

# **COVERED CALL JUICE**

## **MARCH 2005**

***“How did you know that tech stocks were going to collapse?”***

That is a question I have peppered with countless times over the past five years. I have answered it politely in many different ways always doing my best to use humor and metaphor to soften the blow. Now that we have just passed the five year anniversary of the NASDAQ peak, 5,048.62 on March 10, 2000 I feel it is safe for me to ask a few questions that I've had a burning desire to ask for years...

***“What were you thinking?”***

***“Did you really think that pet stores online and virtual grocery stores were prudent long-term investments?”***

***“Did you believe that Stewart the Ameritrade guy, Al the tow truck driver that owned his private island, were real?”***

***“Did you really believe that earnings didn't matter?”***

Anyway, let's not live in the past, let's learn from it. We have been preaching that overall equity growth is going to be nothing more than average for an extended period of time. Sluggish equity growth, historically low interest rates and less than stellar (yet improving) dividend yields I believe is in the cards for a long period of time. Some of the best and brightest including Warren Buffett, Steve Lehman, John Templeton, Roger Ibbotson and Jermy Siegel have forecasted annualized market returns of 6-7% for the next 20 to 30 years.

In an effort to inject some ***“juice”*** (not to be confused with BALCO, Barry Bonds or Jason Giambi) into our clients' portfolios we have utilized time-tested measures such as preferred stocks, leveraged dividend funds and covered calls. Covered call options have been a tool used by the super wealthy for years. Covered call options have generated income from call premiums, they raise portfolio yield, and provide downside protection. This seldom used strategy (they don't teach this in dimwit stockbroker school) is quite simple to put into practice. Investors who own shares of a company or certain exchange-traded funds can sell the right to buy those shares at a predetermined price (strike price) for a specific length of time (exercise period).

For example:

Barry B. buys 1000 shares of BLCO for \$20 a share on March 1st. Barry B. wants to sell his BLCO for \$24 a share. To create some additional income (juice) in his portfolio Barry B. sells covered call options with a \$24 strike price with an exercise period of the third Friday in August. The buyer of that option pays Barry B. \$1.50 a share earning him \$1,500 in additional income which is pocketed and can be reinvested on March 1<sup>st</sup>. If the price of BLCO rises to \$24, then Barry B. gets the \$4000 in capital appreciation he had hoped to get from BLCO in the first place plus the additional \$1,500. If BLCO is at \$22 on the third Friday of August Barry B. can write another option generating income once again or sell his position. By writing covered calls Barry B. can limit his downside as well. If BLCO drops in value to \$18 a share Barry B's loss is a total of \$500 because of the option premium he received.

The drawback of writing covered calls is the call writer gives up any capital appreciation on the securities above their strike price. Investors are exchanging income today for further capital appreciation in the future. In a period of lower equity growth this is not as much of an issue, aside

from the fact that setting parameters is a good thing (*a little Martha humor*). If writing covered calls helps investors and portfolio managers to set goals for their positions I am all for it. My efforts in futility, (trying to get people to take a profit during the 1990's) were like pulling teeth. ***"I don't want to sell; \_\_\_\_\_ said its going higher."*** Billions were lost on that sentence alone.

Many investors that do not own common stocks that are primarily mutual fund owners have been left out of this strategy for some time. In fact, the overall management of the bulk of funds lately has been horrible at best. A covered call strategy involves work and many mutual fund managers would rather be playing golf. In fact, the number of actively managed equity funds that are nothing more than closet index funds has tripled in the past four years according to Morningstar. At the conclusion of 2004, 27.6% of all large-cap funds had a three-year R-squared of 95 or higher. R-squared measures the strength of a statistical relationship. The higher the number, the closer the relationship between two variables. A fund is highly correlated to the S&P 500 if its R-squared reaches 90. 95 is a closet index fund. (For further explanation of r-squared contact Matthew Markowski, matt@minvest.com, he is our family's math nerd.)

***"Why pay more for little to no work?"***

Did you know that the R-squared of American Funds Growth Fund of America has an r-squared of 93.25 or the Fidelity Magellan Fund with an R-squared of 98.83! These managers for the most part are spineless. Their large-cap funds are nothing more than an index fund with a fancy logo and a high expense ratio. Chet Currier, columnist for Bloomberg put it very eloquently when he states...

***"In the whole world of money management, few things are so widely despised as the practice known as closet indexing. It shrinks from making tough decisions. It substitutes artifice for skill. Then it asks to be paid as though it delivered a service it only pretends to attempt. In simplest terms, managers of closet index funds operate in the guise of active stock-or bond-pickers, but don't really aim for superior absolute returns. Instead, they seek to preserve their jobs by sticking close to the up's and downs of whatever index or other benchmark their work is measured against. They will never excel, and that is just the point. By hiding in the middle of the herd, they protect themselves from being singled out either for acclaim or blame."***

Finally, coming to market over the next 30 days are two mutual funds that are conservative in nature, but will actually put the work in to achieve a greater yield for the investor. What if I were to tell you that there is an S&P index fund coming that will employ the covered call strategy and have a **yield of 10%**? How about a global equity fund that utilizes the same covered call strategy and will be **yielding 9.5%**. Well...I am. If you have not utilized the covered call strategy (the juice) I strongly recommend you doing so, or you could always stick with your current lackluster performance with portfolio managers that are more concerned with their golf handicap. The choice is yours!