GLOBAL X ETFs INSIGHTS

How to Enhance Income Potential with Covered Call ETFs

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Finding income to complement a portfolio and risk profile can – at times – prove to be a difficult task. Options-based strategies may help to generate income, manage risk, or both, depending on the investment objective and policy.

Options strategies may help investors potentially navigate a variety of market conditions or achieve outcomes like generating income or managing risk. Often, these strategies can invest in specific assets, such as the stocks in an index, and buying or selling option calls and puts on those same stocks to attempt to achieve the desired outcome. ETFs investing in options may be an efficient tool for investors looking to incorporate these strategies in their portfolio.

Please see a glossary of terms at the end of this document to be read in conjunction with this material.

Key Takeaways

- Covered call strategies may be an effective tool to possibly enhance and diversify income potential, particularly during times of uncertainty and market volatility.
- Implementing a covered call strategy is a sophisticated investment technique which, when undertaken by investors directly, requires an understanding of derivatives trading and the ability to manage margin calls.
- The Global X Nasdaq 100 Covered Call UCITS ETF (QYLD LN) and Global X S&P 500 Covered Call UCITS ETF (XYLU LN) provide access to covered call strategies on two of the world's largest equity indices, which are predominantly, if not entirely, focussed on U.S. companies.

What is a Covered Call strategy?

A covered call strategy typically involves buying a stock or basket of stocks and selling a call option on those securities. Selling a call option forfeits the upside potential (it limits how much money the strategy could make from investing in a stock or basket of stocks) on those underlying stocks if it's written at-the-money (ATM). In exchange, the strategy receives a premium (income) for selling the call option. Therefore, a covered call strategy can be used to generate additional income from equities.

Covered Call Strategy Features

- Generates income based on option premiums received from selling the call options.
- Upside potential is capped, while downside risk (e.g. the risk of losses that could occur from investing in a stock or basket of stocks) is mitigated to the extent of the option premiums received.
- Can generate higher income during volatile markets since option premiums are historically correlated to the underlying security's implied volatility.[1]
- Full coverage (100% covered) entails writing calls on 100% of the value of the underlying securities owned in the portfolio. A portfolio which is 100% covered maximises the option premium income but forfeits all upside potential.

Covered Call ETFs

- Covered call ETFs are popular strategies for some investors and can potentially save investors the time and avoid some of the potential pitfalls, like managing margin calls, of running covered call strategies directly.
- Whilst ETFs have management fees, there are still potential cost benefits that come with the scale at which the ETF is investment managed compared to the brokerage and risk of management by an individual investor acting on their own.
- Global X has been running Covered Call ETF strategies globally for 10 years and its UCITS strategies QYLD LN since November 2022 and XYLU LN since July 2023.

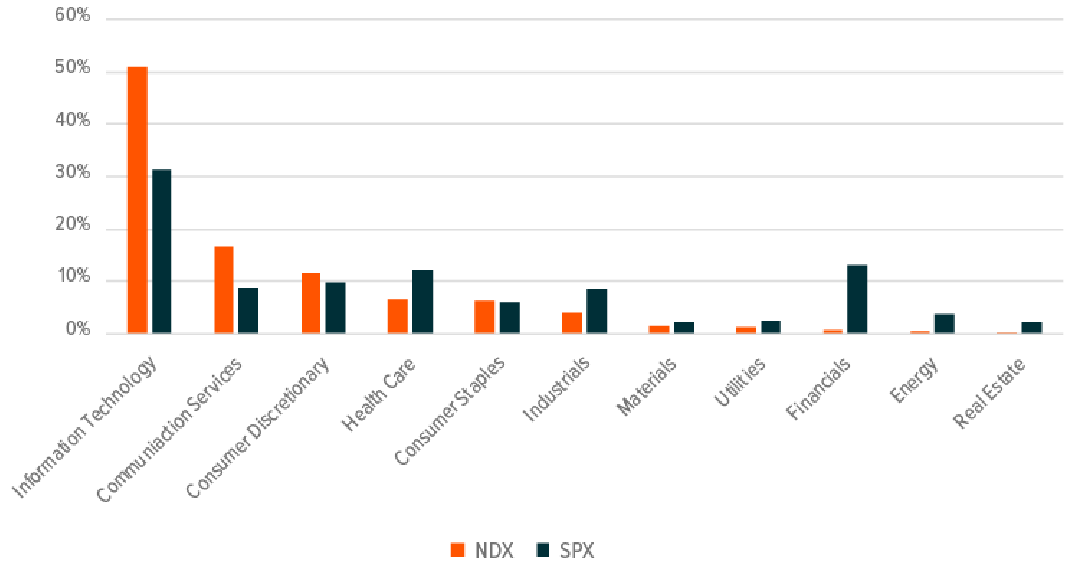
Why use Covered Call ETFs?

