Enhanced Equity Income

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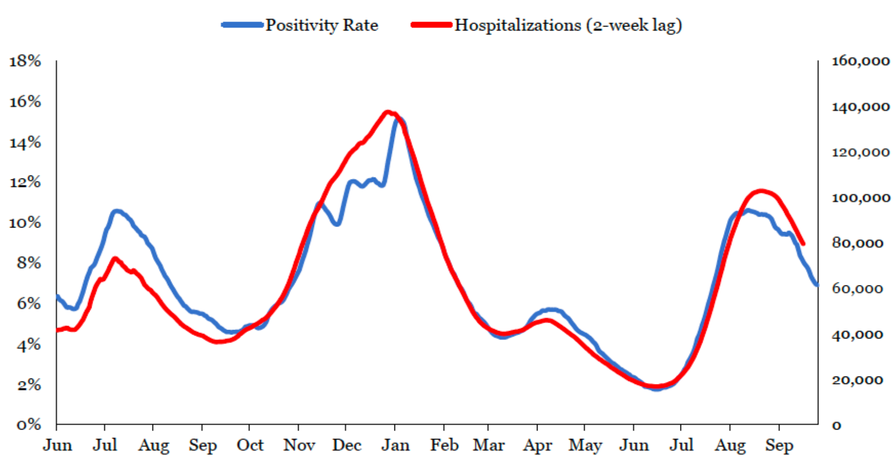
Q3 2021 Commentary

Market Review:

US equities experienced a volatile 3rd quarter but finished roughly flat, as the S&P 500 was up +0.6% while the Russell 1000 Value declined -0.8%. Stocks rallied for much of the quarter, with the S&P 500 posting seven consecutive months of gains through August. However, this was followed by a sharp pullback in September on concerns regarding the Delta variant of Covid-19, continued supply chain disruptions and the impact on global growth, and shifting Fed policy, among other uncertainties. At the beginning of the quarter, the US economy appeared to be on track for a strong reopening in the fall. Although the Delta variant quickly altered that reality, new cases and hospitalizations began to roll over in August, which bodes well for a recovery and reopening as we enter 2022 (Figure 1).

Figure 1: US Covid Trends



Source: Strategas, Quarterly Review in Charts, 10/4/2021.

Financials was the best performing sector, up 2.7%. Several banks and insurers posted strong quarterly earnings and a late quarter jump in interest rates and rotation into Value stocks benefited the sector. Utilities (+1.7%) was the 2nd best performing sector, rebounding slightly after being the worst-performing sector in the first half of the year. Communication Services was the next best performing sector, driven by gains in Media and Entertainment stocks while Telecom lagged. Industrials (-4.3%) was the worst-performing sector, as transportation stocks were hit particularly hard by the Delta variant's impact on travel as well as rising labor costs. Materials (-3.5%) also lagged, as commodities producers were heavily impacted by the drop in commodities prices largely due to concerns surrounding China's economy.

On the policy front, Fed Chair Jerome Powell indicated the central bank may begin tapering its monthly bond buying program by year end. Powell also said the economy has much ground to cover before reaching maximum employment, so despite elevated levels of inflation, interest rate increases are not imminent. On Capitol Hill, the Senate passed a roughly $1 trillion infrastructure package and a separate $3.5 trillion budget proposal. Both policy measures, if passed, will further lift inflation expectations and potentially drive interest rates higher.

Income and Options Summary:

In the Enhanced Equity Income strategy, total income receipts increased to 7.4% annualized during the 3rd quarter, including a 4.1% contribution from dividends. Volatility began to return to equity markets during the quarter, as the VIX generally trended upward and posted considerable spikes during mid-July, mid-August, and mid-September. Calls written averaged nearly 18% annualized income and were written at more than 3.5% out-of-the-money, while call premium breadth remained focused on a few sectors.

Assignment rates remained characteristically low during a period of strong total return. Contracts from only eight of 38 positions exposed in the rep account and 22% of contracts written in the composite were assigned, reducing the YTD assignment rate to 31%.

