Enhanced Equity Income
Q3 2018 Commentary

Market Review:

US equities surged in the 3rd quarter of 2018, with the S&P 500 advancing 7.7% and the Russell 1000 Value up 5.7%. It was the strongest quarterly return for the S&P 500 since the 4th quarter of 2013. Health Care was the best performing sector, up 14.5%. The sector rallied on news that the Trump administration is considering drug pricing policies that would not significantly alter the current drug supply chain or pharmaceutical industry profits. Information Technology (+12.4%) continued to outperform and the Industrials sector rebounded (+10.0%) after being the worst-performing sector in the 2nd quarter; several leading transportation and capital goods firms posted strong earnings and the Purchasing Managers' Index rose in August to its highest level in 14 years. Energy (+0.6%) and Materials (+0.4%) were the laggards in the quarter. Energy stocks declined in July and August on concerns of rising supply and slowing global economic growth, and Materials stocks struggled partly on declining commodity prices.

Now a full decade from the financial crisis of 2008, the bull market that began in March 2009 is now the longest-running bull market in history. Stocks' ongoing advance has been supported by a host of positive economic data, including GDP growth for the 2nd quarter at 4.2%, unemployment at 3.9%, and consumer confidence at its highest level in 18 years. Moreover, year-over-year EPS growth for the S&P 500 is expected to be over 20% for 2018, the highest level of growth since 2010. However, the bull market will have to contend with a number of increasing headwinds going into 2019. The Federal Reserve, which increased interest rates another quarter percentage point in September, is expected to raise rates again in December and continue its tightening policy for the foreseeable future. Furthermore, while the US, Mexico and Canada reached a last minute compromise to revamp NAFTA, the Trump administration remains in conflict with China over trade disputes. After imposing 10% tariffs on an additional $200B of Chinese imports, bringing the total to $250B, China retaliated with tariffs on an additional $60B of US imports on top of $50B instituted earlier in the year. The trade war has raised concerns from business leaders about the potential disruption of supply chains and increase in materials costs.

Income and Options Summary:

Total income ended the quarter at 7.1% annualized; dividends contributed 3.5% and options 3.6%. In the quarter, 6 additional portfolio companies declared dividend increases with an average increase of 17.8%. Year-to date, 27 companies out of the 37 average have increased dividends at an average of 9.2%.

Options premiums remained attractive throughout the quarter, although market surges into the close of some monthly cycles increased the assignment rate to 42%, year-to-date. Calls were written against 16 positions in the portfolio during the month of September. Of the contracts written in the representative account year-to-date, 42% were assigned. Calls were written at an average of 2.3% out-of-the-money. The out-of-the-money average for calls written has been 2.3%, which is the average, long-term percentage.

Performance Analysis:

Growth outperformance within the broad market continued unabated during the quarter, as the Russell 1000 Growth Index outpaced its Value counterpart by 38% (9.17% versus 5.70%). However, the new highs made by the S&P 500 in late August were primarily due to market over-weightings in the five largest companies. Companies in the Information Technology and Consumer Discretionary sectors resumed their outperformance of the high-dividend sectors (Real Estate, Utilities, Consumer Staples, and Telecommunications).

The Enhanced Equity Income strategy recorded a very strong quarter, netting 6.60%, well in excess of its benchmarks; the S&P 500 Buy/Write Index (BXM) gained 4.92% and the SPDR Barclays High Yield Bond ETF (JNK) returned 2.47%. The strategy's allocations in the Communication Services, Real Estate, Consumer Staples and Energy sectors powered the return. They outgained those S&P sectors significantly, while trailing the Consumer Discretionary and Materials sectors.

Figure 1: Enhanced Equity Income Returns vs. Benchmark

	Q3	YTD	1 Yr	3 Yr	5 Yr	Since Incept*
SCCM Enhanced Equity Composite (gross)	**6.9**	**2.9**	**4.2**	**11.2**	**8.2**	**9.7**
SCCM Enhanced Equity Composite (net)	**6.6**	**2.0**	**3.0**	**10.1**	**7.0**	**8.6**
S&P 500 Buy-Write Index (BXM)	4.9	6.8	9.8	10.3	9.0	8.0
SPDR Barclays High Yield Bond ETF (JNK)	2.5	1.8	2.0	6.5	3.9	5.2

**December 31, 2010. Performance for periods greater than 1 year is annualized.*

Portfolio Changes:

Buys

No positions were purchased during the quarter.

Sells

The position in **AstraZeneca (AZN)** was sold in the quarter. AstraZeneca has performed well over the past 18 months as three major oncology pipeline drugs approvals with differentiated trial results have bolstered the sales outlook for the company. However, at 22x 2018 earnings, the stock reflects improving top-line and pipeline prospects while earnings growth will be restrained by further patent expirations. While there will be several oncology pipeline trial results released in the next year, the competitive landscape in oncology has intensified and high drug costs in the space has drawn scrutiny from the US government and commercial payers. In addition, the company's increasing reliance on externalization – the monetization of specific pipeline drugs – has boosted earnings over the past several years but those deals have stripped the company of the full upside of success. The prospect of a takeout of the company appears to be less likely as US tax reform removed the need for tax inversions and Pfizer's past attempt to acquire AstraZeneca drew heavy scrutiny from UK authorities and UK shareholders. Lastly, Brexit poses an additional risk for AstraZeneca as it is a UK-domiciled company subject to the direct shockwaves of a potential hard Brexit outcome, namely weakness in the UK Pound and loss of market access. In terms of the dividend, AstraZeneca's gross yield is ~3.4%; however, the company appears unlikely to increase it given its high payout ratio and significant investment needs.

Thank you for your continued support. Feel free to reach out to us if you have any questions.

Respectfully,

James Cullen
Jennifer Chang, CFA
Timothy Cordle
Michael Kelly, CFA

Portfolio Managers, Schafer Cullen Capital Management, Inc.