Alternative and Diversified Income Source

These strategies could also possibly diversify an investor's source of income away from just equities and bonds, which typically struggle in rising rate environments or times of volatility.[2] Diversification across asset classes is important because simple diversification, such as the 60/40 portfolio split across equities and fixed income respectively, may not meet investors' specific income and growth needs.

Home bias is also inherent in many portfolios where the sector and stock allocations favour the largest companies or specific factors such as dividend stocks. Dividends are generally tied to their earnings which has the propensity to be volatile depending on economic conditions.

Covered calls could help to possibly diversify that income to be less tied to economic conditions, outside stock or market volatility, which see more consistent income throughout the year. However, there is still a risk of loss of capital on the investment in a covered call ETF itself and investors may get less back than invested, despite any income paid from the ETF.



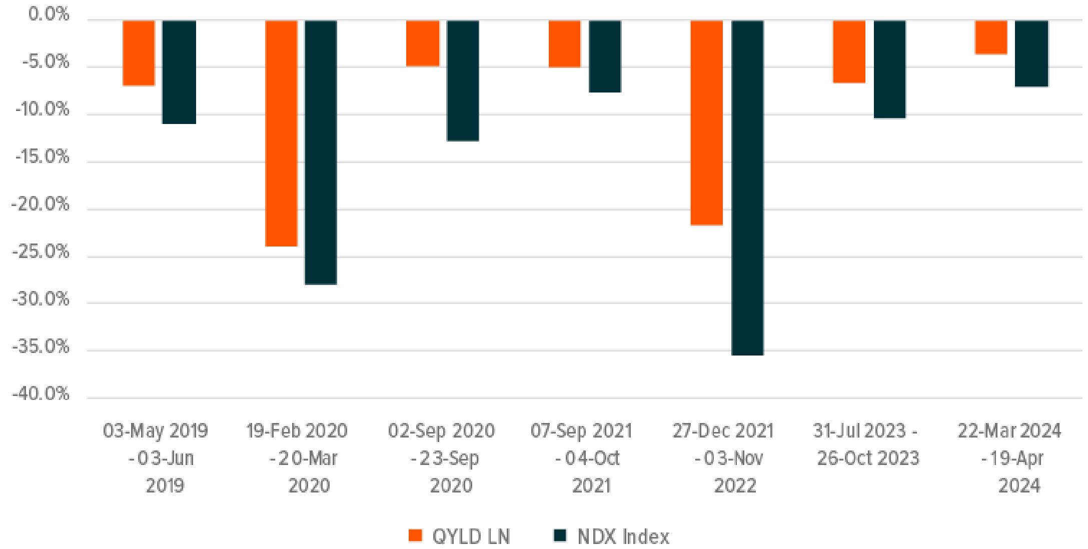
Offers a Buffer During Drawdowns

Covered call strategies, by receiving the premium of the sold call option, can potentially help reduce somewhat the effect of a fall of investments in a portfolio during market selloffs as the premiums paid to the ETF provide an additional source of return for the ETF. This is reflected in the graph below, which shows the lower drawdowns of covered call indexes.

However, this does come with a trade-off. In the case of rising stock markets, due to covered calls capping the upside, the gains that could have been made over holding the underlying stock or index are limited. This means investors may not receive as much back from their investment in a covered call ETF as they might had, had they invested in a similar basket of stocks or index such as the Nasdaq 100 or S&P 500.