Amid the crescendo of the transitory-versus-systemic-inflation debate, dividends remained a strong contribution to portfolio return, with more than a third of companies held declaring dividend increases during the quarter, at an average of 14.9%. Year-to-date, 24 of 35 companies held had declared increases, at an average of 11.6%.

Performance Analysis:

The Enhanced Equity Income composite declined 1.0% (net) during the quarter, underperforming its primary benchmark, the S&P 500 Buy/Write Index (BXM), which gained 1.4% and its secondary benchmark, the SPDR Barclays High Yield Bond ETF (JNK), which returned 0.7%. The composite has netted 16.2% year-to-date, compared with a 12.6% return by the CBOE S&P 500 Buy/Write Index (BXM). While the strategy has benefited from its allocations to the Energy, Financials, and Industrials sectors, underperformance in Consumer Staples, Health Care, and Materials impacted 3rd quarter returns.

Figure 2: Enhanced Equity Income Returns vs. Benchmark

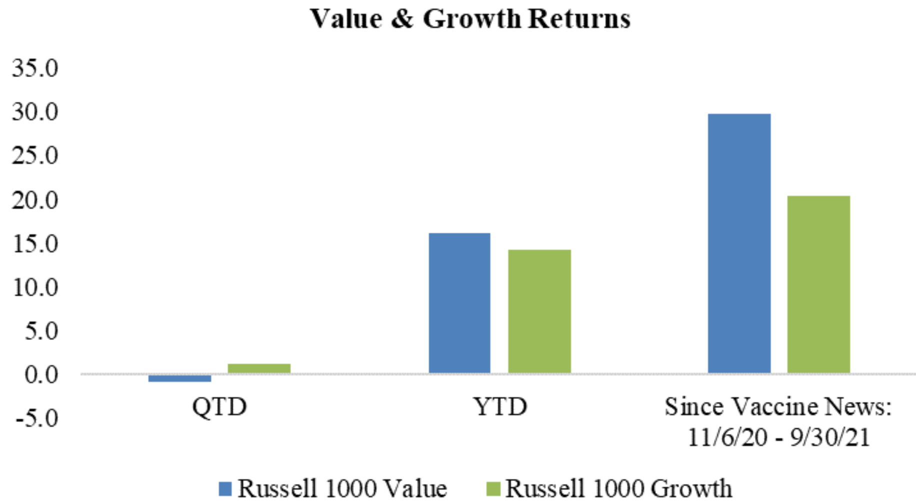
September 30, 2021	QTD	YTD	1 Yr	3 Yr	5 Yr	Since Incept*
SCCM Enhanced Equity Composite (gross)	**-0.7**	**17.2**	**32.4**	**9.7**	**9.4**	**9.7**
SCCM Enhanced Equity Composite (net)	**-1.0**	**16.2**	**30.9**	**8.5**	**8.2**	**8.5**
S&P 500 Buy-Write Index (BXM)	1.4	12.6	21.1	4.2	7.0	6.9
SPDR Barclays High Yield Bond ETF (JNK)	0.7	3.7	9.9	5.9	5.5	5.4
Russell 1000 Value Index	-0.8	16.1	35.0	10.1	10.9	11.3

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

The marginal outperformance of the growth style during the quarter brought the two styles within two percent total return year-to-date and lent credence to the analysis that the broad equity market remains in a style-neutral preference for quality earnings and earnings growth. Indicated preferred performance characteristics included upward EPS revisions, upside earnings surprises, and dividend growth. The Enhanced Equity Income strategy exhibited these characteristics, with 100% of its names in the first category and nearly 70% in the third.

The strong US equity market returns this year have been broad-based with most style and capitalization indices participating in the rally. Value has outperformed Growth in 2021 and is ahead by more than 9% since Pfizer's successful Covid-19 vaccine trial announcement last Fall (11/6/20) (Figure 3). However, Growth stocks began to regain leadership in the second quarter. This extended into the third quarter, with the Russell 1000 Growth up +1.2%, slightly outperforming the Russell 1000 Value, which declined -0.8%.

Figure 3: Equity Style Indices Performance (YTD)



Source: SCCM Research, Bloomberg, 9/30/2021.

