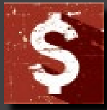

DSR PREMIUM NEWSLETTER

IN THIS ISSUE…

- Understanding covered call options
- Covered call ETFs
- Split-share corporations

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NOVEMBER 17th, 2023

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COVERED CALLS & COVERED CALL ETFs, & SPLIT SHARE CORPS

In our August newsletter entitled *Retirement and the Withdrawal Mechanics*, I described several high-income investment products, including covered call ETFs and split-share corporations. I also gave you my thoughts about their value, which can be summarized like this: I just don't think they are worth it, and I much prefer a classic dividend-growth investing strategy that will generate a higher total return.

That being said, I know that in times of economic uncertainty, many investors who are looking for safe income generation might turn to these products. I believe now is a good time to go over this again, expand on the subject, and provide you with more analysis.

UNDERSTANDING COVERED CALL OPTIONS

First, let's demystify covered call options, or covered calls for short. Here are each of these words, covered – call – option, defined in reverse order.

- **Option**: Simply put, an option is a contract. It's a financial derivative contract. This means that, in and of itself, the contract has no value. It derives its value from the value of the underlying asset.
- **Call**: A call is a type of option that allows, but does not force, the holder of the contract to buy some shares. These shares are the underlying asset of the option. If the holder of the call option exercises the option, the owner of the shares must sell them; the shares are "called away" from the seller of the option.
- **Covered** just means that when the option is written, the seller of the option already owns the shares. The option is therefore "covered" by this collateral.

To recap:

Covered	Call	Option
• Seller of option already owns the shares • Option "covered" by this collateral	• Type of option • Allows the purchase of shares • If exercised, shares are "called away" from the seller	• A contract • Financial derivative • Contract value is "derived" from the price change of underlying asset

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Details of a covered call

The person offering a covered call option is said to be **writing the option.** A covered call option gives the option holder the right, but not the obligation to buy stock from the writer of the option at a set price, within a specified period of time. In exchange for the right to buy the shares, the holder of the covered call option pays a premium to the writer of the option, who owns the shares.

For example, you have 100 shares of XYZ company that you purchased at $80/share and that are currently trading at $80. You write a covered call option granting the right to buy these shares from you at $85, at any time during a three-month period. You specify that to buy the covered call option, you want $2 per share, so $200 total.

- $85 is the option's **strike price.**
- The option's **expiry date** is in three months.
- The **premium** you ask to be paid for the option is $2 per share.
- The holder of the option can choose to buy the shares from the writer of the option at the strike price by **exercising the option** at any time before the expiry date. The writer of the option is then obligated to sell those shares.
- If the contract holder fails to exercise the option by the expiry date, the writer of the option keeps the shares in addition to having received the premium.

What's in it for the seller and buyer?

The writer of the covered call gets paid the premium regardless of whether the holder of the contract exercises their option to buy the shares before the expiry date or not. It's passive income, without any risk.

For the option writer, the ideal outcome is for the stock to remain below the strike price so that the holder doesn't exercise the option, letting it expire. The option writer pockets the premium, and still has the shares.

If the share price goes up and the option holder exercises the option, the option writer pockets the premium and makes a profit from selling the shares at the strike price. However, the profit per share earned by the option writer is capped by the strike price; it's the maximum the seller can get.

The option holder benefits if the share price surpasses the strike price before the expiry. Continuing our earlier example, let's say the stock price rises to $90 and the contract holder exercises the option, in effect buying the shares at $85, as stipulated in the covered call option. That's an immediate profit of $5 per share on paper for the option holder. The net profit from the option is:

$5 * 100 shares = $500 - $200 (premium paid) = $300

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The option holder can sell the shares immediately to cash in that profit or hold on to the stock in anticipation of a greater return in the future.

If the share price remains below the strike price and the option expires, the option holder paid a premium and received nothing in return.

In essence, the person writing a covered call option believes and hopes the stock price will not surpass the strike price, and the option holder believes and hopes that it will.

Who writes covered call options?

All shareholders can write covered call options often by using their online brokerage platform or with the help of a human broker, depending on their preferences.

Online platforms are generally cheaper, while human brokers offer personal assistance but come with higher fees. It's essential to understand the costs, risks, and requirements associated with options trading, and choose the method that aligns with your goals and preferences.

