrees to forego upside on the overwritten stocks far more frequently.

Figure 11 shows values for hypothetical weekly, monthly and quarterly options using a Black-Scholes calculation that assumes a 1.79% annual dividend yield, 5% annual risk-free rate and 15% annualized volatility. Notice that the weekly call options, which can be sold four times a month (or 13 times per quarter), have roughly half the value of an option with one month to expiration (0.90% vs. 1.86%). Also, selling ATM weekly call options for 13 consecutive weeks can potentially generate 11.7% of income with the assumptions used in the example, compared with 3.36% for an ATM option sold once a quarter.

There are two key factors that investors should recognize about short-term options as compared to longer-term options. First, there are more opportunities for the investor to give up potential upside for short-term options. Second, the risk that the option is exercised is moderated somewhat by the fact that a move above the strike price is less likely within a shorter period.

FIGURE 11: AVERAGE OPTION PREMIUM FOR WEEKLY, MONTHLY AND QUARTERLY OPTIONS, AS A PERCENTAGE OF UNDERLYING



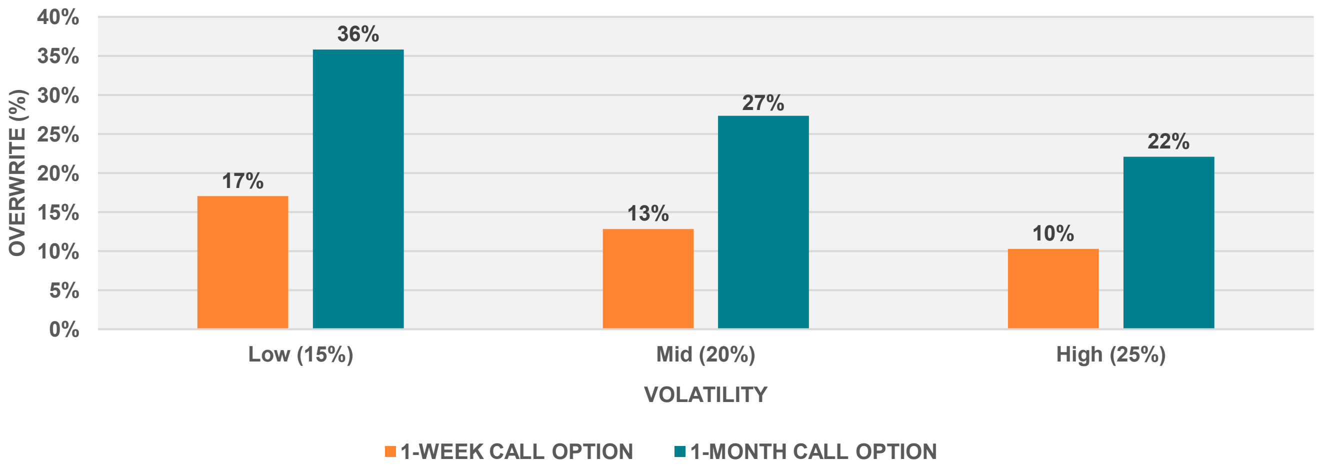
Source: Bloomberg

It is important to note that the movement of a stock price may impact the return features of short-term call options sold against it. For example, an option with a monthly expiration may end the month worthless, but if the stock has periods of appreciation during the month, one or more of the weekly options may have been exercised.

One consideration in deliberating whether to sell weekly or monthly options is that weekly options allow investors to participate in greater upside in the stockholdings if they have a fixed target for annual income. As an example, Figure 12 compares the proportion of a portfolio that would need to be overwritten with weekly or monthly options to generate 8.0% annualized income, based on the premiums collected, using a hypothetical Black-Scholes option calculation and three different volatility assumptions. Notice that for this 8.0% income target and 20% expected volatility, only 13% of the portfolio would need to be covered when writing weekly options, compared to 27% for monthly options.

Although upside potential might be capped out more frequently with weekly options, this impact would be felt on a very small portion of the portfolio. Monthly options, on the other hand, for a given volatility level, would require a larger portion of the portfolio to be covered, generating less total option premium for the strategy on an annual basis.

FIGURE 12: PERCENTAGE OF PORTFOLIO OVERWRITTEN: ONE-WEEK VS. ONE-MONTH ATM CALL OPTIONS TO REACH 8.0% ANNUAL YIELD



Source: Bloomberg

IMPACT OF TIME DECAY

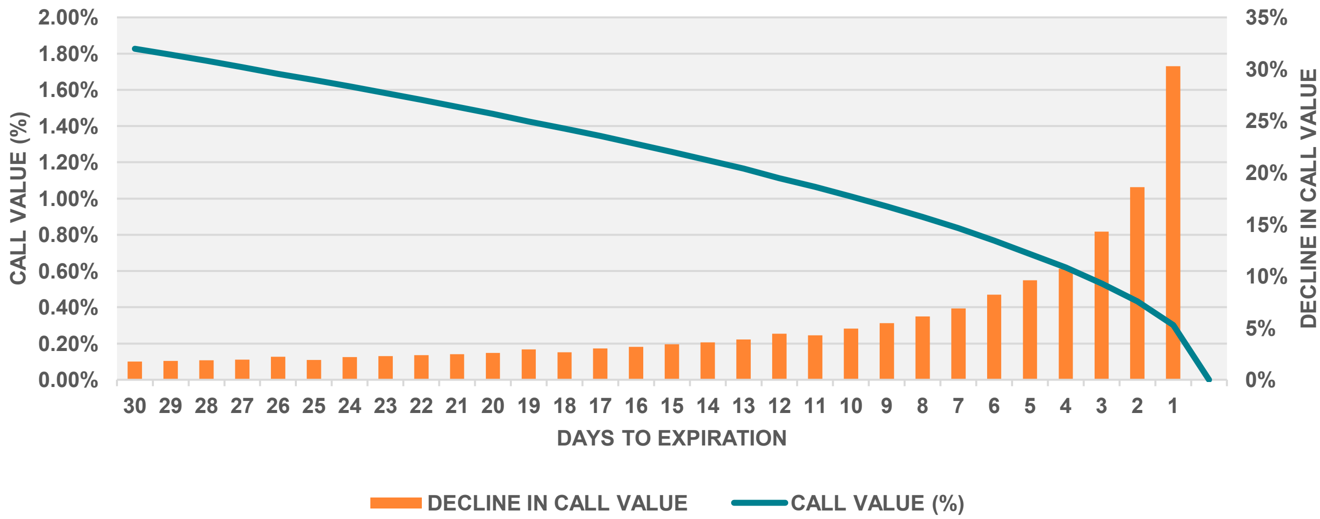
One of the reasons for the different values for weekly, monthly or longer expiration options is the extent to which the investor benefits from time decay as an option moves closer to expiration. Time decay accelerates as options get closer to their date of expiry because, as this date approaches, the chance of the investor foregoing potential upside goes down more rapidly.

