Enhanced Equity Income
Q2 2020 Commentary

Market Review:

The 2nd quarter marked the best quarter in over 20 years for the US equity market, a remarkable rebound from one of its worst quarters in history. The S&P 500 returned 20.5%, while the Russell 1000 Value returned 14.3%. For the S&P 500, it was the best quarter since 1998, following its worst 1st quarter ever. Only three months ago, investors were gripped by fear of the consequences of the coronavirus pandemic, worldwide lockdowns, record unemployment claims, and a plunge in economic growth. Yet investor sentiment reversed just as quickly as it declined, thanks in part to unprecedented fiscal and monetary stimulus from governments and central banks worldwide.

Globally, Covid-19 cases reached 10.5 million with over 500,000 fatalities. The US alone recorded 2.7 million cases with approximately 130,000 fatalities. Weekly unemployment claims smashed the previous record at 6.9 million in March and have since declined to just under 1.5 million. In April, U.S. retail sales declined a record 14.7%, then rose 17.7% in May, a record increase (The Wall Street Journal, 6/16/2020). The crisis facing the country was compounded with widespread protests and unrest in nearly every major city following the death in Minneapolis of George Floyd.

Consumer Discretionary (+32.9%) was the top performing sector, as retailers benefitted from consumers stocking up on essential items, a gradual re-opening of non-essential stores, and an enormous surge in online shopping. Information Technology and Energy were the next best performing sectors, both returning 30.5%. Technology continued to benefit from the lockdown, particularly cloud computing applications related to workplace collaboration and online entertainment. In April, leading oil producing nations including the US, Saudi Arabia and Russia agreed to a record cut in daily production of 9.7 million barrels per day, a pact that was extended in June. The WTI oil benchmark nearly doubled in the quarter to $39 after an unprecedented and chaotic dive into deeply negative territory in April. Utilities (+2.7%) and Consumer Staples (+8.1%) were the two worst performing sectors, as defensive, lower volatility stocks lagged. Financials (+12.2%) also underperformed largely due to the uncertain recovery for banks. The Federal Reserve released the results of its annual stress tests, ordering the largest banks to suspend share repurchases in the 3rd quarter and also capping dividends at their 2nd quarter levels.

Although every state began phased re-openings, with most non-essential retail and manufacturing resuming operations, investors are clearly relying on the Federal government to help bridge the gap until the economy fully reopens. Assets on the Federal Reserve’s balance sheet now exceed $7 trillion, up from $4 trillion at the beginning of the year, and the Federal budget deficit is now forecasted to be $3.8 trillion for the 2020 fiscal year. Lawmakers are discussing a second stimulus bill for July, following the $2.2 trillion stimulus passed in March. Internationally, European Union members are discussing an $840 billion stimulus plan on top of a roughly $1.5 trillion stimulus effort from the European Central Bank.

Income and Options Summary:

Options writing increased during the quarter as equity markets rallied and followed through after late-March lows. Fifty-one calls were written, increasing the pace of income received from options premiums. They were executed at greater than 6% out-of-the-money, more than doubling inception-to-date averages. Premiums received from these contracts averaged a large 23% annualized return, and fewer than 30% of them were assigned (163 of 565 contracts) in the representative account.

Dividend-receipt totals were strong during the quarter, which included May, the largest dividend-receipt month of the year. Dividend growth continued, as five companies increased dividends during the period. Year-to-date, 12 out of 36 currently-held companies have increased dividends at an average of 5%. On an annualized basis, dividends tracked at 3.5% at quarter end, combining with 3.3% from options premiums to total 6.8%.

Performance Analysis:

The broad equity market generally rose steadily throughout the quarter, rallying to a peak near its 200-day Moving Average in early June, before retreating slightly. Despite the short-lived value/cyclical rally in May, the first half's correction did not significantly compress the performance differential between the best-performing and worst-performing stocks in the S&P 500, and the quarter ended with that margin marking higher than it did before the correction began in February. As the 3rd quarter began, the top 15 names in the S&P 500 comprised the same total market capitalization as the bottom 420.

However, the Enhanced Equity Income composite recorded a strong total-return figure for the period, while increasing annualized income and minimizing assignment rates. The strategy's allocations to the rebounding Energy and Materials sectors outperformed those of the S&P 500, while underperforming in the growth dominant Information Technology, Communications Services and Consumer Discretionary.

Demonstrating the benefits of selective versus systematic call-writing, the strategy netted 15.8% during the 2nd quarter, compared with 9.1% from its primary benchmark, the S&P 500 Buy/Write Index (BXM). It also surged ahead of the BXM on a year-to-date basis, three months after the trough of the correction. The strategy also significantly outperformed its secondary benchmark, SPDR Barclays High Yield Bond ETF (JNK), returning 8.4%, which benefitted from large purchases by the Federal Reserve, now the 5th largest JNK share holder (about $4B).

