Chandler Nichols

Episode 1: Covered Call ETFs, with Chandler Nichols of Global X ETFs

GUEST Q & A

Madie: Welcome to our first episode of Assets Under New Management, an insuranceaum.com series. My name is Madie B, and I'll be your host. We're joined today by Chandler Nichols, product specialist at Global X ETFs. Chandler, thanks so much for being on.

Chandler: Awesome. Thanks for having me, Madie.

Madie: Just as a reminder to everyone, Assets Under New Management is a new podcast designed for fresh faces, fresh voices, and fresh ideas. Today's topic is covered calls and the format of this podcast is to ask questions on the topic. I'm relatively new to this industry and to InsuranceAUM.com. I'm learning so much on a daily basis and I'm incredibly grateful and excited to learn more from my guests on this podcast. Tell us a little bit about Global X ETFs.

Chandler: Yeah, no, definitely. A little background on the firm, so we were founded in the midst of the global financial crisis, towards the tail end, so towards 2008, 2009. We launched our first ETF in 2009 in which we actually were founded upon an international access-based ETF. Our first ETF we've ever listed in the United States was actually a Columbia ETF, and we've grown a lot since then. Today we are a 40+ billion dollar asset manager in the United States. We have a headquarters in midtown, New York. We're a wholly owned subsidiary of one of the largest asset managers in Seoul, South Korea, Mirae assets, so we've grown substantially since our founding and we're very well known in the thematic ETF space. We have a lot of ETFs within that particular realm. We're very much a leader there, but we're also a leader in the alternative income space as well, so covered calls, preferred stocks, which I know was a topic in previous podcasts here, so yeah, hopefully that gives a good background there for the viewers.

Madie: That's great. Thank you so much. And I'd like to ask you a personal question right off the bat to just learn a little bit more about you before we dive into your questions. Any pets, kids or hobbies you care to share?

Chandler: In terms of personal, I don't have a kid right now, but I do actually have one coming in the next two months, so very excited for that. Yeah, I know we're definitely getting ready. We're having a little baby girl in mid-February, and yeah, excited to see with that, how that changes our lives and I'm definitely very, very excited to be a dad.

Madie: Wow, congratulations. That is so exciting. Amazing. And how did you end up where you are today?

Chandler: I started my career in asset management in 2018 at BlackRock in which I ended up working as an ETF due diligence analyst at a broker-dealer called Oppenheimer & Company, and really got my legs wet in the overall ETF industry in the ecosystem, fell in love with the industry and ended up at Global X, have been here for close to two and a half years now since 2021, and really excited to be a part of the pretty substantial growth that we've had thus far since I've been here. Definitely, it's been a pretty nice journey.

Madie: Thank you. And for anyone who doesn't already know, can you briefly define what a covered call is? And, why do people write covered calls?

Chandler: Yeah, so that's definitely a good question and it comes down to really two key components there. It's also known as a buy-write strategy in which the owner of a specific asset, albeit an equity or stock index via an index fund in which while owning that underlying long asset, that same long owner will write a call option in which that option is represented by that same underlying asset in which they already own. It's a two-pronged process. You have two main components there, the long stock or long index-based strategy portfolio with that sold call option on top of that. That's the main components behind what a cover call strategy essentially is comprised of. In terms of why investors do that, essentially it's a game of trade-offs in the option space, so forfeiting a level of upside participation, you're selling a call option on an asset you already own as a means to generate premium.

Typically these premiums are received as a means to generate income within a portfolio, so being able to monetize the valuations and the volatility of that underlying asset as a way to generate income, albeit that also comes with, you're still getting the downside participation of that long stock reference asset that you're owning in the portfolio. However, that premium can also provide a level of risk management capabilities as well, so the two main components of reasonings as to why an investor might write cover calls, typically the main reasoning is going to be for income, elevated income potential, as well as those types of potential risk management capabilities as well. Yeah, hopefully that helps clear that up for the listeners there.

Madie: Thank you so much. Given the current macro environment, what is your outlook for the market and why might covered calls be considered now?

Chandler: Yeah, no, definitely happy to dive into that. I'm going to break this apart into really three parts here in terms of one, I'm going to go over the overall macro environment as to what we're seeing and what potential capital markets expectations we might see going forward and how covered calls potentially fit into a portfolio to prepare oneself and their portfolios for the types of capital markets expectations that we believe could potentially ensue. But to start off with the first item, 2023 was a very good year for equity markets. We saw very positive growth and a rebound in the S&P 500 and the NASDAQ 100. However, those two indexes are still below peak levels, so there's definitely some concerns from a macro standpoint. However, we do have a general outlook that there is potential for an economic soft landing.