This is not too different from the value that may be lost by event tickets in the time period leading up to an event. Consider a musical event that features a rock star at a venue with limited seating. The rock star's popularity means that all seats are sold out a few months in advance of the event. At such a time, a ticket holder can sell his or her ticket at a high premium to take advantage of the high demand. However, as time passes, the demand may wane as potential attendees make other plans. This will result in a drop in the secondary market price of the ticket a few days before the event. The ticket could have little to no value a few hours before the event if few people are prepared to attend the event at a moment's notice.

Figure 13 shows the loss in option value over time for an ATM call option with one month to expiration, assuming a 1.79% annual dividend yield, 15% annualized volatility and a 5% annual risk-free rate. You can see that roughly half of the option time value is lost in the first three weeks of the month, and the other half in the final week, assuming the option remains at the money for the entire period.

A covered-call writing strategy that sells weekly options captures half the time value of monthly options four times as frequently. This feature allows a Target Income Strategy that sells options weekly to generate more frequent benefits of time decay than a strategy that sells options monthly. This means that the strategy that uses weekly options can have a higher annual income target than the strategy that uses monthly options and have a smaller portion of the portfolio covered with options, allowing for more upside potential.

FIGURE 13: VALUE OF ATM CALL OPTION AS IT APPROACHES EXPIRATION



Source: Bloomberg

CONCLUSION

An interest rate environment that is challenging to fixed-coupon bonds can leave a gaping hole in the income-with-growth portion of investment portfolios. Finding investments that can bridge the gap left by inconsistent fixed income instruments in a rising-rate and rising-inflation environment becomes a high priority for investors. Investors looking for an alternative source of income that also seeks to provide growth that outpaces inflation may turn to high-dividend-yielding stocks. However, this approach comes with certain drawbacks, such as potential for lower total returns with higher volatility, high concentration in certain sectors, and potential quality issues associated with high debt levels. Target Income offers something more compelling: an investment that can provide both income and growth without compromising total returns, volatility, quality or sector diversification.

Stock selection is the primary driver of strategy returns. Combining strong stock selection with an innovative option strategy designed to achieve an income-with-growth objective is the goal of Target Income. To seek to generate price returns that are comparable to those of the S&P 500, Target Income Strategies use short-term options and vary the overwrite amount dynamically to continuously strike the balance between income and growth. By utilizing a covered-call strategy on a relatively small portion (typically less than 20%) of the holdings of dividend-paying stocks, Target Income produces a consistent level of income that is attractive relative to other fixed income investments. By implementing the partial covered-call strategy with weekly or monthly options, Target Income Strategies can "remodel" the portfolio into a higher income strategy without sacrificing growth prospects. Target Income strikes the dynamic balance between income and growth to deliver an optimal income-with-growth solution.

FOOTNOTES

[1] Source: Bloomberg, as of 2 March 2024.

[2] Volatility is a statistical measure of the dispersion of returns for a given security or market index. Commonly, the higher the volatility, the riskier the security.

[3] Dividend yield is calculated by dividing the annual dividend paid per share of stock by the current stock price.

[4] Cash flow is the net amount of cash and cash- equivalents being transferred into and out of a business.

[5] Assumes the options sold have the same characteristics, including moneyness (at-the-money), time to expiration (one month), dividend yield (1.79%), and risk-free rate (5.00%).

[6] S&P 500® Dividend Aristocrats® Index measures the performance of S&P 500 companies that have increased dividends every year for the last 25 consecutive years. The index treats each constituent as a distinct investment opportunity without regard to its size by equally weighting each company.

[7] The Dow Jones U.S Select Dividend Index is based almost entirely on dividend yield and dividend history.

[8] Target Income Strategies can sell calls against each individual stock within the portfolio or employ an index option call overwrite strategy. In an index option call overwrite strategy, call options on broad-based indexes like the S&P 500, the Nasdaq 100 or the Russell 2000 are used to generate option premiums instead of writing options on each constituent stock. Index options are highly liquid and may be used if the beta of the underlying portfolio is close to the beta of the broad-based benchmark index. Index options are sometimes preferred in Target Income if the liquidity of the underlying single stock options is poor or if many of the constituents do not have listed options available for trading. However, the use of index options introduces a degree of basis risk because the respective portfolios are not perfectly matched.

[9] The Cboe S&P 500 BuyWrite Index (BXM) is a benchmark designed to track the performance of a hypothetical buy-write strategy on the S&P 500 Index.

[10] The hypothetical call options were priced using the Black-Scholes formula (also called Black-Scholes-Merton). Black-Scholes is a widely used mathematical model for option pricing.

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