Enhanced Dividend Income Portfolio: Increasing Income Through Moderate Growth

EXECUTIVE SUMMARY

As a successful advisor, you know that the ability to create wealth and build financial independence is not limited to luck or inheritance. It takes strategy and discipline, which are just a few of the benefits that you bring to your clients. One part of our strategy – and one fundamental way of achieving assets that help earn income for your clients while they sleep – is including dividend-paying stocks and the incorporation of covered calls. Many investors don’t always have a clear picture, however, of how dividend stocks and covered calls can add a stream of steady income to their overall portfolio.

Within this paper, we set out to explore some commonly held illusions around income-oriented investing, and provide an in-depth overview of a winning strategy for helping your clients achieve growth and add dividend income to their portfolio. We will also demonstrate how, by knowing what they own, you can help your clients avoid emotional and short-sighted decisions that cost them money, and we will discuss the importance and power of staying invested. The right investing strategy is not about market timing, so we’ll explore why a market-timed approach can be risky.

Upon a closer look behind the curtain, you will discover two important strategies used by portfolio managers, like those at Capital Wealth Planning (CWP), to help maximize portfolio return and minimize risk. No matter the economic environment, whether it be a bull or bear market, the insights shared here on dividend investing and covered calls can help augment your clients’ income and sustainably nurture their wealth over the long term.
BACKGROUND

Introduction to the Enhanced Dividend Income Portfolio (EDIP)

The Enhanced Dividend Income Portfolio (EDIP) separately managed account (SMA) strategy was uniquely developed by CWP to meet the needs of investors who are looking to adequately manage risk and increase cash flow. This equity portfolio, made up of high-quality, dividend-paying stocks, is strategically designed to deliver income by tactically selling short-term covered calls against the underlying holdings to generate additional income.

Concentrated in domestic equities, the portfolio is comprised of 20 to 30 mega-cap, blue-chip stocks from the S&P 100, with the objective of achieving a consistent estimated 5% to 7% combined cash flow from dividend and option premiums. CWP’s goal is to earn an estimated 2.5% to 3% of annual portfolio income from dividends, and 2.5% to 4% from the option premiums, which is dependent on levels of volatility and market conditions.

A rules-driven approach factors in upside risk in addition to absolute return. It’s important to note that a driving philosophy behind this approach is that there’s not only risk to the downside, but also the risk of missing out on the potential capital gains that strong, long-term equity market cycles can possibly offer.

Widely known as “the father of value investing,” Benjamin Graham once stated that, “if you can take care of managing the risk, the upside will take care of itself.” By developing portfolios to participate in over 80% of the upside, they are well-positioned to weather only 70% of the downside. How? By focusing on four key investing areas that, when used in tandem, can create portfolio growth and income while minimizing risk.

A DEEPER LOOK

Four Key Investing Areas for Building Real Wealth Over the Long Term

People everywhere want to take charge of their portfolio, but the lack of time until retirement and the lack of knowledge about buying and selling investments can slow progress.

As a trusted advisor, you help your clients simplify their investments while helping meet their combined need for growth and income. At CWP, we believe in full transparency with investments in our portfolios; this means that your clients can easily see and understand what they own. In that regard, four key areas of investing must take place:

1. Identifying Opportunities with Dividend Growers

The first measure in building a high-growth, low-risk portfolio is to identify large-cap, high-quality, blue-chip companies from the S&P 100. These
companies must be able to sustain their earnings and cash flow growth, as well as increase their dividends over time.

Each candidate should also have a liquid option chain. For example, CWP’s Enhanced Dividend Income SMA is managed with a strong emphasis on owning blue-chip DOW 30 and S&P 100 components with historical dividend and earnings growth. This focus is important because companies that grow dividends have historically outperformed the rest of the market with significantly less volatility.

2. Diversifying with Sector Allocation

A second area of key investing focus falls within diversified sector allocation. We maintain exposure to the 10 traditional sectors to produce consistent capture ratios.

Portfolio design must occur under the objective of achieving competitive returns when compared to broad market indices, while reducing volatility. This is accomplished by constructing an asset allocation that is relatively balanced among the traditional 10 S&P sectors to maintain diversified sector exposure.