While I am not recommending a covered call option strategy, if you choose to do so, keep this in mind:

- Covered call options trade on options markets.
- You must own the shares you plan to offer in a covered call option.
- One covered call contract usually represents an option to buy 100 shares.
- The premium you specify in the option is an amount per share.
- When you put the covered call option on the market, other investors will see the strike price you set, the premium per share, and the expiry date. They might purchase the option right away, bid for it at a lower premium than what you are asking for, or pass on it completely.

Tips:

- Check the commission your brokerage firm charges for options trading: they tend to be higher than they are for trading stock on the market.
- Choose a stock that interests a lot of people, i.e., one with high trading volumes, otherwise you won’t get a bite.
- Don’t price yourself out; the premium you ask and the strike price you offer must be appealing to prospective buyers.

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- Many investors, though not all, believe it is better to write covered calls on green days, i.e., days when the overall performance of the market is positive, and the price of the shares is rising. The reasons behind this opinion are that:
  - You might be able to get higher premiums than on a day when the asset is not performing as well.
  - Writing the covered call option on a green day allows you to set a strike price that locks in more potential profit while still generating premium income.
  - The premium might partly offset potential losses, should the share price decline after you wrote a covered call option on a green day when the price was higher.

Drawbacks

Writing covered calls is a popular strategy. However, as an investor focused on the long term, I'm not a big fan. I feel that it's a strategy that essentially sacrifices long-term gains for short-term income – not a good trade-off, in my opinion.

Sure, if the stock doesn't rise above the strike price, the option holder won't exercise the option and you keep the shares and the premium. That's a win-win for you, win-win-win if the stock also paid you dividends.

On the other side though, if the share price rises above the strike price, the option holder exercises the option and buys the shares from you. You keep the premium, but you no longer have your shares, and you sold them below market price. You gave up the potential upside of the share price continuing to rise. The option premium offsets some or all of that loss, but now you have to reinvest your cash into something else. Selling covered calls is not really aligned with a buy-and-hold dividend growth investing approach.

In fact, it's almost like you're betting against the stock you own, hoping its price doesn't go up too much so that you can pocket the premium and keep the shares. I much prefer having stocks I firmly believe will increase in price, without limiting the profit I can make on them!

Also, writing covered calls means you are committed to selling the shares at the strike price if the option is exercised. Think of the shares as earmarked until they are either sold or the option expires; this limits your flexibility in managing your portfolio.

Writing covered calls is more appropriate for investors who are seeking current income as opposed to those who are trying to build wealth via dividend growth and reinvestment.

Being successful at writing covered calls can get complicated. When do you write the option, on green days or at another moment? What premium amount will appeal to other investors? What strike price do you set to entice buyers without limiting your profit too much should the share price go up? Since I like to keep it simple, it's just not a strategy that I use.

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Many companies offer ETFs that use a covered call option strategy so that income-seeking investors can benefit from the strategy while leaving its complexities to fund managers.

COVERED CALL ETFs

There are several covered call ETFs offering juicy yields. But are they really worth the risk? To answer this, let's begin by explaining how they work.

Covered call ETFs are designed to generate income for investors by selling call options on the assets they hold in their portfolio:

1. The ETF holds a portfolio of stocks or other assets, often from a specific sector, banking for example, or based on an index.
2. The ETF manager writes call options on some or all of the assets in the portfolio.
3. When investors buy call options, they pay the premium to the ETF for the right to buy the underlying assets at a specified strike price before a specific expiration date.
4. The ETF collects the premium from selling these call options, which generates income for the fund, and the unitholders.

In exchange for collecting the premium, the ETF gives up some of the potential gains from the assets in its portfolio, just like individual investors who write their own covered calls do. If the price of the underlying asset rises above the strike price of the call option and the buyer of the option exercises it, the ETF has to sell the asset at the strike price, missing out on further gains.

Usually, covered call ETFs are used by income-focused investors who want to generate regular cash flow from their investments while still having some exposure to the underlying assets.

Covered-call ETFs vs. regular ETFs

Let's compare these two ETFs, both manufactured by BMO and with a long history:

- ZEB.TO is an equally weighted ETF on the big six Canadian banks.
- ZWB.TO is a covered call ETF on Canadian banks.

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The graph below depicts the total return of each of these ETFs over 10 years. While their total returns were close early in the decade, the regular bank ETF started to outpace the covered call ETF and is now outperforming it by over 45%! That's a lot of money left on the table. Worth it? Not really.

Now, considering that banks have been on a downtrend since 2022, we would have expected the covered call ETF to outperform the regular ETF. Looking at the next graphic, we see that over the last two years, while both are very close, the regular ETF still outperforms the covered call at a time when it should lag behind.