In terms of where we might be at in the business cycle, we believe that potential is that we are in a slowdown phase. However, we think stable growth can continue via that soft landing given some of the positives that are still occurring throughout the overall macro economy. You have unemployment below 4%, corporate credit spreads have tightened pretty nicely, and the US consumer is still pretty strong, so we think there's definitely some positives there. Naturally there are risks. You have corporate margins having fallen from their peaks, given some of the stickier levels of inflation still being around such as elevated wage inflation. However, we think companies were well-prepared for the vast amount of interest rate hikes that occurred throughout 2022. The weighted average cost of debt for S&P 500 companies was below 5% as of the recent data, so being able to be prepared for that and having lower costs of debt lower than what you can get from say a T bill right now is definitely a nice level of preparation taken by some of those companies within that particular index.

Actually, it's definitely a good timing in which we're doing this episode because we got some news on Wednesday from the Federal Reserve that the potential for rate cuts may occur in 2024, so that brings about a whole new slew of potential opportunities from a capital market standpoint, but also things to be aware of moving forward. Why are they looking to cut? The Federal Reserve has a dual mandate, price stability and maximum employment in the economy. The potential for those rate cuts to occur might be a level of pivoting towards their seeking out of keeping unemployment as minimal as possible. In terms of how we view the potential impacts on capital markets expectations moving forward, as I mentioned earlier, 2023 has been a pretty good year for equity markets, but valuations are actually pretty stretched right now. Forward price-to-earnings ratios in the S&P 500 are pretty elevated.

From Bloomberg actually, as the end of November, the forward PE ratio of the S&P 500 index was 21.12x versus its 10-year forward PE average of 19x. And we measured that timeframe from November, 2013 to November of 2023. Most of that's been driven by tech. Given the AI story we've seen in recent times, we believe that the potential for the other players and sectors in the market such as your low volatility type equities, defensive sectors and quality-based types of equities might be able to resume and catch up to some of the performance we've seen out of those mega cap tech-oriented equity-led companies.

But a couple other things we're keeping an eye on, and I think this pivots over into the final part as to why we think covered calls might be interesting now, equity to fixed income correlations are still pretty elevated are one thing to consider. Ever since inflation increased and the Federal Reserve was raising interest rates, their correlations are much more elevated than where they were pre-COVID, which having some type of options overlay such as selling volatility might be able to provide a level of diversification from an income standpoint as well as from an asset class standpoint. VSM data we have from Morningstar Direct measured with monthly returns and a 12-month rolling shift average correlation from 2015 to 2019 between the S&P 500 index and the Bloomberg U.S. aggregate bond index for actually in the negatives at -0.1, but when analyzing those same correlations in the same manner from 2020 to the end of November of 2023, average correlations were 0.5, so positive correlations. Definitely a level of consideration to have.

But in recent news, given the fact that the Federal Reserve is now starting to potentially telegraph that they might seek to cut interest rates in 2024, you might start seeing a trickling of outflows from money market funds and the differing types of risk on types of asset classes. Covered calls might be one of those given the overall income potential that can be had within this particular type of strategy, specifically on an equity index or some type of equity-like asset. Just to close this off in terms of potential use cases for an equity-based covered call strategy in this environment, one is that there's still a lot of unknowns in the macro economy from the potential for more range bound to flat market, given some of those valuation concerns. We believe it could potentially occur in 2024 given some of those stretch valuations, particularly within the tech sector, so being able to potentially profit from flat and choppy markets via the reception of call premiums could be pretty enticing. And then the second part from a strategic allocation standpoint is the differentiation of incomes.

You can get income mainly from bonds and equities, those tend to be the two most common ways, but the reception of equity dividends are going to be derived mainly based off balance sheet health or the income statement health of a particular company within some of those types of strategies. Typically during times of economic uncertainty or economic stress, you see higher levels of dividend cuts, so that's something definitely to be aware of. And then on the fixed income side of things, so your overall income's going to be derived based on the level of interest rates, so being able to diversify out of those two differing income streams into a covered call strategy by monetizing volatility, selling volatility via a covered call strategy could be a nice opportunity there, and definitely one of the key use cases that we've seen in recent times for these types of strategies.