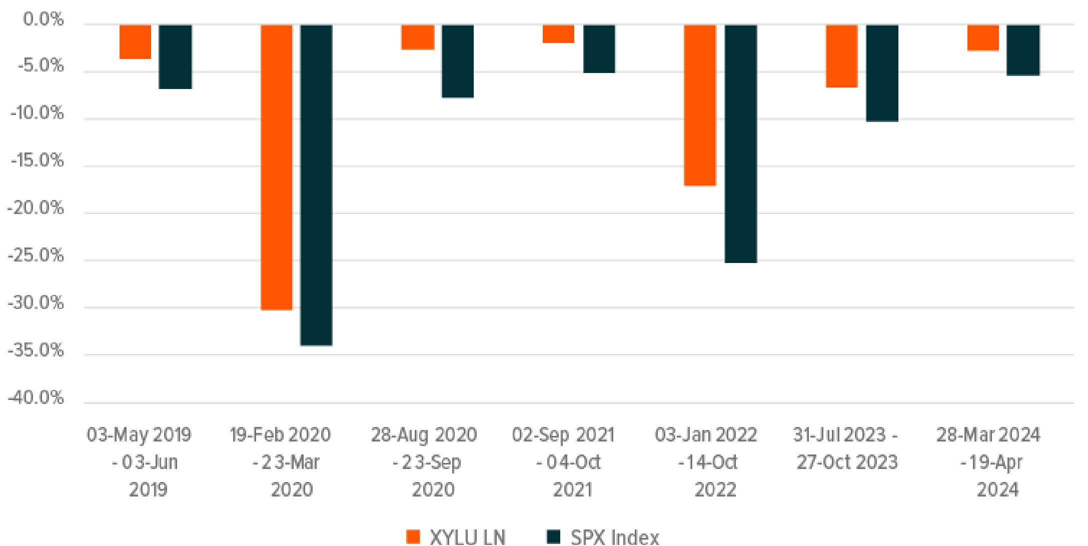
QYLD LN VS NASDAQ 100 -5-YEAR DRAWDOWN HISTORY

Source: Global X ETFs illustration with information derived from Bloomberg as of 29/07/2024. Data presented represents past performance. QYLD LN returns derived from the Cboe NASDAQ-100 BuyWrite V2 UCITS Index (BXNTU Index). Past performance does not guarantee future results. Performance data quoted represents past performance. Investment return and principal value of an investment will fluctuate so that an investor's shares, when sold or redeemed, may be worth more or less than their original cost. Current performance may be higher or lower than performance quoted.



XYLU LN VS S&P 500 -5-YEAR DRAWDOWN HISTORY

Source: Global X ETFs illustration with information derived from Bloomberg as of 29/07/2024. Data presented represents past performance. XYLU LN returns derived from the Cboe S&P 500 BuyWrite 15% WHT Index (BXMU Index). Past performance does not guarantee future results. Performance data quoted represents past performance. Investment return and principal value of an investment will fluctuate so that an investor's shares, when sold or redeemed, may be worth more or less than their original cost. Current performance may be higher or lower than performance quoted.



Global X Covered Call Strategies Deep Dive

Options strategies offer investors the potential for flexibility and the ability to shift market factor exposure, which can be particularly attractive during periods of macroeconomic uncertainty and market volatility. They can also offer a range of potential outcomes for investors, the mechanics of which we break down here.

At-The-Money (ATM) Covered Call Strategies: High Income Potential with possible Reduced Volatility

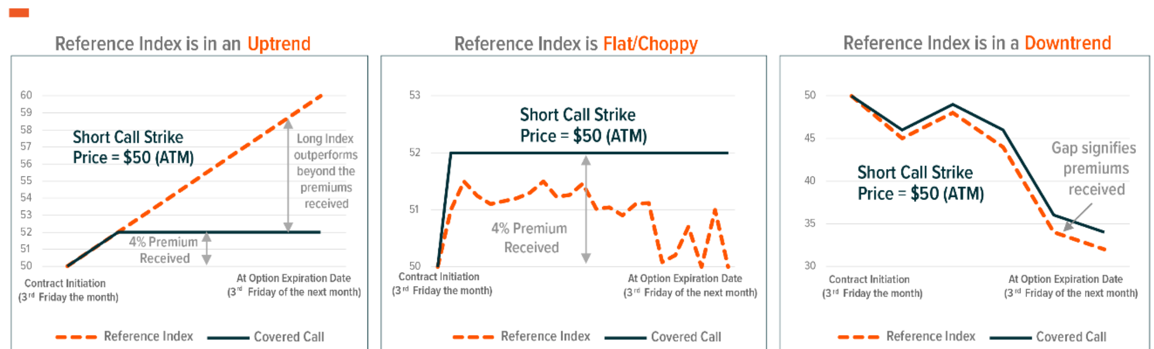
To begin we need a quick overview of some options language.