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VAL
BMO Equal Weight Banks ETF Total Return -13.58%
BMO Covered Call Canadian Banks ETF Total Return -14.51%
Nov 06 2023, 5:40PM EST. Powered by YCHARTS

During bull markets, covered calls' upside potential is limited because stock prices going up makes it more likely that the options will be exercised. During bear market, the covered call options aren't exercised, leaving the investors with the shares + the dividend + the premium from the options. Yet, the covered call ETF underperforms compared to its underlying asset in both situations.

Let's look at another example, this time looking at U.S. index-based ETFs.

- Invesco NASDAQ 100 (QQQM) is an ETF that invests at least 90% of its total assets in the securities of the NASDAQ-100 index

- Global X NASDAQ 100 (QYLD) is a covered call ETF that invests at least 80% of its total assets in the securities of the CBOE NASDAQ-100® BuyWrite V2 Index, which is a benchmark measuring the performance of a theoretical portfolio that holds the stocks included in the NASDAQ-100® Index, and that writes a succession of one-month at-the-money covered call options.

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Note that since QQQM was created near the end of 2020, we have a much shorter timeframe for the comparison. Still, let's have a look at their total return and compare.

	VAL
Invesco NASDAQ 100 ETF (QQQM) Total Return	22.81%
Global X NASDAQ 100 Covered Call ETF (QYLD) Total Return	10.61%

30.00%
15.00%
0.00%
-15.00%
22.81%
10.61%
Jan '21 Jul '21 Jan '22 Jul '22 Jan '23 Jul '23
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Oct 23 2023, 10:58AM EDT. Powered by YCHARTS

Again, we see that the regular ETF outperformed the covered-call ETF, and now by more than 100%.

Contrary to the Canadian example, we see a better performance for the covered call ETF during down markets. However, it's never enough to compensate for when the market goes back up. The regular ETF always wins.

For more details about my thoughts on high yield covered call ETFs, I suggest you watch this video.

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Wrapping up covered calls and covered-call ETFs

Covered call strategies entail limiting the profit made from share price appreciation, almost hoping the shares don't increase too much in value. That's contrary to my preference for long-term dividend growth investment strategy.

Covered call writing can generate passive income and boost total return occasionally; while that is alluring, we've seen clear examples of non-covered call investments doing much better than their covered call counterpart.

SPLIT-SHARE CORPORATIONS

Split-share corporations are specialized investment corporations created primarily to provide investors with a choice: a regular income stream or the potential for capital appreciation. They do this by splitting their shares, hence their name, into two classes.

A split-share corporation is created by purchasing a diversified portfolio of common shares of other companies, often blue-chip stocks. Then, the corporation issues shares:

- Preferred Shares: usually offer regular dividends, have a set redemption value, and take precedence over other shares if the company is dissolved.
- Capital Shares (or Class A): are more volatile but provide potential capital appreciation. They receive the residual value after preferred shareholders are paid in full. They can show high returns if the portfolio appreciates, and large losses when the reverse happens.

Using the dividends of the underlying portfolio, split-share corporations pay the preferred shareholders first. They reinvest excess dividends into the portfolio or distribute them to capital shareholders.

Split-share corporations usually have a maturity date, when their sell their assets, and pay the proceeds to shareholders. Again, preferred shareholders are paid first, up to their original investment plus accrued dividends. Remaining funds go to capital shareholders.

Some split-share corporations use derivative strategies, such as options, in their investment strategy.

Advantages and drawbacks

Advantages of split share corporations include the choice between a more stable income or potential capital appreciation, tax advantages for some investors due to how the income is distributed, and potential for high income, provided the company pays.

Unfortunately, they come with many risks. Not immune to market fluctuations, both preferred and capital shares can suffer if the portfolio's stocks drop, with capital shares being the most vulnerable.

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With an under-performing portfolio, many shareholders could decide to redeem their shares, forcing the company to sell assets at an unfavorable time; capital shareholders might not recover their full investment upon the corporation's maturity.

Split-share corporations often borrow to purchase assets, which amplifies both gains and losses based on asset performance vs. interest rates and heightens the volatility of capital shares. Poor-performing assets can also hinder loan repayment and affect the corporation's credit rating.

Rising interest rates can devalue their portfolio just as fixed-income options become more attractive to investors.

Examining some split share corps

Let's look at how these two split share corporations have performed for class A share investors: Financial 15 Split Corp (FTN.TO) and Brompton Split Banc Corp (SBC.TO).