And then final note, certain US-based market cap weighted equity benchmarks become more concentrated in a handful of companies, albeit the magnificent seven. You have the potential for those indexes to potentially exhibit elevated levels of volatility given some of those concentration risks there, that being the S&P 500 and the NASDAQ 100, for example. We believe selling volatility on those particular indices might be an enticing strategy given some of those concentration risks there.

Madie: Thank you so much. It's a great, thorough answer. And so let's say I'm an insurance investor, what would be my avenues of access for covered call strategies?

Chandler: Yeah, so there's definitely a lot of ways one can implement a covered call strategy. One, naturally like a separately managed account, but what we tend to see the most often in terms of what we've seen from a utilization standpoint is within the 40 Act wrapper. Within the 40 Act wrapper you have ETFs, closed down funds and mutual funds. ETFs in particular have seen a lot of substantial growth lately, given the overall potential benefits from a tax efficiency standpoint, the transparency of the ETF of daily transparency, and that's actually seen from what we've seen from a broader landscape perspective. We've seen a lot of flows go into these types of derivative income strategies, particularly within the ETF ecosystem relative to those other two 40 Act wraps. Albeit though we have seen growth throughout the entirety of the 40 Act, really throughout the entire 40 Act landscape as an avenue of access for these types of strategies, so those tend to be the most popular. Given it's all public equities, the underlying tends to be pretty liquid, so definitely has been a key driver there.

Madie: Okay. Okay, thank you. And since ETFs have been a key area of growth for derivative income strategies, can you tell us why that is?

Chandler: Yeah, so I think that goes back, and I was going into it earlier, mainly the benefits of the ETF wrappers, the potential tax efficiencies of the ETF wrapper, their daily transparency, and honestly just the vast amount of strategy types that we've seen within the ETF wrapper. There's been a lot of differing types of derivative income and risk management oriented strategies. We have a landscape of well over 300 ETFs throughout the entire derivative-based ETF landscape, so that comprises of derivative income strategies across buyer strategies, put-write strategies, what have you, but also different types of collar-based strategies for risk management purposes. I would say that's been one of the more key reasons as to why we've seen a lot of growth within the ETF wrapper is really just because of the vast amount of innovation we've seen within the overall space, and we're still seeing a lot of that even happen.

One, interest rates were still high in 2023 and throughout 2022 as the Fed was raising rates pretty rapidly, and that naturally in terms of the questions we got from clients was derivative income strategies, they're meant for high income, however, rates are higher now, why not look at fixed income? However, flows actually have still substantially gotten into these strategies because of some of those secondary factors that I was talking about earlier from a risk management standpoint as well in terms of being able to receive call premiums as a way to lower your beta to the overarching equity markets. Flows still continue to occur within this space and we're really excited to be a part of this growth. In fact, I was actually just looking at it earlier, so as of the end of November, 9% of all U.S. ETF landscape flows have gotten into a derivative-based strategy, so the overall landscape has seen a lot of growth and we're really excited to see that transpire moving forward.

Madie: Can you tell us what a passive ETF is and why it might be an attractive way to obtain exposure?

Chandler: Yeah, so within a covered call type of ETF or covered call strategy that's passively managed, the one key thing here is the systematic nature of this strategy, so being able to have an elevated level of transparency as to what is exactly going on from how the portfolio is being managed is a key way as to why investors may seek to implement a passive-oriented strategy. Passive ETF means index-based, so it is tracking an index similar just as like SPY tracks the S&P 500 index, a derivative-based strategy that's passively managed would track passively an index-based covered call or put-write strategy depending on what the strategy is doing. But that ease of implementation in terms of how an investor can utilize a passive strategy in a portfolio might be potentially attractive because of that rules-based methodology. You have a level of anticipation as to what the underlying stocks that are going be held within the portfolio and what those are going to be.

And then also the overarching options overlay as well, which is the most intriguing standpoint of these index-based strategies, naturally. How are they going to be rolling their options? What's going to be the time to expiration for those options? What level of moneyness are they going to be running those options or what level of money are they going to be running those options at? Being able to have those knowns, we've seen that has been a key benefit as to why investors typically seek out a passive-oriented strategy in this space. One, given the complexities of options, trading options is definitely a complex area, being able to outsource that to a very systematic type of strategy can be beneficial from an ease of implementation standpoint, as well as you're also, and I think this is actually one of the more understated areas, is that stock portfolio as well.