Performance by valuation quintile in the S&P 500 mirrored the spread with the highest Price/Earnings quintile outperforming the lowest Price/Earnings quintile by 140 basis points (Figure 4).

Figure 4: Performance by Valuation Quintile

S&P Relative Forward P/E Quintiles		Q3	YTD	Weight in S&P 500	Forward P/E Ratio	Dividend Yield
High P/E	11.94 To 1.54	0.2	7.4	23.4	47	0.4
↓	1.54 To 1.08	2.7	22.3	32.9	26	0.9
	1.08 To 0.81	-2.8	11.2	15.9	19	1.5
	0.81 To 0.60	-1.8	15.9	16.6	14	2.5
Low P/E	0.60 To -5.30	-1.2	17.8	11.1	10	3.3

Source: BofA Research, US Performance Monitor, 10/4/2021. Forward P/E and Yield as of 9/30/21.
Past performance is no guarantee of future results.

Risk factors, particularly Beta, have been some of the strongest factor groups in the year. The highest beta quintile in the S&P 500 has outperformed the lowest beta quintile by 19.7 percentage points in 2021. Partially reflecting this factor trend, the highest dividend yielding quintile (dividend yield > 2.9%) – exhibiting the lowest overall beta – slightly underperformed the market in the quarter and for the year (Figure 5).

Figure 5: Performance by Dividend Quintile

S&P Dividend Yield Quintiles		Q3	YTD	Weight in S&P 500	Forward P/E Ratio	Dividend Yield
Low Yield	0.00 To 0.00	1.0	16.3	27.6	30	0.0
↓	0.00 To 0.99	2.1	15.2	24.6	27	0.6
	0.99 To 1.86	-1.2	15.5	15.1	18	1.5
	1.86 To 2.93	-0.9	12.9	19.0	16	2.3
High Yield	2.93 To 9.55	-1.7	14.3	13.7	13	4.4

Source: BofA Research, US Performance Monitor, 10/4/2021. Forward P/E and Yield as of 9/30/21.
Past performance is no guarantee of future results.

Underneath the seemingly benign performance gap between Value and Growth has been sharp swings in relative performance between the styles, reflecting the hesitancy the market has in embracing one style over the other. The narrative supporting Value stocks centers on the stronger rebound in earnings over that of Growth stocks – the growth rate of earnings of Value stocks over Growth stocks is currently 65% higher than average. In addition, Value stocks remain ~20% under-owned in active funds and trading at significantly cheaper valuations relative to historical levels, creating a meaningful opportunity for Value stock outperformance as mean-reversion narrows these disparities. The strength in Growth stocks has been fueled by the continuation of Central Banks' quantitative easing programs, with the Fed, ECB and BOJ balance sheets expanding by 60%+ in the last 18 months. The flood of liquidity has lifted valuation multiples disproportionally benefiting growth and momentum stocks. Alongside this driver, the rise of the Delta Covid-19 variant and fears of slowing economic growth pushed interest rates lower, driving flows into long-duration growth stocks.

Portfolio Changes:

Purchases / Additions

No new positions were purchased during the quarter.

Sales

Lowe's (LOW) was purchased in March 2020 during the steep drop in US stock prices following the outbreak of Covid-19. At that time, we examined Lowe's balance sheet and cash flow prospects and determined the company had the strength to withstand an extended pandemic. The retailer benefited tremendously in 2020 and 2021 from home improvement trends, with at-home consumers working on remodeling projects and a increase in new home buying. Furthermore, CEO Marvin Ellison has successfully revamped Lowe's omnichannel shopping strategy, significantly increasing online sales, as well as increasing sales through its important Pro channel. While we continue to like Lowe's growth prospects, with the shares having appreciated over 100% since purchase, the dividend yield has declined to 1.5%.

Market Outlook:

After a historic rally from the March 2020 lows, equity indices paused and consolidated gains as the market digested the impact of decelerating US growth, the surge of the Delta Covid-19 variant, new financial and regulatory concerns in China and Washington DC funding uncertainty along with heightened inflation and supply chain disruptions. Despite these issues, robust financial market liquidity and easy monetary policy conditions continued to provide downside support to markets.