First, let's see what Financial 15 Split Corp is all about. On the company's website, FTN.TO is described as: *"…a high-quality portfolio consisting of 15 financial companies made up of Canadian and U.S. issuers*". With a yield of 24.8% as of October 24, 2023, sounds great! Well, that yield jumped recently because the share price dropped about 33% since the summer. From mid-2022 to earlier in 2023 the yield was ~16%. Still sounds promising…

Digging deeper, you find this in their 2023 annual information form:

- *"Up to 15% of the net asset value of the Company may be invested in equity securities of issuers other than the Portfolio Companies."*
- And: *"To supplement the dividends earned on the Portfolio and to reduce risk, the Company will from time to time write covered call options in respect of all or part of the Portfolio."*
- It goes on to mention writing cash covered put options or purchasing call options, purchasing put options to protect itself from declines in the market, trading to close out positions, using derivatives for hedging purposes, etc.

In English: on top of what's in the portfolio, there could be 15% of "mystery" equities. It's up to option strategists to work their magic to generate astronomical income.

How did FTN.TO work out for investors in Class A shares? Well, the monthly distribution remains unchanged since September 2008. Oh, it also skipped 34 monthly payments between September 2008 and December 2020, including 18 consecutive months starting in 2012 (source).

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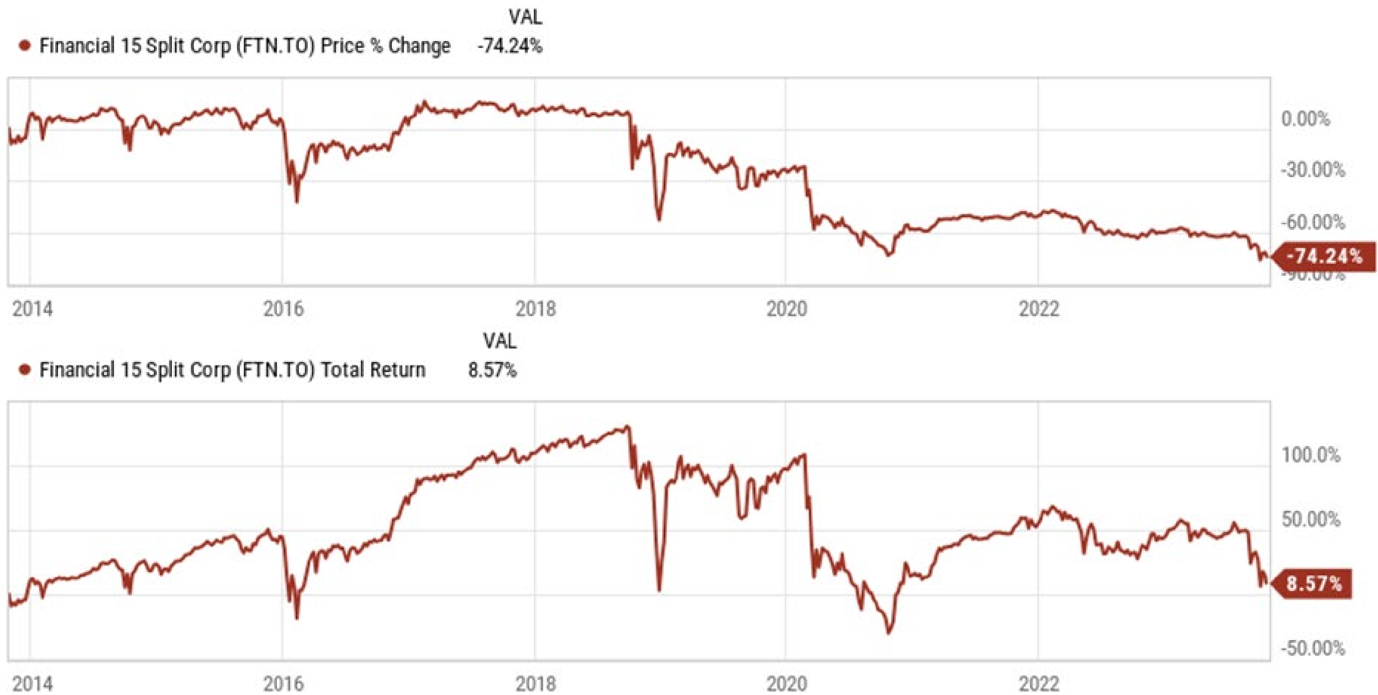
Add to that a total return over 10 years of 8.57% and a share price dropping more than 74%. So, not well *at* all.



What about the preferred share investors? Did it work out better for them?