The Global X Nasdaq 100 Covered Call UCITS ETF (QYLD LN) and Global X S&P 500 UCITS ETF (XYLU LN) follow a synthetic covered call strategy via entering a swap agreement, in which the fund seeks to replicate a buy-write index by selling covered calls, with underlying exposure designed to match constituents of the respective underlying indices. This means the ETF invests in a basket of securities and exchanges the performance/return of the basket for the return of the index minus any associated fees of the swap. The intention of the Fund is thereby to gain exposure to, and replicate the performance of, the Index via the Swap. The manager may, from time-to-time switch partially or totally between using the Swap to replicate the performance of the index or invest directly in global equities and equity related securities.

These strategies seek to generate income by replicating a buy-write index via premiums received from writing calls ATM as this can be appealing to investors seeking income with the potential for reduced volatility in their equity exposure. Historically the Nasdaq 100 is more volatile than the S&P 500 due to overweight in growth sectors like technology and communication services.[3] The ability to collect premiums can potentially mitigate volatility in down markets (where prices of stocks held in the strategy are falling).

What the investor can expect in terms of premiums received depends on how much notional exposure the call option is written, and the moneyness of where it's written at the money (ATM), out of the money (OTM), or in the money (ITM).

Covered call strategies written ATM forfeit the upside potential in exchange for current income collected from the premiums received from writing the call option. As option premiums tend to rise in volatile markets, covered call strategies tend to perform better in volatile yet sideways markets than in major bull or bear markets.



Covered Calls can be Used Both Strategically and Tactically

For long term strategic investors covered call strategies may be helpful in market environments where income becomes scarce. Covered call strategies can produce high income while diversifying the source of risk in a portfolio as the calls are written on diversified indices such as the Nasdaq 100 or the S&P 500 as opposed to single company securities. They also help increase income certainty and consistency by paying either monthly or quarterly distributions.

Covered call strategies can be appropriate for tactical portfolios as well, where making a call on market direction can either support or contradict covered call use. Underperformance will likely occur in a strong up market (where prices of stocks held in the strategy are rising) as the covered call strategy will forfeit the upside of the index exposure held, only receiving the premium. Whereas in a flat market, the strategy will likely outperform due to the premiums received from selling call options while there is no lost opportunity cost of the underlying index exposure rising. In a down market (where prices of stocks held in the strategy are falling), the strategy may also outperform because they keep the premium received from selling the call option, which may offset some or all of the underlying market's decline.

Considerations for Investors in QYLD LN and XYLU LN

Before investing, investors should ensure they understand covered call option writing risk

By writing covered call options in return for the receipt of premiums, the Fund will give up the opportunity to benefit from potential increases in the value of the Reference Index above the exercise prices of such options, but will continue to bear the risk of declines in the value of the Reference Index. The premiums received from the options may not be sufficient to offset any losses sustained from the volatility of the underlying stocks over time.

As a result, the risks associated with writing covered call options may be similar to the risks associated with writing put options. In addition, the Fund's ability to sell the securities underlying the options will be limited while the options are in effect unless the Fund cancels out the option positions through the purchase of offsetting identical options prior to the expiration of the written options. Exchanges may suspend the trading of options in volatile markets. If trading is suspended, the Fund may be unable to write options at times that may be desirable or advantageous to do so, which may increase the risk of tracking error.

Investors should be willing to accept a high degree of volatility in the price of the fund's shares and the possibility of significant losses.

The risks of investing in QYLD LN or XYLU LN are Currency Risk, Derivatives Risk, Equities Risk, Swaps Counterparty Risk, Covered Call Option Writing Risk, Market Risk, Operational Risk (including safekeeping of assets), Risks associated with the ability to track an index, Liquidity Risk and Fund Counterparties. More details regarding the risks of investing and in this ETF specifically is available in the 'Risk Factors' section of the Prospectus).

Making a Call on a Portfolio's Income Potential

Options-based strategies can help investors navigate various market conditions, including the type of elevated rising interest rate, inflation-driven volatility and sector concentration in the market currently. These strategies may help investors achieve certain objectives like generating income or managing downside risk. For example, compared to traditional equity opportunities, certain option strategies may achieve a more efficient balance of income and growth and increase portfolio yield. Markets are variable, but certain options strategies, including those offered by Global X, could help provide investors some stability amid uncertainty.

Investors can consider using covered call strategies in a portfolio as:

- A core portfolio holding to replace a portion of US equity exposure, as the options premiums generated from selling calls can smooth drawdowns without deviating substantially from benchmark.
- A satellite providing an alternative source of income, especially in times of heightened volatility or rising interest rates.