A lot of different types of passive ETFs may own the underlying basket of a well-known stock index, say like the S&P 500, the NASDAQ 100. These are bedrock benchmarks throughout the overarching ETF landscape, throughout the overall asset management industry, so being able to maintain core exposure in your equity sleeve of an options-based strategy and then write differing types of index options as a way to do that could be particularly beneficial within a passive ETF, which is typically how we've seen these having been implemented throughout the entire ecosystem. Again, I think it really does come down to that systematic nature. You know what you're getting and you know what you're not getting from these strategies, which make the ease of implementation a lot easier.

Madie: Thank you so much. You explained that really well. And can you tell me a little bit about the covered call ETFs at Global X? What are the main characteristics?

Chandler: 100%. At Global X we have a whole suite of covered call ETFs. These are all rules-based passively managed ETFs, so wanted to set the stage with that. Our most popular ETFs within the space are typically what we call our 100% covered or fully covered buy-write strategies, and I'll dive into what exactly that means. I'll actually use one as an example if that's okay. Our largest ETF within our lineup is our NASDAQ 100 covered call ETF. Now, I'm using one as an example because it actually represents the same exact strategy that's utilized throughout all of the others and via the rules-based index for our NASDAQ 100 covered call ETF it's very simple.

You have two sleeves of the portfolio, you have that stock index and then that options overlay. The stock index that we're tracking there is the NASDAQ 100 index, we'll own the underlying stocks outright, we'll follow the rules and methodology of the NASDAQ 100 index as we do for all of our other covered call ETFs, in which on a monthly basis that particular strategy will write at the money index options utilizing NASDAQ 100 index options in perpetuity on the third Friday of every month utilizing SIBO-listed NASDAQ 100 index options. We're not writing the calls on each individual position, we're utilizing index options as a way to systematically implement that strategy, so we do this for a whole slew of differing types of ETFs on our platform. We have one on the S&P 500, Dow Jones Industrial Average, even emerging market equities as well, so we have a whole slew of strategies within this space.

And one thing to note, as I mentioned, these are what we call 100% covered, so one thing to note is that the index options we're writing are always at the money, meaning that the strike price upon the call option roll date is expected to be at a very similar level to that of the current market price of the underlying reference index on that date. Essentially you're forfeiting the upside participation of the reference asset as a way to maximize the potential premiums that can be received from those strategies in which we're covering 100% of the notional exposure of the net assets with those options, so that's what I mean by 100% covered.

The other portion of our lineup, it's a smaller area of our lineup, but definitely have started to see traction, and is our covered call and growth lineup. These actually operate in the same exact way as our other ones, so we have a NASDAQ 100 covered call and growth ETF that operates exactly like QYLD. However, the only difference is that we're covering half of the notional exposure with those at-the-money calls in order to, one, you're forfeiting essentially only half of the upside, you're still able to receive half of the upside participation in the reference index, albeit you're trading off relative to its fully covered call ETF counterpart, you're trading off a level of the premium income that you would be expected to receive. The overall arching platform has definitely grown, and we're really excited to see the continuing growth within our overall ETF lineup.

Madie: That's really impressive and you did a great job of explaining that. Thank you so much. Once again, let's say I'm an insurance investor. Can you give me some examples as to how a passive covered call strategy can be implemented within a portfolio?

Chandler: Yeah, so I'm actually... I'm going to set the stage here, one, in terms of performance expectations, so that's one thing that we typically get asked about our covered call ETFs, but naturally with all covered call strategies too. In terms of how you can expect a cover call ETF to perform, really three market scenarios. One, an uptrend in market scenario, especially a prolonged up trending market environment, you anticipate that a covered call, especially a passively managed cover call ETF, has the potential to underperform the reference asset over that timeframe. Again, you're forfeiting upside participation to receive elevated premiums. However, it's flat and choppy in down trending markets in which these strategies have the potential to outperform during. Flat and choppy markets, that's naturally the... We call it the Goldilocks zone for out performance potential. Again, a lot of passively managed ETFs, you're getting that one-to-one exposure to the stock portfolio, so if that's flat but you're receiving premiums on top of that, that can generate the potential for out performance there.

