WEBB ASSET MANAGEMENT

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WAM Funds Research

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A Summary of Call and Put Writing vs. Owning the S&P 500 Outright

Most investors are unaware of the benefits of covered call writing or naked put writing vs. owning stocks out right. The advantages of writing options vs. owning stocks out right are substantial. To illustrate the advantages I will use data provided by the Chicago Board of Options Exchange (CBOE). The CBOE published two indexes of option writing on the S&P 500 with data going back to July 1986.

The BXM index tracks being long the S&P 500 while writing the at-the-money one month call options on that index. At-the-money means writing the nearest strike above the S&P index. At each monthly expiration, the option either expires worthless if out-of-the money or is repurchased if in-the-money. Meanwhile the BXM index stays long the S&P. The BXM index mimics a classic one month at-the-money buy-write strategy.

The PUT index tracks writing naked at-the-money one month S&P 500 put options. This would be the nearest strike below the S&P. The PUT index is not long the S&P, but consists of writing naked puts and earning interest on the cash set aside to honor a possible exercise. At each monthly expiration, the option either expires worthless if out-of-the money or is repurchased if in-the-money. The PUT index mimics a classic one month at-the-money naked put strategy.

What are the returns and volatility of these two indexes vs. the S&P 500 total rate of return index (SPTR)? From July 1986 to October 2009 the SPTR increased 11.1% CAGR. The returns of both option writing indexes beat the SPTR producing returns of 11.6% for the BXM and 13.5% for the PUT.

Additionally, the volatility of the two option writing indexes was lower than the SPTR over that same period. The volatility of the SPTR was 15.8% while the volatility of the BXM was 11.2% and the PUT was 10.3%.

Thus it is clear that writing options on stocks produces higher returns and lower volatility vs. owning stocks out write. Option writing basically reduces both extreme positive and negative monthly returns in exchange for more consistent monthly returns. The average at-the-money call option yield was 1.7% per month over the 270 period from July 1986. Thus the average monthly return was capped at 1.7% or 22.3% annually. Conversely, losses of the S&P were reduced by 1.7% on average per month or 22.3% annually.

The highest monthly option yield for the BXM since 1986 was 8.1% in December 2008 while the lowest yield was .5% in July 1993. Option yields are directly correlated to expected volatility or the VIX. The higher the VIX, the higher the option yield. The lower the VIX, the lower the option yield.

The returns and volatility were more attractive for the PUT index than the BXM index. The PUT index had higher returns due a variety of factors including: 1) higher demand for puts vs. calls due to portfolio insurance, 2) interest rates, and 3) market direction.

We would expect the returns using option writing in the WAM Enhanced Income Fund to be far superior to those of the above analysis. The above figures use only index options for the S&P. We use quantitative screens to find options that have much higher monthly yields than index options. In addition, we only write on those stocks that our model expects to increase in price over the one month option duration.

Since January 2008 the average monthly option yield of the WAM Enhanced Income Fund was 3.9% on options that were written an average of 3.8% out-of the money. Over the same period, the average at–the-money one month S&P index option yielded 2.4%.

Our option yields are significantly higher due to: 1) the underlying stocks are more volatile than the indexes, 2) the options are cheaper, and/or 3) the options are pricing an upcoming event such as an earnings announcement or a corporate action. The stocks we write on do have higher volatility. But these stocks also have a higher probability of increasing more than the index due to our use of quantitative screening.

– Derek Webb

Disclaimer: Commissions, trailing commissions, management fees and expenses all may be associated with the Fund. The investment may not be suitable for all investors. Some conditions apply. Investors should carefully review the Fund's Offering Memorandum, including the risk factors detailed therein under the heading "Risk Factors", prior to investing in the Fund. The indicated rates of return are the historical annualized compounded total returns (periods less than 1 year are un-annualized simple returns) including changes in unit value and reinvestment of all distributions and do not take into account sales, redemption, distribution or optional charges or income taxes payable by any security holder that would have reduced returns. There can be no assurance that the Fund objectives will be met. The Fund is not guaranteed, its value changes frequently and past performance may not be repeated. The opinions expressed in the commentary are those of the author and do not necessarily reflect the views and opinions of the Manager or any distributor of the Manager Funds. The views expressed are of a general nature should not be interpreted as investment advice to you in any way. Please consult a qualified financial advisor before making an investment decision. The portfolio manager/advisor/sub-advisor has a direct interest in the management and performance fees of the Fund, and may, at any given time, have a direct interest in the Fund itself.

Webb Asset Management Canada, Inc.

Phone (416) 646 0975 Toll Free (866) 611 9590 Fax (416) 777 5181 | 920 – 26 Wellington St. E Toronto, Ontario M5E 1S2 | info@WAMfunds.com www.WAMfunds.com