Well, over the last 10 years, the price of the preferred shares has been stuck, hovering around $10/share. The yield went from 5.25% in 2013 to 7.5% today. So overall, a yield increase that just about covers inflation with not stock price appreciation.

In the next graph, we compare the 10-year total return of the Financial 15 Split Corp preferred shares with three ETFs: the iShares ETF that tracks the performance of the S&P/TSX 60 Index, the BMO Equal Weight Banks ETF, and the iShares ETF that tracks the performance of the S&P/TSX Capped Financials Index.

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	VAL
Financial 15 Split Corp. II Total Return	76.78%
iShares S&P/TSX 60 ETF Total Return	108.8%
BMO Equal Weight Banks ETF Total Return	114.3%
iShares S&P/TSX Capped Financials ETF Total Return	109.4%

120.0%
114.3%
109.4%
108.8%
76.78%
60.00%
0.00%
-60.00%

2014 2016 2018 2020 2022

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Nov 06 2023, 6:02PM EST. Powered by YCHARTS

So even the preferred shares underperformed both the market and traditional investment products with the same holdings! While the total return for the split share corporation's preferred share is not bad, investors still left a lot of money on the table.

Let's turn to another split share example, Brompton Split Banc Corp. (SBC.TO). Its portfolio is approximately equally weighted in common shares of Canada's Big Six banks.

The 2023 annual information explains that the company might:

- Hold up to 10% of the total assets of the portfolio in investments in global financial companies for the purposes of enhanced diversification and return potential.
- Selectively write covered call options and cash covered put options from time to time for the securities included in the portfolio to generate additional distributable income.
- Invest a portion of the portfolio's assets in exchange-traded funds in addition to, or instead of, investing in Canadian banks and/or global financial companies directly. This includes investing in ETFs managed by Brompton, but without duplicating the management fees.

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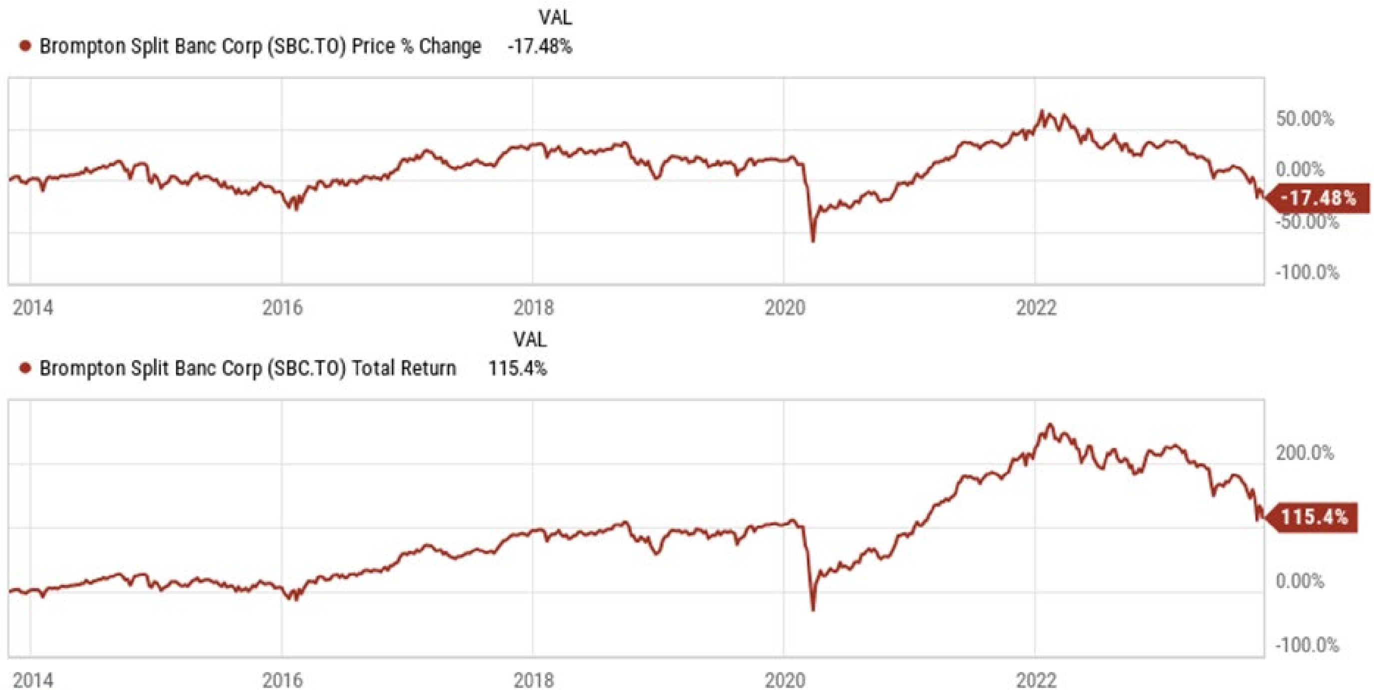
How did it perform for Class A shareholders? Total return over 10 years is 115%, with a share price decline of 17.5%. Investors benefited from two stock splits (in April 2017 and in December 2021). The distribution amount remained at $0.10/share monthly throughout the period, but the stock splits increased the distributions received.



