Options for Income

Reducing Interest Rate Risk with Dividends and Derivative Income

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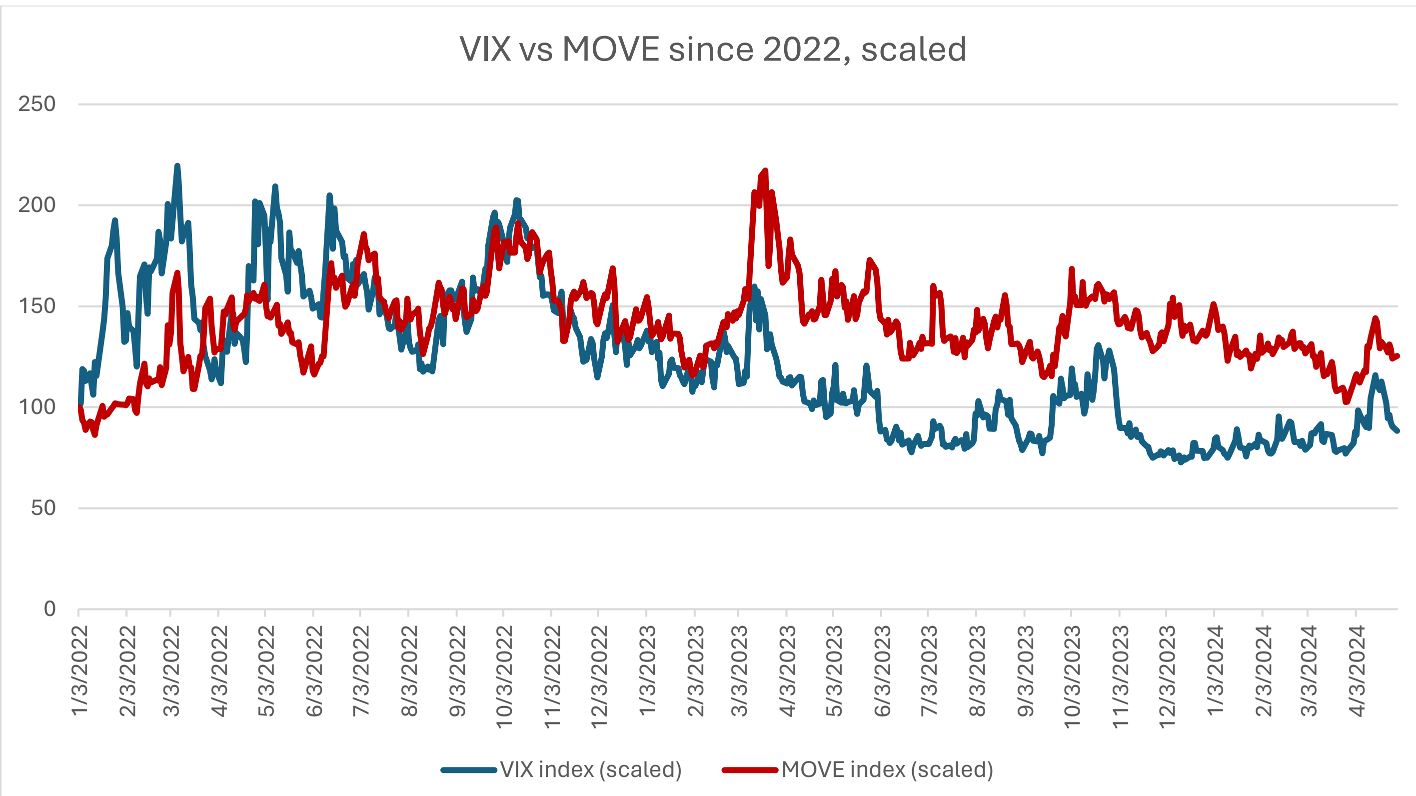
Since the Global Financial Crisis of 2007-09, fixed income investors have suffered the worst of both worlds. For a dozen years they endured the stingiest of yields on their fixed income holdings. This was followed by painful losses in 2022 as the Federal Reserve finally raised rates to combat the worst inflation seen in a generation.

Although bond yields are now closer to their historic levels, bond investors are still nervous and uncertain about what comes next. Investors with income needs are wise to diversify the risk of being wholly dependent on the whims of the Federal Reserve monetary policy.

