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# Concentrated Stock Plus
## Quarterly Update

Q2 2022

## Executive Summary

— Higher inflation readings persist; Fed responds with interest rate hikes and signals more are likely
— Volatility remains elevated while global tensions mount, particularly in Eastern Europe
— Despite strong employment and a July rally, equities are down year-to-date as recession fears loom
— Portfolio insights: navigating a challenging market through active management

## Inflation Frustration and Recession Obsession

***excerpted from the July 2022 NorthCoast Navigator***

Investors breathed a sigh of relief in July as the markets rebounded on the combination of rate reprieve, bearish positioning, and tentative signs of fading inflationary pressures. The Dow gained almost 7% and the S&P 500 was up by 9.2% for the month. The technology-heavy Nasdaq Composite outperformed by advancing 12.4%.

Inflation pressure, monetary tightening and slowing growth remain the dominant global macro themes. In July, U.S. consumer price inflation accelerated to a new peak with a 9.1% increase on a year-ago basis. Continuing inflation pressures prompted the Federal Reserve to hike by 75 basis points for the second straight meeting, boosting the target range for the federal funds rate to 2.25-2.50%, a long-term “neutral” level at which any further rate hikes would be considered “restrictive” to economic activity. We expect a slower pace of hiking from here, anticipating another 50bp hike in September and 25bp hikes in November and December, though the decisions remain data-dependent, with a 75bp hike possible in September.

## Market Exposure


We remain conservative (U.S.) and cautious (International) with equity exposure as we believe that near-term equity drawdown risk remains elevated with the unfriendly mix of higher inflation, recession risk, and rising rates.

Our base case view is that the monetary policy response priced by markets should curb inflation with only an economic slowdown or a mild recession. However, markets will likely remain volatile until the growth/inflation backdrop improves, as investors swing between inflation frustration and recession obsession.

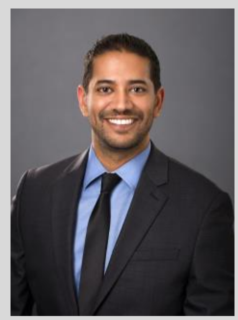
## Stock Analysis Update

In the second quarter, our stock selection models outperformed the large cap universe by 4.3%. We remain bullish on energy and healthcare in the near term. During the quarter, we added 500 stocks and a couple signals to our scoring model. We now have research coverage of almost 3000 stocks in our scoring model.

## Options Market Observations

The second quarter saw investors accelerate demand for put options to help protect against downside risk[1]. The biggest concerns weighing on markets are how much interest rates will go up and how effectively the rate hikes can stop inflation. Add to that, the Russia-Ukraine war may be prolonged and the price of oil could remain high unless consumer demand drops significantly.

Market Exposure | Stock Analysis | Options Trading | Advisory Services



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Senior Vice President
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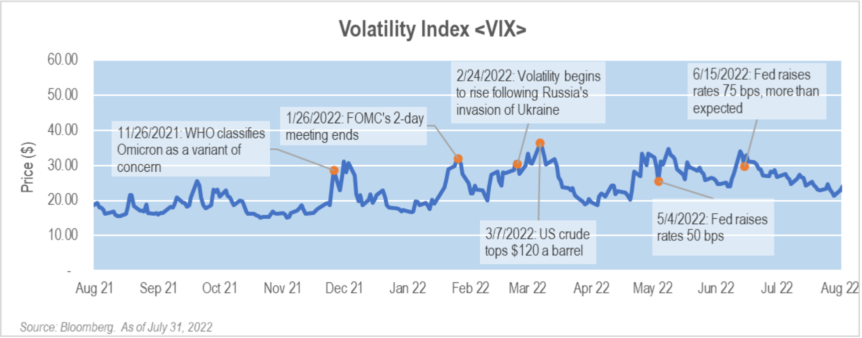


A useful indicator for this negative outlook is the **put/call ratio**[2], a measurement of the trading activity of put options compared to call options. Generally, a ratio greater than 0.7 indicates bearish sentiment. The ratio is currently elevated and the 30-day average at July month-end was 0.98. The last time the ratio climbed to this level was in March 2020, when the world realized how rapidly COVID-19 was spreading around the globe and governments began enacting lockdown measures and travel restrictions.

