



## Commentary

### Why the decline in the Enhanced Income Fund in 2011?

One of the things I love about our industry is that you can analyze past errors. I completed an attribution analysis of the Enhanced Income Fund for 2011, which clearly underlined that almost all the losses came in July and August.

The significant daily declines of the fund were as follows: July 11th -1.6%, July 27th -1.7%, August 4th -4.1%, August 8th -4.2%, August 18th -5.5%, August 24th -2%, and August 22nd -1.6%. The sum of these 7 daily declines was -21%. The losses on these days resulted from declines in all of our positions, whether they were conservative pipeline stocks like Veresen or buy write positions like Capital One Financial. Similar to the 2008 decline, the market was indiscriminate as all risk assets corrected. Particularly hard hit were growth and cyclical stocks. The only places to hide were bonds or REITS.

Many of the growth and cyclical names that we had over written declined -20% to -50% during the summer. They included: Baker Hughes -47%, Caterpillar -38%, Potash Corp -33%, Cameco Corp. -33%, etc. These large cap stocks were instantly re-rated with substantially lower multiples. Though we had been receiving a +4% monthly yield to overwrite these stocks, that premium was not enough to off set the significant declines in the underlying.

Off setting the declines in individual names were hedges in the form of an S&P 500 total rate-of-return put spread and a VXX position. These hedges were implemented in fear that the process of raising the debt ceiling in the USA would be ugly. Though both hedge positions added protection, the declines in individual names were too significant.

We also mitigated losses by shorting stock against our short option positions. This was the favorable course of action vs. repurchasing the options due to the increase in option prices due to the increase in volatility. The volatility index or VIX increased from \$16 to \$48 or 200% from July 1st to August 8th.

In summary, the Enhanced Income Fund had a poor year due the melt down in July and August. The melt down was broad based with the largest declines occurring in growth and cyclical stocks. Though we employed various hedges, they were not enough.

Going forward we are going to write on lower volatility names. The option premiums will be lower, but there is still more than enough cash flow to cover the distributions without paying out capital.

On a positive note, the cash flow of the fund actually increased over this period. Remember that when the VIX increases, option premiums also increase. When yield securities decline, the current yield on these securities increases. Thus, the overall cash flow yield of the fund increases during declines in the NAV.

The current yield to unit holders is > 10% and is fully funded by income. So we are not dipping into capital. We continue to generate significant cash flow. This same thing happened in 2009 and proved to be a great buying opportunity for the fund.

*-Derek Webb*

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