

Concentrated Stock Plus Quarterly Update

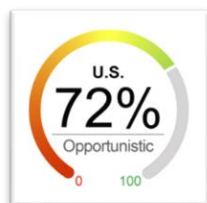
Executive Summary

- Strong US stock market performance in 2021 while significant headwinds persist
- Ongoing spread of COVID-19 threatens global economic recovery
- Despite the challenges, steady optimism for 2022
- Concentrated Stock Case Study: Amazon

In the Face of Obstacles, a Record-Breaking Year

Now that we've closed the books on 2021, we look back and reflect upon some of the year's biggest headlines—inflation reaching 40-year highs, labor shortages, global supply chain disruptions, and of course, the pandemic. Regardless, confidence in economic principles held firm, and strong corporate earnings helped guide stock indices to all-time highs. Over the twelve months, the S&P 500 gained 28.7% while the Dow and Nasdaq were up 20.9% and 22.2%, respectively, even as the virus was making resurgences around the world.

Market Exposure



In our view, consumer demand will continue to push stocks upward this year. As mentioned in a recent [NorthCoast Navigator](#), we estimate the global economy still has room to grow and is far from a stagflation scenario, an economic situation of stagnant growth with high inflation.

Persistently high inflation readings could be potential performance drags. Due in large part to shortages in raw materials, inflation is now averaging 6.8%, a level not seen since 1982¹. In response to increasing price levels, the Federal Reserve ("Fed") has announced the possibility of multiple interest rate increases this year to prevent the economy from overheating. Markets are expecting rate hikes to begin as early as March².

Stock Analysis Update

In the fourth quarter, our top 15% small cap picks outperformed the small cap universe by 4.4% and our large cap picks outperformed the large cap universe by 1.9%. Our stock scoring and market exposure models continue to add significant value leading to better option selections consistent with investment strategy parameters.

Options Landscape Observations

The below graph is a visual representation of VIX, also known as the *fear index*. The index calculates the expected level of price fluctuation in S&P 500 Index options, or the **implied volatility** of the markets. During market selloffs, the index shoots up. The most recent spike was on November 26, 2021, the day the World Health Organization (WHO) confirmed the emergence of a new variant of COVID-19, which would be named Omicron³.

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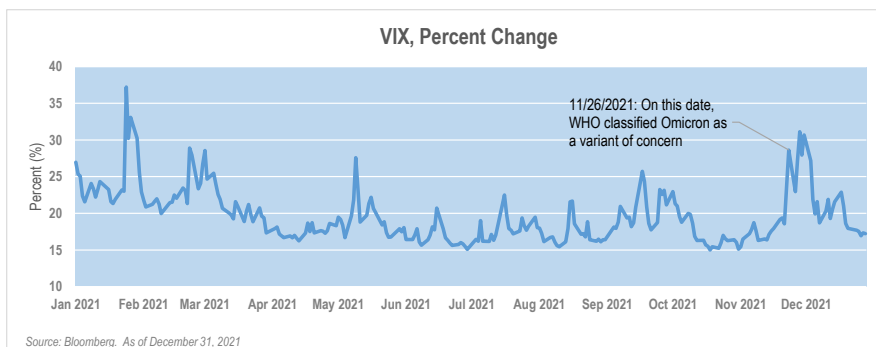


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¹ Santilli, Peter, and Gwynn Guilford. "Inflation Is near a 40-Year High. Here's What It Looks like." *The Wall Street Journal*, Dow Jones & Company, 17 Dec 2021, <https://www.wsj.com/articles/inflation-is-near-a-40-year-high-heres-what-it-looks-like-11639737004>.

² According to World Interest Rate Probability <WIRP> on Bloomberg. Accessed on 7 Jan 2022.

³ "First Confirmed Case of Omicron Variant Detected in the United States." Centers for Disease Control and Prevention, 1 Dec 2021, <https://www.cdc.gov/media/releases/2021/s1201-omicron-variant.html>.



Dramatic price swings, as measured by implied volatility, are usually favorable as premiums collected in overlay strategies tend to increase.

Next, we discuss how these economic conditions may be beneficial for concentrated stock portfolios.

How a Covered Call Strategy Can Add Value—a Case Study on Amazon

Our moderately bullish outlook coupled with elevated volatility have helped create an environment that we believe is attractive for Covered Call Liquidation and Covered Call Upside, solutions offered to our concentrated stock clients. Our strategy is to write call options on the equity positions. These options generate premiums that are additive to the stock's performance while still allowing for potential upside on the stock. Option overlay strategies for concentrated stock portfolios frequently perform best when the stock is down, flat, or modestly positive, or when the market's implied volatility is high. A detailed discussion on covered call writing can be reviewed [here](#).

The best way to conceptualize this options strategy is through an example. The below illustration shows the performance of an actual account under management that inceptioned on January 11, 2021.

From January 11 to December 31, 2021, Amazon <AMZN> stock was up 7.1%, underperforming the broad market. Options contributed an additional 5.9% for a net 13.0%.

Scenario	Total Return
#1 AMZN stock only	7.1%
#2 AMZN stock with options overlay	13.0%

What happened? AMZN experienced an incredible run-up in price during 2020 when retailers were forced to close their doors due to the pandemic and consumers had to subsist with online shopping. But as lockdown restrictions were lifted and businesses reopened, AMZN's growth began to level out starting in Q4 2020. The stock had only a few volatile swings but generally maintained stability. The market volatility helped with option premium collections and the steadiness of the stock ensured that each options trade we executed in the account last year was profitable.

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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>).

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