Diversify Income Sources or Rely on the Fed

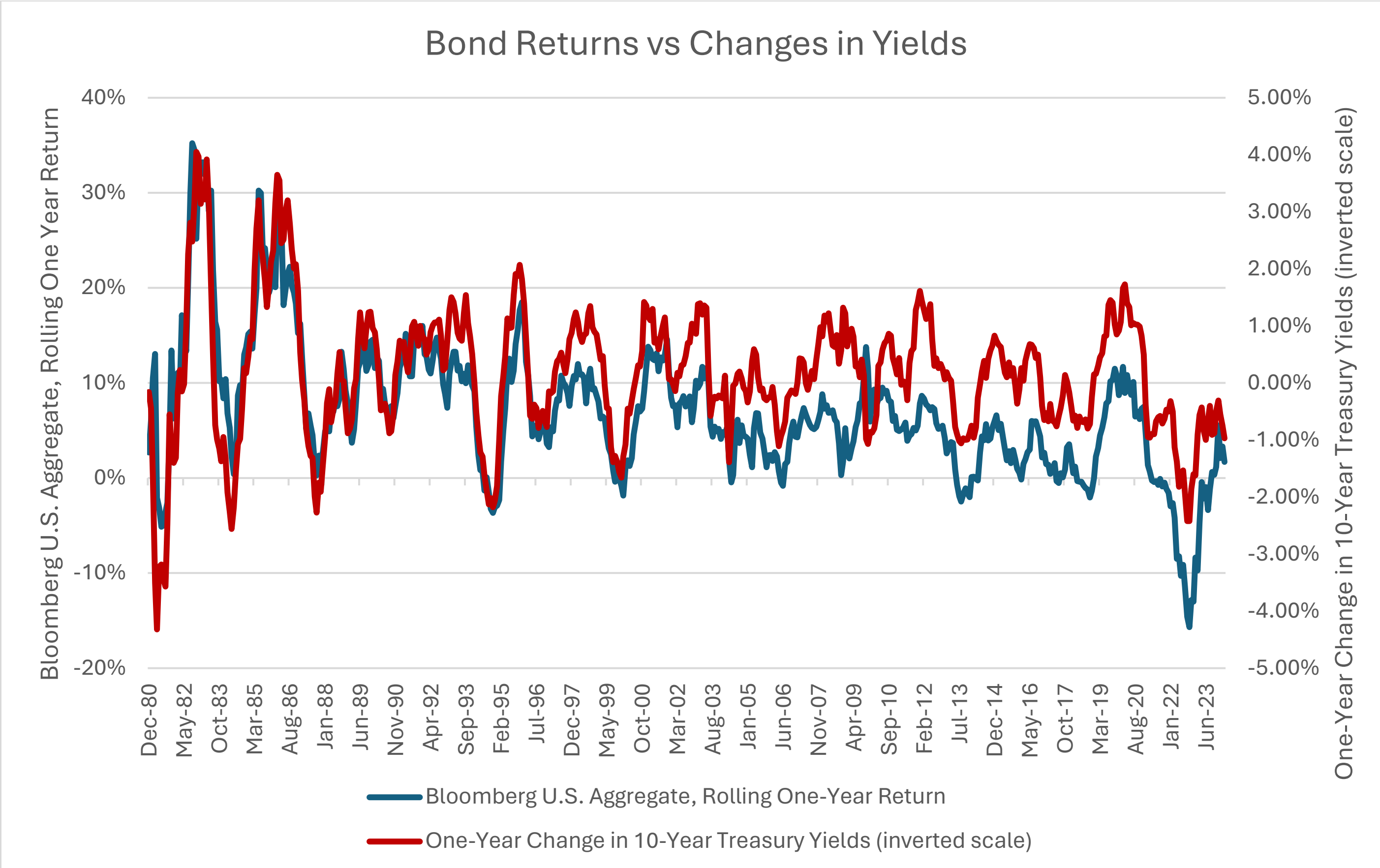
The chart below compares the implied volatility of stocks compared to bonds. The blue line is the VIX index, commonly called "the fear gauge." Many people are familiar with the VIX, a measure of sentiment and the anticipated volatility of the S&P 500. A higher VIX reading generally indicates higher uncertainty, fear, and anticipated volatility while a lower VIX suggests the opposite. Fewer investors are familiar with the bond market equivalent, the MOVE index, shown below in red.



Source: Swan Global Investments, finance.yahoo.com. The VIX and the MOVE are scaled to the same starting point of 100 at the start of 2022.