Broadly, Technology benefited from the heightened concerns and lower rates while several cyclical sectors, Materials and Industrials, with greater ties to the economy took the brunt of market fears. While the correction from recent high price levels has been modest, market internals deteriorated as weakness has spread to a growing number of stocks - the average stock in the S&P has declined 12% from its 52-week high. The divergence in performance between Covid beneficiaries (Growth) and Recovery beneficiaries (Value) has widened considerably to near Q1 levels (Figure 6). As a result, the valuation spread between Covid beneficiaries and Recovery beneficiaries is back near record wide levels (Figure 7).

Figure 6: Covid Beneficiaries vs Recovery Basket Performance

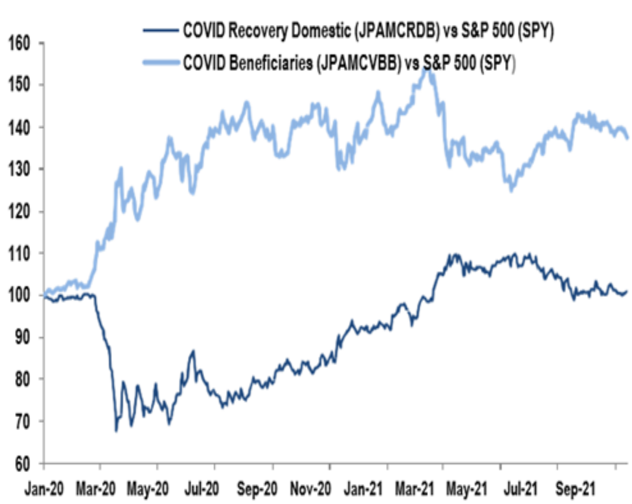
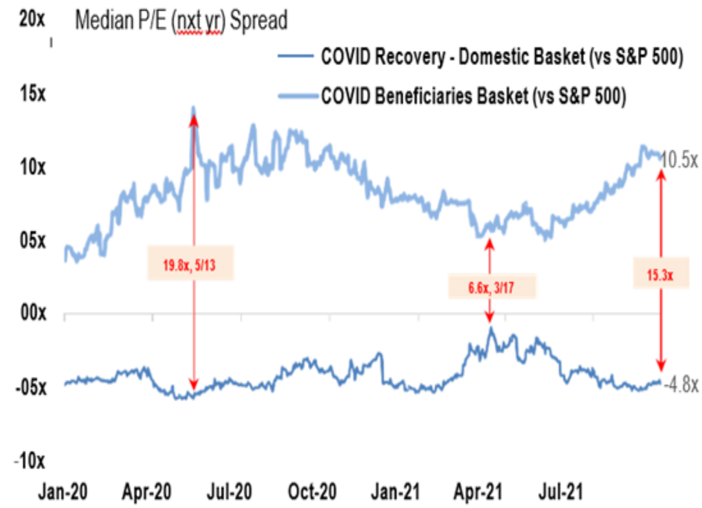


Figure 7: Valuation Spreads Between Covid Beneficiaries and Recovery Basket



Source: JPMorgan, US Equity Strategy, 9/15/2021.