"At CWP, we believe in investment transparency and direct access to the minds behind the money. I welcome your call on my personal cell to discuss any questions about our strategies."

- Founder and Chief Investment Officer
  Kevin Simpson
3. Protecting the Downside with Security Selection

A third element of focus for building an income-paying, low-risk stock portfolio includes selling short-term call options tactically. Avoiding the obligation to cover each individual position 100 percent of the time is key; it’s a real differentiator in the marketplace of covered call writing managers.

The goal is to seek to provide 5% to 7% of gross income from dividend income and option premiums, in addition to the potential for capital appreciation. By further filtering the universe by qualitative factors, suitable candidates within each of the traditional sectors can be identified. Once 40 to 60 candidates have been reached, fundamental and technical analysis is applied to the list to determine which candidates offer attractive risk to return over a 6- to 12-month period.

4. Increasing Total Return with Tactical Covered Call Writing

The fourth and final element to an income-paying, low-risk portfolio involves entering into contracts to sell investments at a higher price. This is referred to as out-of-the-money covered-call writing, and is a traditional means of capturing some of the potential capital appreciation of stocks as well as an upfront premium income. When a call option on a stock holding is sold, the investor receives a premium in exchange for passing on the stock's upside returns above the option strike price over a certain timeframe. The end result is consistent income and an increase in the potential total return of the portfolio. Earned income can then be used for living expenses, or the proceeds can be reinvested back into the portfolio.

Strategies such as EDIP deploy a relatively conservative, tactical, covered-call overlay that isn’t obligated to continuously cover each individual equity position. When one of the underlying stocks demonstrate strength or an increase in implied volatility, managers can then identify that opportunity and sell call options tactically, rather than keeping all positions covered and limiting broader potential upside. When a strategy is managed on a total return basis, it’s important to remember that patience and discipline are required.

The Three "R's" Strategy Behind EDIP

As with most things, exceptional and predictable results are invariably fueled by a unique, strict, and structured discipline. The specific strategy behind EDIP is no exception, and is formally referred to as the Three R’s ~ Rules, Risk, and Returns™. Every decision to invest or not to invest is based on this strategy, which includes all of the above mentioned areas of key investing methodology.
1. Rules

Regardless of where the market currently stands (up, down, or horizontal) rules must always follow in an unchanged progression to achieve the desired results. While some variables, changes and inconsistencies do arise, a rules-based strategy should remain fixed and revolve around how stocks are selected or sold. Investment in companies with strong balance sheets, great free cash flow, and good earnings and dividends is the first part of this high-payoff equation.

Consideration is also given for how the company and its market sector fit into the diversified portfolio being offered. The rules also apply to how a stock is sold; whether it’s underperforming or overperforming.

Those rules combined with the defined strategy, play a tremendous role in how and when covered calls are written. Covered calls are not written for every investment at all times, but only those which will fit the strategy to mitigate risk while maximizing profits within a predictable range.

It’s important to remember that a good rules-based strategy will always trade on mathematics and sound fundamentals, not emotions. At CWP, we believe that by separating emotions from the rules helps investor clients find success in meeting their stated goals. The strategy is designed to seek income from dividend-paying stocks and by opportunistically writing covered calls on those stocks. Although we maintain a 5% maximum allocation to our positions, here are examples of our October 2020 holdings: UnitedHealth Group Inc., Walmart Inc., Nike Inc., McDonald’s Corp., Visa Inc., Caterpillar Inc., Home Depot Inc., Apple Inc., Microsoft Corp., and Goldman Sachs Group Inc., Procter & Gamble or Johnson & Johnson – all a result of this carefully implemented strategy.

2. Risk

To manage risk in investing, one must not only manage the downside of investments, but also make it the foundation for what they do. It’s worth reiterating the Ben Graham philosophy when it comes to this element of investment strategy: manage risk via the downside of a portfolio for the upside to take care of itself.

3. Returns

In order for the defined 3 R’s strategy to operate effectively, returns must be consistent with set expectations. When markets are up, participation in the upmarket is essential. But far more importantly, when markets are down or flat, managing the risks and mitigating the downside capture is crucial.