Figure 1: Enhanced Equity Income Returns vs. Benchmark

	QTD	YTD	1 Yr	3 Yr	5 Yr	Since Incept*
SCCM Enhanced Equity Composite (gross)	**16.2**	**-13.2**	**-6.6**	**1.1**	**4.7**	**7.4**
SCCM Enhanced Equity Composite (net)	**15.8**	**-13.7**	**-7.7**	**-0.1**	**3.5**	**6.3**
S&P 500 Buy-Write Index (BXM)	9.1	-15.1	-10.9	-0.5	2.8	5.0
SPDR Barclays High Yield Bond ETF (JNK)	8.4	-5.5	-1.8	2.4	3.3	4.6
Russell 1000 Value Index	14.3	-16.3	-8.8	1.8	4.6	9.5

12/31/2010. Performance for periods greater than 1 year is annualized.* ***Past performance is no guarantee of future results.*

Portfolio Changes:

Purchases / Additions

Bell Canada (BCE) – Bell Canada was added to the Enhanced Equity Income Strategy in June. Bell Canada is one of the largest telecommunications and cable providers in Canada with 50% of its business in wireline (cable, internet, voice), 37% in wireless and 13% in media. The company operates in attractive regulatory regimes with rational competitors which has allowed the company to grow its earnings above a mid-single digit rate. Wireline is growing through subscriber additions as its fiber investments pay off while Wireless is benefitting from higher data plans and subscriber additions. With a 6% dividend that is considered highly sustainable in our opinion (70% normalized payout ratio), the total return profile is attractive.

Sales / Reductions

AT&T (T) – AT&T was sold from the Enhanced Equity Income Strategy. BCE was purchased to diversify the portfolio out of the US telecommunications market. While the valuation of AT&T is attractive and the dividend has been prioritized by management, several of the company's businesses are negatively impacted by Covid-19, specifically Time Warner/Media and its traditional video business.

Market Outlook:

The equity market rally that began off the March 23rd market lows is one of the strongest in history with the S&P 500 up 36% through the second quarter. While the unfolding Covid-19 pandemic and resulting global economic shut-downs triggered the fastest bear market on record, unprecedented monetary and fiscal stimulus eventually helped to stabilize capital markets. V-shaped improvements in some economic data in addition to record liquidity injections have fueled markets higher. Economic data that have bounced back to prior levels have benefitted from an uplift from rising off of significant lows. Historically, market recoveries have been led by Value (Figure 2); in all of the past fourteen recessions, Value has outperformed the S&P 500 coming out of each downturn (BofA/ML, Covid-19 and the Economy, June 2020). And in this recovery, Energy has been the best performing sector, up 61%, from the March 23rd low through the end of Q2.

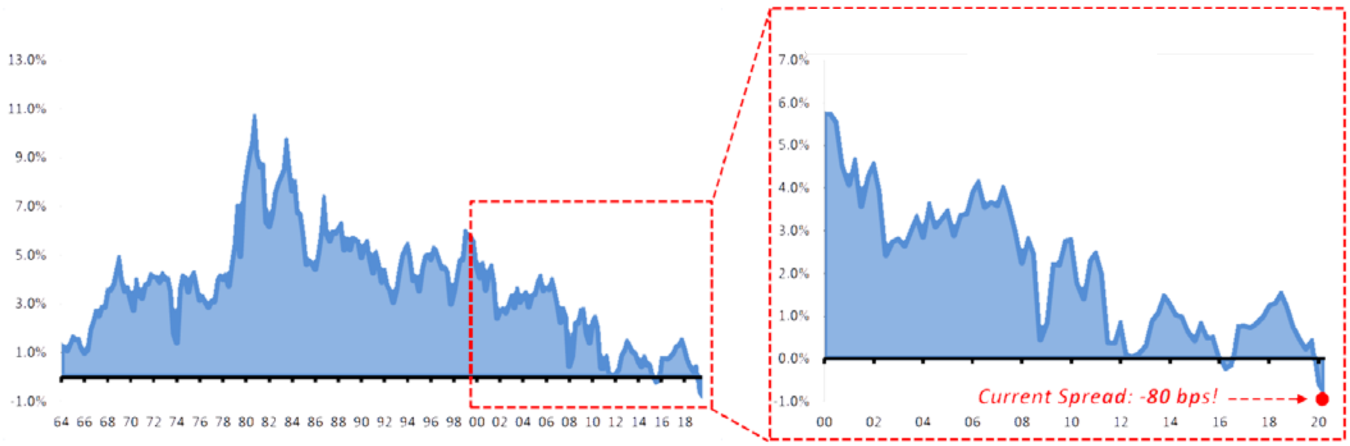
Figure 2: Relative Performance of Value vs. the S&P 500 After Recessions

