GLOBAL X INSIGHTS

RYLD: A Covered Call Strategy for Rising Rates

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The Russell 2000 Index (RTY) is facing turbulent market conditions in 2022 relative to prior years as financing needs increase, credit spreads widen, and expectations for US economic growth begin subsiding. With inflationary pressures continuing to persist, the Federal Reserve is now well underway in its rate hiking regime, creating headwinds for equity valuations, including small cap companies like those in the Russell 2000. Few strategies thrive in volatile markets like the one witnessed in the first half of 2022, but covered call strategies on the Russell 2000 have proven to be resilient and well-positioned. Expectations for elevated volatility could potentially keep premiums at higher levels received from writing covered calls, relative to historical averages. In this piece, we address how covered call strategies focused on the Russell 2000 could help investors navigate a challenging market environment.

Key Takeaways

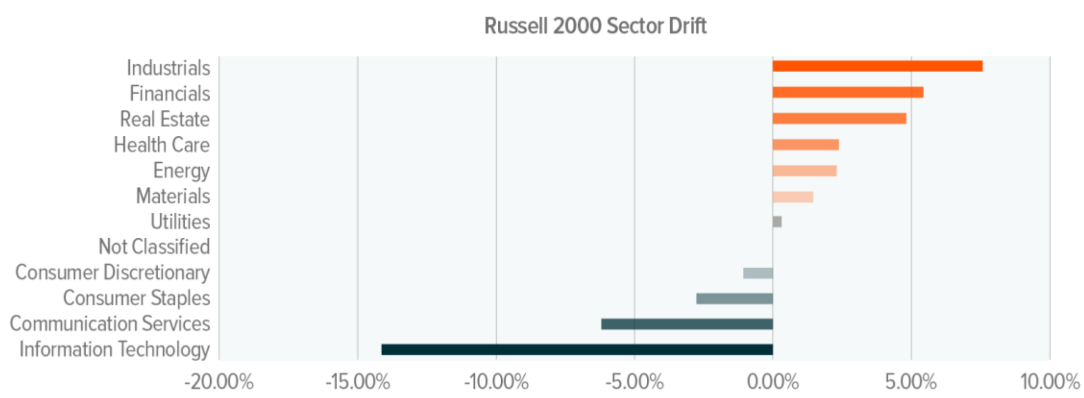
- The Russell 2000 has not disappointed this past decade, due to the benefits of a strong domestic economy low interest rates, and conducive financing conditions.
- The Russell 2000 is sensitive to cyclicality, and higher inflation can cause the RTY to come under pressure when interest rates rise.
- Covered call strategies on the Russell 2000 can help investors generate potential income and monetize volatility in turbulent markets.

The Russell 2000's Value-Oriented Profile

The Russell 2000 Index has performed well over the last decade due to the benefits of domestic revenue exposure, a strong dollar, US economic growth, and cheap financing conditions. The index, comprised of 2000 small-cap stocks in the US, has outperformed high growth indices such as the Nasdaq (NDX) year-to-date as of August 15, 2022 by over 650 basis points (bps).[1]

The outperformance of the Russell 2000 can be attributed to the index's strong overweight towards value-oriented constituents, helping to alleviate some of the pain felt by sectors with high price multiples such as Information Technology and Communication Services. From start of the year of 2022 to August 4, 2022, the Russell 2000 returned -15.09%, while the Nasdaq returned -18.44%.[2]

RUSSELL 2000 SECTOR DIFFERENCES (COMPARED TO S&P 500 INDEX)
Source: Global X ETFs with information derived from: Bloomberg, L.P. (n.d.). [Russell sector differences] [Data set].
Data as of and retrieved on August 4, 2022.



Rising Rate Environment Present Risks to the Russell 2000

After a period of strong fiscal and monetary stimulus, economic growth has accelerated, accompanied by inflation uncertainty. The MSCI USA Value's return is -6.68% as of August 10, 2022, compared to MSCI USA Growth of -17.85%.[3] Part of the reason for this change has been for the Federal Reserve raising interest rates that have coincided into the re-opening economy. After a period of strong fiscal and monetary stimulus, coupled with accelerating economic growth in the first half of 2022, inflation headwinds have been rising.

