S&P Dow Jones Indices

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InsuranceTalks

Indexing Covered Calls

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Insurance Talks is an interview series where insurance industry thinkers share their thoughts and perspectives on a variety of market trends and themes impacting indexing.

Robert Scrudato joined Global X in 2023 as an Options Research Analyst monitoring its Covered Call suite and other Risk-Managed ETFs.

Chandler Nichols joined Global X in 2021. In his current role as a Product Specialist, he works closely with the research analysts and sales team to maintain and promote client-facing research content, as well as communicate insights with clients and internal stakeholders around the globe.

S&P DJI: Why are some insurance companies implementing equity-based covered calls in their portfolios?

Chandler: "Consistency" is key, and equity-based covered call strategies may exemplify this in a meaningful way. By selling a level of upside participation in a stock or stock index in exchange for a premium, the return potential over the outcome period may be defined by the trajectory of the underlying asset and the sold option contract's specifications. This offers the potential for a reduction in downside risk relative to owning the equity asset by itself. By mitigating potential equity downside risk through covered call writing, insurance companies may obtain a lower level of asset return dispersion than with a relatively more unpredictable set of liabilities found within a portfolio of insurance policies.

Over the past 20 years of monthly S&P 500® total returns (240 total observations), 23 of those months (9.5% of all observations) saw negative returns of 5% or lower.[1] We believe this number is elevated relative to investor expectations, which tend to view broad U.S. index-based returns as normally distributed. For example, harvesting the volatility risk premium that is commonly found within listed equity options markets may have been particularly useful in reducing an equity portfolio's volatility in 2022, a challenging market environment in which the Federal Reserve raised interest rates at a precipitous pace.

S&P DJI: What are the potential benefits of an index-based approach to covered call investing?

Chandler: The "rules-based predictability" of an index-based covered call strategy is meaningful to our previous point on covered call portfolio implementation. Index-based covered call strategies seek to reflect a consistent stream of hypothetical option premia that may assist in the reduction of equity return dispersion, which insurance company portfolios may seek to limit. Furthermore, these strategies contain a specified set of rules behind both the stock portfolio and the options overlay.

[1] Source: Morningstar Direct, measured monthly from Jan. 1, 2004, to Dec. 31, 2023

Passive investment strategies typically seek exposure to the underlying holdings of an equity benchmark that is well known to the investor community to which an insurance company may already have exposure within its equity holdings. Furthermore, these same covered call strategy rules typically include contract specifications such as the level of the intrinsic value of an option (“moneyness”), the time until expiration, the contract type and the process of rolling written call options. When combined, there is greater clarity as to the performance of rules-based hedged equity exposures.

S&P DJI: How are covered calls traditionally used in portfolios?

Robert: Covered calls are generally utilized in an effort to harvest option premia and create a source of current income while simultaneously seeking to provide a level of risk management. By applying such a strategy, an effective cap is placed on the price appreciation potential that may be realized through their underlying investment, depending on the strike price of the option. Although this could create a situation in which the strategy trails the performance of its reference asset or underlying index when it’s on an upward trajectory, the positive performance needs to breach the strike price of the sold call option plus any option premium income to outperform. Moreover, the premia generated may help the covered call strategy outperform in instances when the reference asset or underlying index is moving negatively. Similarly, it may also demonstrate positive performance when the underlying instrument is trending in a relatively flat or choppy pattern due to the consistent incorporation of option premia. The reinvestment potential that exists for these option premia is why a covered call strategy is often described as a total return strategy.

S&P DJI: How do covered calls tend to respond to volatility?

Robert: Covered call strategies are generally intended to help to soften the measures of volatility and dispersion that may be exhibited by the underlying assets underpinning the sold call option contracts. They do this on both the positive and negative sides, with price movements to the upside being limited to the strike price of the written call option plus the premia received. On the downside, returns are limited to investment losses of the underlying asset minus the premium that’s received from writing the option. The end result of implementing the strategy is generally (1) performance distributions that have more narrow tails; (2) a beta coefficient that lies below the underlying reference asset or index; and (3) price patterns that feature less oscillation than a position on the underlying instrument alone.

S&P DJI: For a taxable investor, what is the treatment of the option premia?

Robert: Option premia are taxed as a capital gain. Capital gains (losses) generated from option premia may be utilized as a means to offset potential capital losses (gains) at the stock portfolio level. By themselves, selling the two main types of listed equity options within a covered call strategy incurs differentiated taxation treatments. U.S.-style options sold on a single asset or ETF typically result in short-term capital gains, which incur the highest potential capital gains tax rate. European-style equity index options are classified as §1256 contracts. Capital gains under these particular contract types are treated as a blended 60% long-term and 40% short-term capital gain. Long-term capital gains are typically taxed in a more preferential manner than are short-term capital gains. Therefore, index options are commonly viewed as more tax efficient than single-stock and ETF options.

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