Oct 23 2023, 10:58AM EDT. Powered by YCHARTS

As of Oct 24, 2023, with SBC.TO closing at of $7.39, the yield is ~16%. SBC.TO performed much better than FTN.TO. Its 10-year total return even surpassed that of the ZEB.TO equally weighted Canadian banks ETF we mentioned earlier (115.4% vs. 108.9%).

So, we've looked at a split share corporation with dismal results (FTN.TO) and one that has done well overall, but still no share price appreciation which is readily available with more classic investments. There's no free lunch when investing. We must be cautious when looking at appealing yields and remember that decent total returns are quite rare with split share corporations.

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CONCLUSION

Covered call writing can generate passive income for investors, but the strategy has disadvantages: it caps the profit investors make from stock price appreciation and doing it right can be a lot of work. Add to that that it does not align with a long-term dividend growth investment strategy, and you see why it's not something I use or suggest.

Covered call ETFs aren't the worst product ever created, but they fail to provide added value compared to index or dividend growth investing. Unfortunately, focusing on income products often means leaving a lot of money on the table.

Split share corporations often use complex options strategies to generate their high yields, which might work, or not. Some do well when the market is moving up, not so much when things get volatile. From what I've observed, I feel that these aren't products to expose your hard-earned savings to at all.

In the end, you are better off with a classic investment strategy that will generate a higher total return.

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RATING CHANGES

This section communicates rating changes on the most popular stocks held at DSR. The changes mentioned below happened during this week upon our latest review.

COMPANY	SYMBOL	PREVIOUS RATINGS (PRO/DIV)	NEW RATINGS (PRO/DIV)	COMMENT
Lockheed Martin	LMT	3/4	4/4	We reduced LMT's rating after an important stock price jump. The stock price has been stagnant for a while now and the rise in political tensions around the world leads us to think military budgets won't slow down anytime soon.

The information contained within this report is for informational purposes only and it is not intended as a recommendation of the securities highlighted or any particular investment strategy; nor should it be considered a solicitation to buy or sell any security. In addition, this information is not represented or warranted to be accurate, correct, complete, or timely. The securities mentioned in this report may not be suitable for all types of investors and the information contained in this report does not constitute advice. Before acting on any information in this report, readers should consider whether such an investment is suitable for their particular circumstances, perform their own due-diligence, and if necessary, seek professional advice.

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OVERALL PORTFOLIO PERFORMANCE

Listed Returns are as of November 16th, 2023:

Portfolios	Inception Date	Return	Benchmark	Added Value	Annualized Return	1 Y	YTD
CAD 25K	10/31/13	193.79%	119.13%	74.66%	11.22%	9.72%	10.21%
USD 25K	10/31/13	159.17%	172.39%	-13.22%	9.85%	2.94%	2.42%
CAD 100K	10/31/13	126.28%	119.13%	7.15%	8.39%	8.62%	7.76%
USD 100K	10/31/13	204.10%	172.39%	31.71%	11.60%	13.04%	10.31%
USD 500K	05/31/14	103.74%	140.65%	-36.91%	7.81%	7.54%	3.81%
CAD 500K	05/31/14	115.92%	92.24%	23.68%	8.47%	6.04%	4.02%
100% CAD	07/31/17	75.02%	41.56%	33.46%	9.43%	8.44%	9.58%
Retirement CAD	07/31/18	25.44%	30.79%	-5.36%	4.37%	-4.99%	-2.03%
Retirement USD	07/31/18	51.85%	63.60%	-11.75%	8.20%	0.90%	-0.58%

*Canadian portfolios added value is calculated based on 50% of VIG and 50% of XDV as half of portfolios are US stocks. Currency hasn't been taken into consideration.

Benchmarks are VIG and XDV.TO for all portfolios.

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