NBER Peak / Trough dates		Value vs SPX performance			
Peak	**Trough**	**Start**	**End (or 12mth)**	**# Mth**	**Rel. Perf. vs SPX**
August 1929	March 1933	05/31/32	8/31/1932	3	78.3%
May 1937	June 1938	05/31/40	5/31/1941	>12	27.2%
February 1945	October 1945	08/31/45	11/30/1945	3	11.1%
November 1948	October 1949	03/31/50	1/31/1951	10	29.7%
July 1953	May 1954	12/31/53	12/31/1954	>12	21.5%
August 1957	April 1958	12/31/57	12/31/1958	>12	26.1%
April 1960	February 1961	06/30/60	5/31/1961	11	9.8%
December 1969	November 1970	12/31/69	8/31/1970	8	9.0%
November 1973	March 1975	11/30/74	11/30/1975	>12	14.7%
January 1980	July 1980	11/30/80	11/30/1981	>12	28.3%
July 1981	November 1982	06/30/83	6/30/1984	>12	16.8%
July 1990	March 1991	12/31/91	6/30/1992	6	18.1%
March 2001	November 2001	10/31/01	6/30/2002	8	10.3%
December 2007	June 2009	02/28/09	4/30/2010	14	25.9%

Source: BofA/ML, Covid-19 and the Economy, 6/30/2020. **Past performance does not guarantee future results.**

The bull case for equities is underpinned by a number of positives. Markets can be driven higher by historically high levels of cash in money market funds (sidelines) and bond flows. While absolute valuations are high – current Price/Earnings, Price/Book, P/E to Growth, EV/Sales, and EV/EBITDA metrics are all above 90th percentile relative to historical levels (Goldman Sachs) – relative valuations are more attractive given the low interest rate environment. The spread between the US 10-year Treasury and the S&P 500 Dividend Yield is the lowest on record and in negative territory.

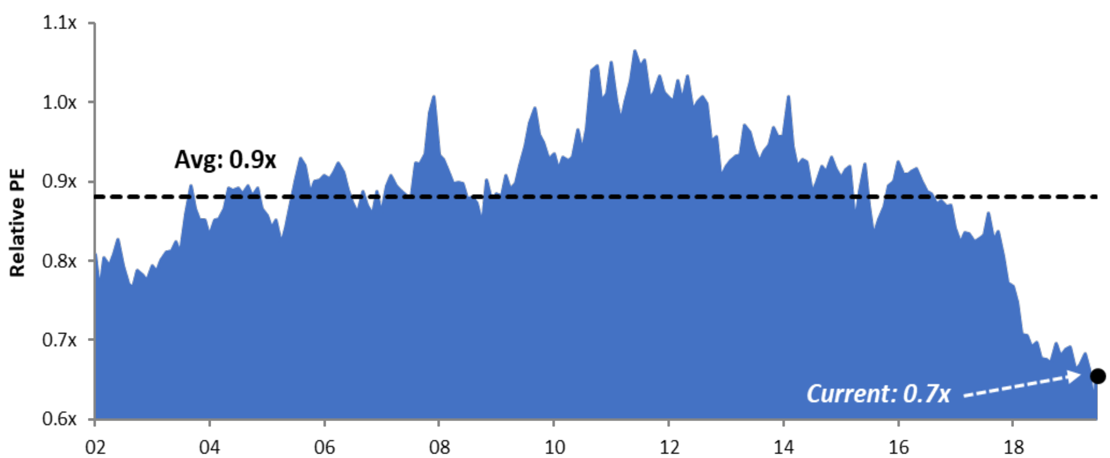
Figure 3: Spread between the US 10-Year Treasury Yield and S&P 500 Dividend Yield



Source: Wolfe Research, Dividend Investing, 6/22/2020.

Within Equities, Low Price/Earnings and High Dividend Yielding stocks are trading at deep discounts to the overall market. Figure 4 shows that the valuation of the highest dividend yielding stocks is at their cheapest level in nearly 20 years.

Figure 4: Highest Dividend Yield Relative P/E to the Market



Source: Wolfe Research, Dividend Investing, 6/22/2020

While equities can continue to grind higher, risks are now building to the overall market and the most popular stocks in broad indices. World economies face steep uphill battles in their attempt to return to pre-Covid levels as the virus has yet to burn out and there is no certainty around the timeline and effectiveness of vaccines and treatments. The US Presidential Election poses a risk if a Democratic agenda takes hold, likely resulting in higher taxes and increased regulation. In addition, the market has become increasingly concentrated in expensive Technology stocks. Concentration within the S&P 500 with the Top 5 stocks (Microsoft, Apple, Amazon, Google, and Facebook), all technology stocks, is now at near record levels – those stocks now comprise 22% of the index, a level not seen since the 1970's. Meanwhile, these five stocks account for 7% of S&P 500 revenues and 12% of S&P 500 earnings (refer to Figure 5).

Figure 5: Weight (%) of the Top 5 stocks in the S&P 500

Source: Morgan Stanley, 6/30/2020.

Investors often believe current trends will persist – currently, that momentum and Growth could continue to outperform for the foreseeable future. However, history has proven that the largest stocks – either due to sheer size, valuation or other factors – eventually underperform as price to value revert to normalcy.

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

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