This, of course, is hinged on prudent choice of investments in great companies that have great management and that pay dividends.
MORE ON RULES

Tactical Covered Calls

It’s not uncommon for questions to surface about CWP’s tactical covered call writing and how the approach differs from a systematic process. Below is an illustration of recent call-writing activity on Microsoft and a demonstration of how the CWP rules-based methodology differs from peer groups:

Summary of recent covered call trades for Microsoft:
• 6/2/20 – Sold call: sold-to-open MSFT 6/26 195s @ $0.82.
• 6/26/20 – Rolled the strike up: bought-to-close MSFT 195s and sold-to-open 7/17 205s – for a net credit of $0.74.
• 7/17/20 MSFT 205 call expired.

Summary to date: CWP sold the 195s, but MSFT still was trading strong and went above our $195 strike (hit $203 on 6/23).

Rather than taking the loss on the option, patience was exercised and the position was able to be rolled out and up to the $205s for a nice credit ($0.74).

MSFT continued to run higher and hit $216 on 7/9. Again, patience was key. Instead of taking a loss, CWP believed MSFT was overbought and the probabilities indicated it would likely pull back. The stock fell from $216 on 7/9 to close just under $203 on 7/17.

There were multiple benefits to the selloff in MSFT:
• The option expired, so the full premium of $1.56 ($0.82 + $0.74) was collected.
• The option position allowed for hedging from the MSFT sell off.
• The position was then free and clear to write on again.
• 7/22 – Sold call: sold-to-open MSFT 7/31 230s @ $1.14. MSFT had an earnings announcement on 7/22 after the close, so the implied volatility was elevated and opportunity was identified to capture the extra premium available.
• 7/31 – MSFT 230 call expired. MSFT had a good earnings report, but technology is very overbought and MSFT reaction is muted.
• 8/20 – Sold call: sold-to-open MSFT 9/18 225s @ $2.00. The price action and market internals were strong in early August, so a decision was made to wait almost three weeks before covering up MSFT again.
• 9/18 – MSFT 225 call expired again.

Summary: Over a three-month time period, $4.70 was collected on MSFT alone, which equates to almost 20 bps of absolute return. The shares were kept intact, and the dividend was collected, adding value/income to client accounts by tactically covering the position at opportune times.
INVESTING PHILOSOPHIES
WE BELIEVE IN

Investing as a Force for Good

The history of investing is accentuated by experimental actions through which brave new investors challenged circumstances in search of transformational wealth. As investing progressed and lessons were learned, people began to step back and take stock of the bigger picture.

To truly capitalize on learned lessons, trusted advisors such as yourself consider your clients’ desired goals, and engage in honest dialogue around the transparency of investing, the importance of commitment, and the myth of market timing.

Combined, these are the makings of a more equitable, low-risk investing future.

Transparency in Investing

Before growth in investments can ever occur, educating your clients must take place. By partnering with portfolio managers that exercise transparency on the companies being invested in, you can give them knowledge and understanding of what they own. Though volatility can be uncomfortable, investors are more likely to get out of the market at the wrong time and cost themselves money when they do not understand what they own.

Most emotional and short-sighted decisions are avoided when investors are given insight from direct access to the minds behind their money – the portfolio managers themselves. At CWP, we give advisors the cell phone number of our founder and chief investment officer. That’s how strongly

20-year Annualized Returns by Asset Class (1999-2019)

Investor commitment is key – returns are lost by missing out on even the 10 best performing days in a 20-year time span.

“Our rules-driven approach factors in upside risk in addition to absolute return. At CWP, we believe there’s not only risk to the downside but also the risk of missing out on potential capital gains that strong long-term equity market cycles can possibly offer.”

- Lead Portfolio Manager Josh Smith, CFA
we believe in advisor and investor education. Incorporating high-quality, dividend-paying stocks of companies that investors know, and products that investors use into their portfolios can be one difference between growth and loss over the long term.

**Commitment to the Investment**

Worry is part of the natural human condition, but when unrelenting, it can cause short-sighted decisions that affect long-term wellness. Nowhere does this scenario play out more unfavorably than in investing. Worrying about the daily fluctuations in the stock market does more harm than good, which is why expert advice is to typically stay invested when stocks are down.