And then on a downside participation level as well, so down trending market environments, again, you're getting all of the downside risks of the equity stock portfolio. However, those premiums can provide a nice level of mitigation for downside volatility there. 2022's challenging equity market returns were a recent example of this. That I think sets the stage in terms of how we've seen these being utilized within an overarching portfolio, so within a multi-asset portfolio, meaning you can think of it as a balanced 50-50 or 60-40 portfolio, we've seen investors utilize these in a key way here. One, again, these are talking about mainly equity-based covered call ETFs, we've seen investors chip away portions, and this very is definitely generalized, it's going be based on a portfolio per portfolio basis.

We've seen clients chip away portions from both of their fixed income sleeve and their equity sleeve as a way to add a volatility risk premium strategy, such as a covered call strategy to their portfolio. They're essentially shaving away differing portions from both of those sleeves as a way to make room for this type of alternative income strategy, and there's key reason as to why we've seen this occur. One, relative to their equity benchmark, they're not getting nearly the same amount of upside as the plain vanilla equity index, so the equity risk premium you're getting out of a covered call is expected to be lower than that of a plain vanilla equity benchmark. However, their standard deviations and risk metrics tend to be lower than that of the equity benchmark too. That scenario tends to be flipped relative to fixed income, whereas in an equity based covered call, passively managed strategy, you're taking on the equity risk, so you're expected to receive a higher level of volatility relative to that of a typical fixed income strategy like high yield bonds, core bonds, et cetera.

But you're also receiving that volatility risk premium and a small level of equity risk premium on top of that, so being able to have a higher level of out performance potential of a higher level of expected returns in a covered call strategy essentially provides a nice balance there relative to both the fixed income side and the plain vanilla equity side of things, which is why we've typically seen investors do that particular type of strategy in their portfolio in which on the, specifically within the equity income sleeve, we've seen investors, and this goes for... It's going to depend on the type of passively managed strategy, but for say an at the money covered call strategy, again, for that type of strategy, you're not getting any upside participation that you're receiving elevated premiums on top of that.

There's a well-known there and a well... You know what you're getting, you know what you're not getting there, you know that the upside participation is being forfeited, but you're receiving premiums on top of that. We've seen investors pair those types of strategies, say with a similar or even precise equity growth strategy that has a similar long stock profile as the covered call strategy that they're pairing it. Say like Russell 2000 covered call, at the money covered call strategy with a Russell 2000 plain vanilla type of index tracking strategy as a way to create an incoming growth and growth blend in an equity portfolio. Those have really been the two key ways that we've seen these types of strategies being used.

Madie: That's wonderful. Thank you so much. That sounds great. Chandler, it's been so great to have you on. Thank you so much. And what are two or three takeaways you'd like to leave our listeners with?

Chandler: Yeah, I'd say two to three takeaways moving forward, in terms of the overarching ETF landscape, there's definitely a significant amount of growth within the overarching landscape, so we're seeing close to $400 billion plus in net new assets come into this overall industry, and we're really excited to be a part of that. And in terms of, just to stay on topic with the overarching derivative income and risk management-oriented derivative-based strategy landscape, again, we're seeing a lot of growth within this space and we think the innovation within this industry is pretty unmatched right now given the differentiated types of strategies both on the active and passive side that we've seen come to market. And we think that having a nice menu of options out there has definitely been key for both definitely institutional and insurance investors. In terms of overarching where we could potentially see the market moving forward and capital markets expectations moving forward is there's definitely a lot of noise out there right now in terms of what's going on in the markets.

You have the potential for a soft landing occurring in 2024, but there are definitely some risks definitely to be aware of out there in terms of corporate profitability and the potential for inflation, disinflation we're seeing now to potentially reverse, so keeping some of those expectations in line and being able to be prepared via the utilization of the options market could potentially be a nice tool there, regardless of whatever type of strategy that's being implemented we think could potentially prepare investors nicely for really to be prepared and not have to implement such a strategy after that volatility may have already occurred. Being able to not time the market and utilize these types of risks management and derivative income-based strategies might be an enticing strategy to look to come 2024 and even moving forward, so I would say those would be the two key things I would leave the listeners with there.

Madie: That's great. I appreciate that. Thank you so much. We've been joined today by Chandler Nichols, product specialist at Global X ETFs. Thanks for listening. Please rate us, like us, and review us on Apple, Spotify, or wherever you listen to your favorite shows. My name's Madie B, and this is Assets Under New Management, an insuranceaum.com podcast. Thank you.