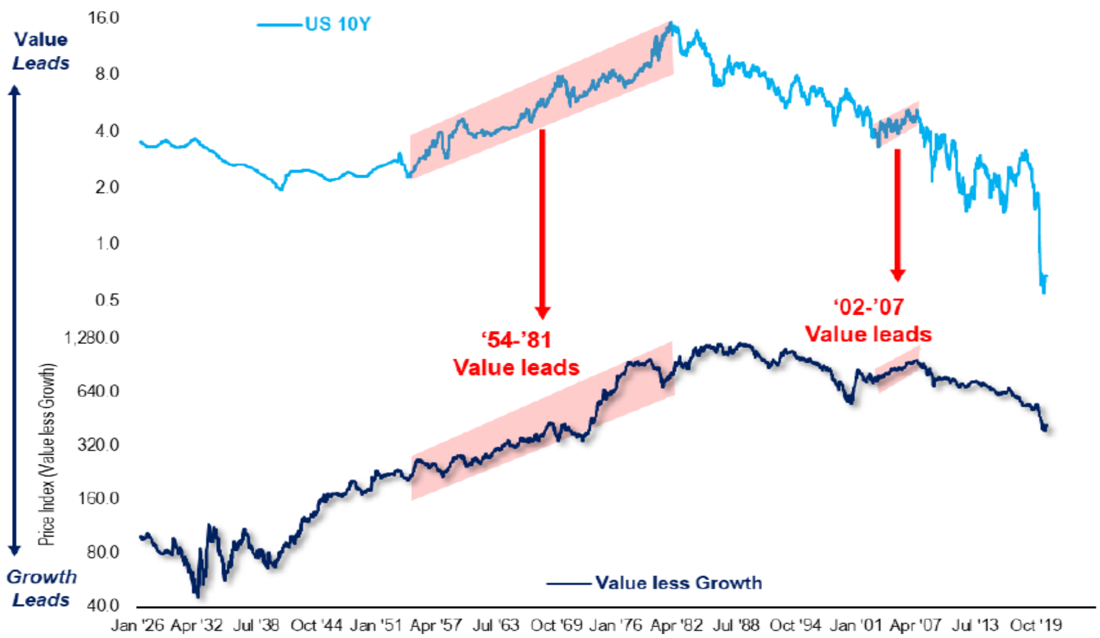
As these recent macro concerns abate, Value stocks should see a lift from an underweight positioning and attractive valuations, especially as these wide valuation disparities narrow. Economic headwinds are now turning to tailwinds, potentially ushering in sustained global growth. The rise of the Delta variant, hampering full reopening, appears to have peaked and as the pandemic lingers on, world populations will increasingly be immunized via vaccinations or antibodies eventually bringing more permanency to the recovery. The deceleration in US economic data, in part caused by rising Covid cases, has set the proverbial "bar" lower for positive surprises. The Citigroup Economic Surprise Index is currently reading levels near the bottom 10% of historical levels potentially propelling equities higher on stabilizing headlines going forward (Figure 8). Lastly, while supply chain disruptions may linger, negatively impacting pockets of companies, over time operations should normalize thus serving to prolong the economic cycle.

Figure 8: Economic Surprise Index

Source: Strategas, 9/30/2021.

The direction of interest rates, which had steadily declined due to economic concerns, institutional flows into Treasuries and record short positioning reversing, continues to drive equity style factor performance. Not to be ignored, algorithmic trading, which accounts for over 60% of US equity trading volume, now drives an estimated 50% of US Treasuries trading volume. Falling interest rates, driving flows into long-duration Growth assets, began to reverse at the end of Q3. Improving economic data, declining Covid cases and higher energy prices are but a few catalysts that could drive rates higher, bringing the herd-like momentum traders to reverse bullish Treasury positions. Importantly, value stocks have historically outperformed Growth stocks when long-term rates rise (Figure 9).

Figure 9: US 10-Year Yields and Value vs. Growth Relative Returns



Source: Fundstrat/Bloomberg, 9/29/2021.

Dividends have largely been ignored in this cycle as the preference for Growth during the pandemic gave way to a rotation into cyclical re-opening beneficiaries. Quantitative easing over the last 12 years has disproportionally benefited growth stocks as excess liquidity pushed valuation multiples higher. Since 2009, those periods <u>without</u> quantitative easing have delivered more mixed market returns, including a significantly greater number of periods with market declines. As monetary policy normalizes (taper) and liquidity tightens, volatility is likely to rise and bring with it a greater dispersion of S&P 500 returns. This transition could favor high-quality dividend paying stocks, which have historically performed well in mid and late stages of a bull market. Alongside these considerations, the valuations of high dividend payers are extremely appealing in an otherwise expensive market. Given the incredibly strong equity returns generated this past decade combined with near record absolute valuation levels, forward market returns are expected to be muted, and dividends will likely be a more important contributor to total returns.

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

Respectfully,

Schafer Cullen Capital Management, Inc.

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