Along with the increased trading activity in puts is the heightened market volatility. In the following section, we discuss how NorthCoast navigates through the price swings for concentrated stock portfolios.

## Portfolio Insights: How We Actively Manage Concentrated Stock Portfolios

**The US has officially entered a bear market, defined as a 20% drop from recent highs. As of June 13, the S&P 500 was down more than 21% from its January record.** As mentioned previously, the threat of recession hangs overhead due to high inflation, interest rate hikes, and market volatility.

Navigating the current market environment is critical. Managing each concentrated stock portfolio successfully is dependent upon three important aspects: 1) developing an insightful market outlook, 2) incorporating a quantitative view on the underlying stock, and 3) selecting the optimal option contract amidst hundreds of possible choices. Our market exposure model uses over 40 signals to identify optimal market exposure in changing conditions. The stock scoring model uses over 20 individual data points across seven broad categories, such as fundamentals, valuation, sentiment, and technicals, to generate our view of how the stock is likely to perform in the near-term. These three aspects help direct the team when selecting optimal options contracts for concentrated stock portfolios.

Stock and options positions are monitored daily with the help of automated systems which evaluate risk levels and alert us to trading opportunities. We reassess positions based on the above parameters. If it makes sense, we employ **dynamic rebalancing**[3] for our flagship Covered Call strategies[4].

In one case, we executed a July 2021-expiring covered call with a $160 strike price on Apple <AAPL> stock which near the time of expiration was in the $140-$150 range. As the stock had been trending upwards in concert with the technology sector, we rolled into January 2022 contracts with a $170 strike price for added upside potential.

As we approached the January expiration, our models projected the stock may still have room to grow and premiums looked attractive due to the market volatility. Therefore, we closed out of the options to lock in gains and generated an additional batch of premiums by writing June 2022 contracts with even more upside potential.

**Performance From June 30, 2021 To June 30, 2022**

| | AAPL only | AAPL With Dynamic Covered Call Overlay |
|---|---|---|
| Return | 0.4% | 4.2% |
| Volatility | 29.8% | 25.6% |
| Ratio | 0.01 | 0.16 |
| Drawdown | -28.3% | -25.0% |

**What happened?** Despite a market sell-off in the first quarter of this year, AAPL stock pared some of its losses, reaching year-to-date highs of almost $180. Subsequently, our models estimated the stock would be vulnerable in this economic and rising interest rate environment. When the June 2022 contracts were about to expire, we rolled into December 2022 contracts with a lower $170 strike price. By dynamically rolling covered call options as the stock declined in the second quarter, we produced incremental premiums for the client. Overall, the return over the 12-month period ending June 30, 2022, was 4.2% compared to 0.4% for the stock alone. Additionally, volatility and drawdown were dampened—portfolio volatility was 25.6% compared to 29.8% and drawdown was -25.0% versus -28.3%.

Sources: Bloomberg, NorthCoast Asset Management

Interested in learning more about Concentrated Stock solutions? Contact NorthCoast Asset Management at info@northcoastam.com.

[1] More information on downside protection available here.
[2] Murphy, Casey. Put-Call Ratio. Investopedia, 12 May 2022 <link>.
[3] More information on dynamic adjustment and glossary available here: <link>
[4] More information on covered calls available here: <link>

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Options overlay strategy does not protect from downside risk. The downside risk protection benefit of a call writing strategy is limited to the amount of the premium received. Portfolio holdings may need to be sold to generate cash to settle options. Such sales may produce tax consequences. Investors must be willing to forgo potential upside appreciation above the premium value in exchange for the incremental income. Options may expire worthless or not perform as expected, resulting in losses.

Options involve risk and are not suitable for all investors. Please refer to Characteristics and Risks of Standardized Options (http://www.optionsclearing.com/about/publications/character-risks.jsp).