An Income-Generating 'Collar'

By Kerry Pechter *Thu, Aug 20, 2020*

Using a 'protective net-credit collar,' the Nationwide Risk-Managed Income ETF has distributed monthly income at an annual rate of 7.88% in 2020, while appreciating 10%. Is there a catch?

Baby boomers who are near or in retirement face particularly nasty tradeoffs these days. They need reliable income, but bond yields are low. They need upside, but the recession makes equities look doubtful—their current Fed-fueled buoyancy notwithstanding.

There are no silver-plated solutions that advisers can offer their clients in the newest "new normal." But advisers need tools that will nudge clients into "staying the course."

A variety of risk managed products from asset managers and life insurers might fill the bill. Nationwide's Risk-Managed Income ETF (**NUSI**), launched last December, aims to check several boxes at once. Client assets are invested in the stocks of the tech-heavy NASDAQ-100. This position is overlaid with a "protective net-credit collar."

NUSI's most eye-catching feature, however, involves income. The fund pays out a monthly distribution composed of dividends, a premium ("net credit") from the options trades, and, if necessary, a bit of fund's assets; the annual expense ratio is 0.68%.

Jonathan Molchan

"The goal is to generate income, protect against market downturns, and over time to smooth the return profile so that it can support a seven to eight percent annual yield," said Jonathan Molchan, the lead portfolio manager of NUSI at the subadvisor of the fund, Harvest Volatility Management in New York, which executes the collar strategy for Nationwide.

Since its inception last December, NUSI has paid its shareholders 0.65% of assets per month, or a respectable 7.88% per year. In addition, its NAV (net asset value) is up about 10% since January 1, for a total return of about 17%. In March 2020, when the S&P 500 dropped 30%, NUSI was down only about 10%.

How NUSI works

If you're at all familiar with options (and if you read Nationwide's NUSI **whitepaper**), NUSI won't be hard for understand (though your clients might struggle with the concept.) It has some wrinkles that may require some re-reading, however. Here's how it works:

Step One. The fund directly owns all 100 stocks in the NASDAQ-100 index, but not by purchasing the **QQQ ETF**. The five biggest stocks in this tech-heavy, non-financial index are Apple, Microsoft, Amazon, Facebook and Alphabet (Google).

Step Two. Each month, the options writer (Nationwide outsources this function to Harvest Volatility Management) sells covered calls on the NASDAQ-100 that are near-the-money or slightly out-of-the-money. In other words, the fund manager sells a counterparty the right to buy the NASDAQ-100 Index at a price slightly higher than the current price.

Step Three. The fund manager uses part of the revenue from the sale of the covered call ("covered" means that the fund already holds the underlying securities as collateral) to buy out-of-the-money puts on the NASDAQ-100. This puts a floor under the losses the fund can suffer if the NASDAQ-100 goes down.

Step Four. Investors receive monthly distributions consisting of the net credit that's left over after selling the covered call and buying the protective put, plus the dividend yield of the stocks in the NASDAQ-100 (about 0.75% a year).

"The fund has a managed distribution of 65 basis points of month," Molchan told *RIJ*. "The composition of the distribution can change; it's comprised of premium from net gain on the options, dividends, and appreciation of the underlying investment. Based on the rules-based mechanism we use, the sale of the call and purchase of the put should always generate a net credit. If it comes up a little short, you turn to the dividends and potential capital gain."

Step Five. Any net realized capital gains are distributed annually. Any excess premium from the sale of the covered call each month is reinvested in the fund.

What could go wrong?

Sounds good so far; what could possibly go wrong? In a rising market, any gain in the NASDAQ-100 above the strike price would normally accrue to the purchaser of the covered call—at the expense of the NUSI shareholders. To prevent that potential disaster, the NUSI fund manager (responding to a signal from NUSI’s hedging model) “closes the call option” by buying it back. (Since he used a “European call,” he can do that.) The NUSI investor benefits from any subsequent growth in the NASDAQ-100 index.

This year, NUSI paid out about 16 cents a share (0.65% of the ~$25 share price) per month. In March, during the crash, the distribution dropped to about 15 cents. During the recovery since the crash, the distribution has risen to almost 17 cents.