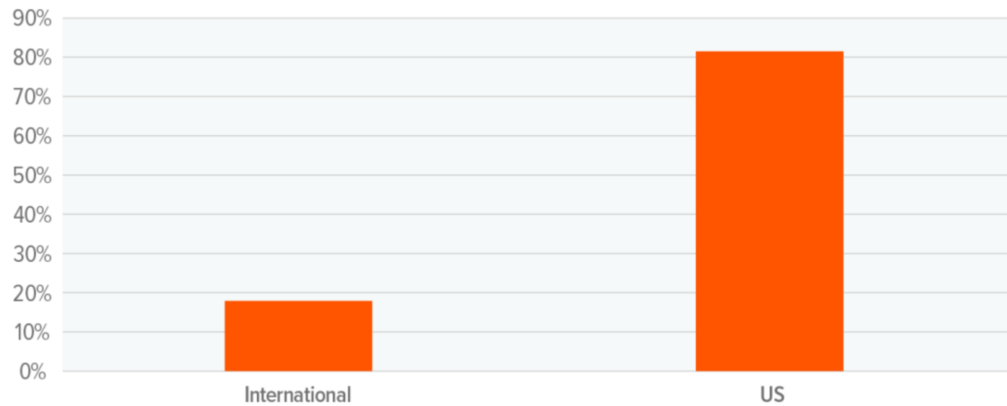
From the chart below, we can see that rising rates tends to have a lower impact on returns for value compared to growth. The most recent CPI print of 8.3% in August 2022 for headline inflation was below analysts' expectations causing growth to rebound compared to value. [4]

The Russell 2000 achieves a higher weight towards value compared to the major US broad indices, the pure small cap exposure has increased the overall volatility. This can be attributed to the fact that small cap companies are usually sensitive to rising rates for two main reasons. The first, being small cap companies tend to be considered a riskier investment leading to higher borrowing cost compared to the large cap counterpart. Second, many small cap companies are still in the early growth phase causing a higher need for debt and/or equity financing as they may not be producing sustainable cash flows, leading to a reinforced loop. Like small caps, Growth companies, such as information technology strategies, are often sensitive to interest rates as their valuations are based heavily on expected future cash flows. Higher rates reduce the present value of those distant cash flows. While both segments have been negatively impacted, the valuation unwind associated with growth have been more pronounced compared to small caps, which have valuations that are more heavily based on near-term cash flows.

The revenues generated from the Russell 2000 are more closely tied to U.S. consumption, as such giving investors more correlated exposure towards the U.S. domestic economy. For example, companies in the Russell 2000 have revenues that mostly come from the US with a small percentage coming from international.

RUSSELL 2000 REVENUE EXPOSURE

Source: Global X ETFs with information derived from: FTSE Russell. (n.d.). [Data set]. Data as of March 31, 2022 and retrieved on August 4, 2022.