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Glossary

Call Option: A call is an option where the entity holding the option has the right but not the obligation to buy at a predetermined price. Typically, a fee is paid for this right. A call is most likely to be used when the price of a security is expected to increase.

Put Option: A put is an option where the entity holding the option has the right but not the obligation to sell at a predetermined price. Typically, a fee is paid for this right. A put is most likely to be used when the price of a security is expected to decline.

Long Call: A position in a call option contract in which one has the exercisable right under the contract. The position reflects a bullish attitude.

Short Call: A position in a call option contract one has in which the right under the contract can be exercised against oneself. This position reflects a bearish attitude.

Long Put: A position in a put option contract in which one has the exercisable right under the contract. This position reflects a bearish attitude.

Short Put: A position in a put option contract one has in which the right under the contract can be exercised against oneself. This reflects a bullish attitude.

Market Price: The current price of the underlying asset of the option contract, such as a stock.

Moneyness: A standardized measure of the intrinsic value of an option at a current point in time, that is, the moneyness will tell the option holder whether exercising the option will be profitable.

At-the-money: An option contract is considered to be "At the Money" when its strike price is equivalent to the current price value of its underlying asset.

In-the-Money: Options that, if exercised, would result in the value received being worth more than the payment required to exercise.

Out-of-the-Money: Options that, if exercised, would require the payment of more money than the value received and therefore would not be currently exercised.

Cboe Index Option Put/Call Ratio: Measures the ratio between the volume of all index put options and all index call options being traded on a daily basis.

Premium: The amount of money a buyer pays and seller receives to engage in an option transaction.

Covered Call: An option strategy involving the holding of an asset and sale of a call option on the same asset.

Expiration Date: This is the day and options contract ceases to exist.

Cboe Volatility Index (VIX Index): The Cboe Volatility Index, commonly referred to as VIX, reflects a market estimate of future volatility, based on the aggregate weighted prices of S&P 500 puts and calls over a wide range of strike prices.

Cboe NASDAQ-100 Volatility Index (VXN): The Cboe NASDAQ-100 Volatility Index, commonly referred to as VXN, reflects a market estimate of future volatility, based on the aggregate weighted prices of Nasdaq 100 puts and calls over a wide range of strike prices.

Footnotes

1. Black, F., & Scholes, M. (1973). "The Pricing of Options and Corporate Liabilities." *Journal of Political Economy*, 81(3), 637-654.
2. Lettau,M. & Wachter, J. The term structures of equity and interest rates. July 2011.
3. Information derived from Bloomberg L.P as of 30 July, 2024. Cboe Volatility Index (VIX), Cboe Nasdaq 100 Volatility Index (VXN), long term volatility is from respective index inception dates: VIX, 19 January,1993; VXN, 23 January.

The Global X UCITS ETFs are regulated by the Central Bank of Ireland.

This is a marketing communication.

The UCITS ETFs are index-tracking funds and as such you should read the investment policy of the fund in the supplement to understand how the UCITS ETF will invest.

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Investors should also refer to the section entitled “Risk Factors” in the relevant prospectus of the UCITS ETFs in advance of any investment decision for information on the risks associated with an investment in the UCITS ETFs, and for details on portfolio transparency. The relevant prospectus and KID for the UCITS ETFs are available in English at www.globalxetfs.eu/funds.

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A UCITS ETF's shares purchased on the secondary market cannot usually be sold directly back to a UCITS ETF. Investors must buy and sell shares on a secondary market with the assistance of an intermediary (e.g. a stockbroker) and may incur fees for doing so. In addition, investors may pay more than the current net asset value when buying shares and may receive less than the current net asset value when selling them. Changes in exchange rates may have an adverse effect on the value price or income of the UCITS ETF.

Past performance of a UCITS ETF does not predict future returns. Future performance is subject to taxation which depends on the personal situation of each investor, and which may change in the future. Neither past experience nor the current situation are necessarily accurate guides to the future growth in value or rate of return of a UCITS ETF.

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Any investment in a UCITS ETF may lead to a financial loss. The value of an investment can reduce as well as increase and, therefore, the return on the investment will be variable.

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The Financial Ombudsman Service is unlikely to consider complaints relating to the ETF and any claims for losses relating to the manager and the Depositary of the ETF are unlikely to be covered under the Financial Services Compensation Scheme.

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The prospectus, the key information documents or the key information documents, the articles of association as well as the annual and semi-annual reports may be obtained free of charge from the representative.

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