Implied volatility was high for equity and fixed income throughout 2022 as the Fed's rate increases hurt both. However, in 2023 and 2024 the VIX has retreated to the lowest levels since before the Covid Pandemic of 2020. Meanwhile, the MOVE index remains elevated as fixed income investors are trying to guess the Fed's next move.

Investors have a right to be worried. Changes in yields drive the returns of their bond holdings. The graph below compares the rolling, 12-month return of the Bloomberg U.S. Aggregate Bond index (red) against the rolling, 12-month difference in the 10-year Treasury yield (blue). As bond prices and yields are inversely related, the yield scale was inverted as well to illustrate the close correlation between the two.



Source: Zephyr StyleADVISOR, Federal Reserve Bank of St. Louis, Swan Global Investments

The simplest interpretation of this graph is "you can't fight the Fed." Changes in Federal Reserve Monetary policy will dictate how well or how poorly bonds will perform.

Options to Diversify

Thankfully investors do have options available to decrease their exposure to this single factor. Just as investors seeking capital appreciation should diversify beyond the S&P 500, investors seeking income should diversify beyond plain vanilla Treasury bonds.

Investors can also seek income from:

- Credit markets: investors can exploit the credit spread by investing in bonds with lower ratings, such as corporate or high-yield bonds.
- Dividend stocks: investors can emphasize stocks with regular or growing dividend payments.
- Option premium: strategies that write options can offer a separate source of profits or income via the collection of premiums.
- Rents: REITs pass through at least 90% of the income they collect from the rentals of their properties to their investors.

- Cash flow: MLPs can pass through qualifying income from natural resources and real estate investing in a tax-efficient manner.

Each of these alternatives has its own set of risks and none will be perfect in every environment. However, that is the whole point of diversification- one should have uncorrelated sources of risk and return in order to dampen the overall volatility of their total portfolio. This line of thinking should be extended to the sources of income.

Diversifying with Derivative Income & Dividend Income

To help investors diversify away from an over-reliance of Fed policy for income, Swan has recently unveiled the Swan Enhanced Dividend Income ETF (SCLZ). Overall, the Fund's objective is total return, seeking both sustainable income and capital appreciation. Developed in conjunction with O'Shares Investments, this ETF focuses on two of the alternatives listed above: dividend stocks and option premium.

The Swan Enhanced Dividend Income ETF follows a unique "active-active" approach. The ETF typically holds about 50 stocks, specifically selected by O'Shares Investments for quality growth characteristics as well as a track record of growing their dividend payments.

Swan then brings over a quarter century's experience in options trading to generate income via the writing of call options on those positions. Unlike some passively managed call writing strategies that follow a "set it and forget it" approach, Swan actively manages their short call positions. Swan will vary the timing and sizing of its short call positions on a per name basis, actively seeking to manage the risk-return trade-off based upon market conditions.

Diversification is simply the old adage, "Don't put all of your eggs in one basket." This is sound advice regarding the sources of income. To reduce dependency upon Federal Reserve monetary policy an income investor should seek diversified sources of income. The Swan Enhanced Dividend Income ETF can help fulfill those needs by focusing on actively selecting stocks for quality dividends and capital appreciation overlaid active call option writing.

About the Author:

Marc Odo, CFA®, FRM®, CAIA®, CIPM®, CFP®, Director of Investment Solutions, is responsible for helping clients and prospects gain a detailed understanding of Swan's Defined Risk Strategy, including how it fitsinto an overall investment strategy. Formerly Marc was the Director of Research for 11 years at Zephyr Associates.

Important Notes and Disclosures:

including the statistical information, verification and performance reports are available upon request. The adviser's dependence on its DRS process and judgments about the attractiveness, value and potential appreciation of particular ETFs and options in which the adviser invests or writes may prove to be incorrect and may not produce the desired results. There is no guarantee any investment or the DRS will meet its objectives. All investments involve the risk of potential investment losses as well as the potential for investment gains. Prior performance is not a guarantee of future results and there can be no assurance, and investors should not assume, that future performance will be comparable to past performance. Further information is available upon request by contacting the company directly at 970-382-8901 or www.swanglobalinvestments.com.

Investors should carefully consider the investment objective, risks, charges and expenses of the Swan Enhanced Dividend Income Fund (ticker: SCLZ). This and other information is contained in the prospectus and should be read carefully before investing. For a prospectus please call 877-383-7259 or 877-ETF-SCLZ, or you can order copies of the prospectus via email: orderswanetfs@ultimusfundsolutions.com. Please read the prospectus carefully before you invest.

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