So someone owning 1,000 shares (worth about $25,000) would have received $150 to $170 per month. At that rate, the annual payout would be about $2,000. In addition, the fund has appreciated by about 10% so far this year. The fund’s total return since inception last December has been about 18%.

Of course, there’s the potential for disappointment or, if you prefer, Fear of Missing Out (FOMO). A NUSI investor is invested in the NASDAQ-100 stocks, but the cost of the protective collar meant that the fund captured about 60% of the 31% gain of QQQ shares so far this year.

“With the downside protection you lose less on the way down, and you have the ability to uncap in a rising market. That gives you a return profile that seeks to smooth out the distribution of returns,” Molchan said.

“This strategy is not new. Institutions and hedge funds have used it for decades. Similar strategies have been around since the 90s. It’s just an institutional quantitative twist on combining two popular options strategies and bringing them to market in an ETF wrapper. A strategy that would have involved multiple trades for an institution or hedge fund is now a packaged product for retail investors.”

The monthly reset of the options and the dynamic nature of the rules-based nature of the hedging makes the fund relatively nimble. With a monthly horizon, it also avoids the duration and credit risks of a bond fund.

Of course, the NASDAQ-100 has soared this year, and the capital appreciation has helped NUSI hit its aggressive distribution target. Could the fund continue to pay out almost 8% a year in a flat or declining market without running down principal within just a few years? "There's a measure of downside protection every month," Molchan told *RIJ*. "Whether the NASDAQ-100 return is 7% or 17%, the mechanism is designed to support the dividend, satisfy the income needs of the client, and reduce volatility."

In a flat market, according to Nationwide illustration, NUSI's covered call options don't generate as much premium, because volatility is low and there's less demand for protection. In a down market, NUSI's downside protective put means fewer losses to overcome when markets rebound.

Alternative solutions

Nationwide is positioning NUSI as a complement to a 60/40 balanced fund, and as an alternative to other strategies that investors use when reaching for yield—high-yield bonds, emerging market bonds, real estate investment trusts, and master limited partnerships.

NUSI will presumably compete with other structured solutions that asset managers and life insurers have placed on the market. One potential competitor would be registered index-linked annuities, or RILAs, which have enjoyed steadily rising sales since they were introduced by Equitable (then AXA) in 2011.

Also known as structured variable annuities, these are general account products—the underlying assets are fixed income investments in a life insurer's general account—that offer interest returns up to cap and down to a "floor" or "buffer."

Their options strategy is the reverse of NUSI's. The fund manager typically sells a put (setting a downside buffer that eliminates the first 10% in losses, say) and then uses the premium and interest from the general fund to buy a call spread (setting an upside cap on gains).

Several life insurers also sell structured ETFs. This spring, Allianz Life and New York Life both introduced these products, which use so-called **FLEX options**. According to the Options Clearing Corporation, these are "customizable products where the investor can set the terms for the tradable contract and have the security of an exchange-traded product."

In addition, "The exercise style, expiration date and strike price can all be chosen by the investor to create a new product that is not currently being traded at an exchange. In general, investors set the criteria and have their brokerage firm solicit the best possible market-price from different market participants.”

Innovator Capital Management introduced the first structured ETF, based on movements of the S&P 500 Index, two years ago. These “Defined Outcome” funds use a FLEX options strategy designed by Milliman, the global actuarial consulting firm. Just this week, the Innovator 20+ Year Treasury Bond 5 Floor ETF – July and the Innovator 20+ Year Treasury Bond 9 Buffer ETF – July were launched and listed on the Cboe.

The first seeks to provide exposure to the upside performance of the iShares 20+ Year Treasury Bond ETF (TLT) to a cap and a floor against downside losses in excess of 5% over the outcome period. The second seeks to provide exposure to the upside performance of TLT to a cap and a buffer against the first 9% of price losses over the outcome period.

Any and all of these products imply a bet that volatility in equities and low interest rates will dominate the marketplace for the foreseeable future. You wouldn’t put all of your money into one of these products. But taking a modest position probably wouldn’t hurt. The future is about as inscrutable as it could possibly get.