Investment abandonment might ‘feel’ like the right thing to do in a turbulent market, but it invariably results in a miss of rebounding equity valuations. This was especially true for Baby Boomers who exited the stock market after witnessing their stock investments plummet during the Great Recession or the COVID-19 crash.

If you invested $10,000 in the S&P 500 index in early 1999 and stayed committed to those investments, they would have grown to almost $30,000 by the end of 2018. However, a miss in just the 10-best performing days of that 20-year span would have cut your returns in half. Additionally, if you owned dividend-paying stocks, you would miss out on valuable periodic payments.

By methodically revisiting your clients’ goals, you can help them avoid short-sighted decisions and ensure that the investments they own align with their long-term investing objectives, risk tolerance and timeframe for when they’ll need the money most.

**The Truth about Timing**

Escaping the market while it’s still relatively high and re-entering when it’s lower is a tough game to win. Solid investing strategies are always more about time in the market than market-timed strategies. While a market-timed investment strategy may seem like the best way to manage ebbs and flows and achieve higher returns, it creates significant risk for misjudgment due to swift and arbitrary market trends.

When a portfolio is properly constructed to fit an investor’s risk tolerance and time horizon, panic around stock-market drops can be mitigated. Until an investor actually sells, most losses are not even realized. And if a decision is made to sell when prices are low, there’s no actual chance for unrealized losses to circle back to unrealized gains when an upward trend resurfaces.

It’s enticing to try to discern repeatable patterns that can serve as
Increasing Income Through Moderate Growth

the foundation for timed decisions, especially considering the immense computing power available to us.

However, facts show that identifying such patterns is not realistic. The most steady and time-tested advice remains to buy low, sell high, and always stay the course. The key is to partner with portfolio managers who not only don’t market time, but also do not sector weight or overcompensate in one specific name, no matter the conviction.

IN CLOSING

We hope this paper provides a strong overview of how CWP believes you can help your clients achieve growth and add dividend income to their portfolio.

Our Enhanced Dividend Income Portfolio (EDIP) – a rising dividend portfolio with tactical covered call writing for additional cash flow – was created exactly for investors seeking high-quality, equity income and growth.
The portfolio delivers an estimated annual cash-flow of 5-7% by tactically selling covered calls. In this near-zero interest rate environment, EDIP may be an attractive alternative for many of your clients, especially Baby Boomers, who are looking for growth and income.

Designed to offer a higher total return on a risk-adjusted basis for growth and income-oriented investors, EDIP is well diversified among the traditional S&P sectors and consists of approximately 20-30 high-quality, blue-chip companies with strong fundamentals and a history of increasing dividends and earnings.

By knowing what they own, you can help your clients avoid emotional and short-sighted decisions that cost them money. We invite you to discover more about the technical aspects of our investing strategies and portfolios at CWP to help maximize your clients’ portfolio return and minimize risk.

Visit capitalwealthplanning.com to learn more about our portfolios, or give Founder Kevin Simpson a call at 239-593-2100.
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Investing in options involves risk that must be considered and reviewed with a professional prior to investing. Before engaging in the purchase or sale of exchange-traded options, investors should understand the nature and extent of their rights and obligations and be aware of the risks involved, including the risks pertaining to the business and financial condition of the issuer of the underlying stock. Listed options are not suitable for all investors. Prior to buying or selling options, a person must be provided with and review a copy of CHARACTERISTICS AND RISKS OF STANDARDIZED OPTIONS.

A copy of this document may be obtained from Capital Wealth Planning, LLC, 9015 Strata Stell Court, Suite 203, Naples, FL 34109.

Illustrations used herein are hypothetical (including any illustration of potential portfolio cash flow from a covered call option writing program). Covered call option cash flow for any portfolio will vary depending on actual portfolio positions, option premiums received, individual stock price volatility, and general stock market volatility. Positions covered by call options may be called away, creating realized capital gains or losses. Cash flow is not guaranteed over any period. The results achieved by individual clients will vary and will depend on a number of factors including the particular underlying investments and their dividend yield, option market liquidity, interest rate levels, implied volatilities, and the client’s expressed return and risk parameters at the time the service is initiated and during the term.

A covered call refers to a financial transaction in which the investor selling call options owns an equivalent amount of the underlying security.

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