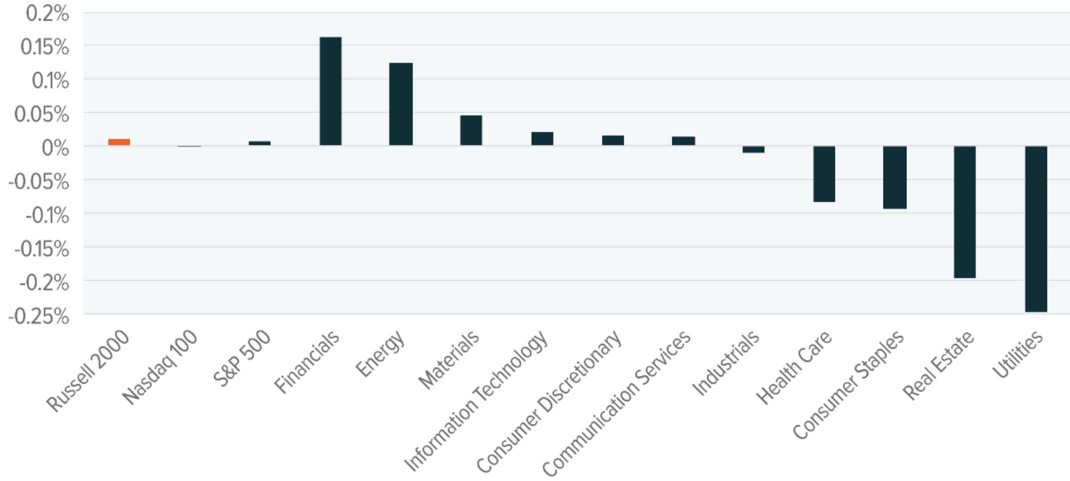


When looking to compare the Russell 2000 and the Russell 1000 indexes, the distinguishing difference between the two is the market cap. The Russell 1000 has an average market cap of $587.5 billion which includes about 1,000 of the largest US equities and represents 93% of the US market. This is in comparison to an average market cap of $3.6 billion in the Russell 2000 which is composed of the 2,000 smallest US equities (FTSE Russell).[5]

There are many risks that are present in both the US and the global economy as high inflation has affected real income levels of customers which ripples into real economic growth. The fear of lower economic growth has led to increased volatility for the index as interest rates trend upwards.

CORRELATION TO 10-YEAR TREASURY YIELD MOVES YEAR-TO-DATE

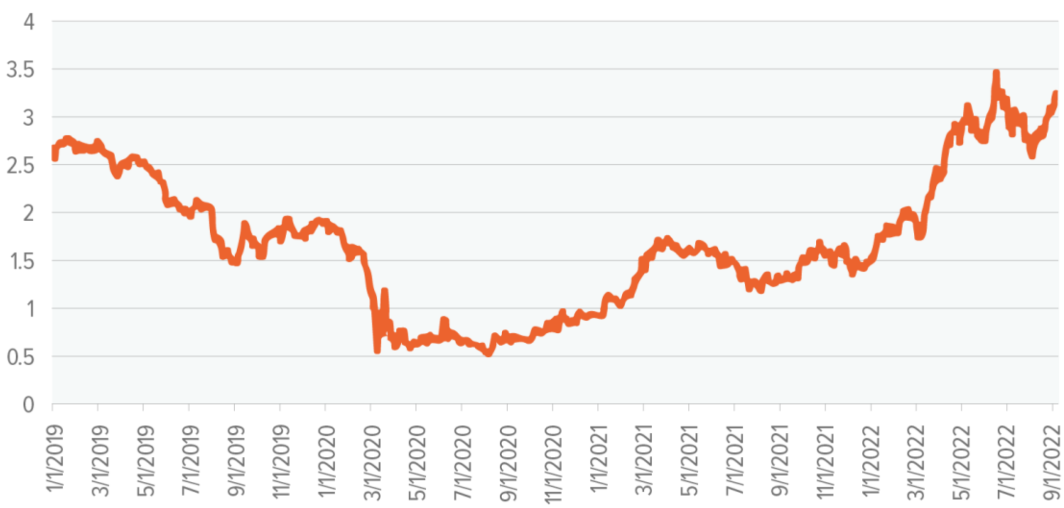
Source: Global X ETFs with information derived from: Bloomberg, L.P. (n.d.). [Correlation to 10-year treasury yield moves December 31, 2021 to August 5, 2022] [Data set]. Data retrieved on August 5, 2022 from Global X Bloomberg terminal.



Investors expect that as economic conditions normalize, rates will continue to increase. Interest rate volatility has also increased as investors are uncertain about the Federal Reserve's interest rate path. The 10-year treasury yields have moved from 1.74% at the end of 1Q21 to 2.67% as of August 4, 2022.[6] Rising rates makes it more expensive for companies to get financing which can cause turbulence for small cap companies as bond investors tend to add a "small cap risk premium" towards Russell 2000 companies that are unprofitable as higher rates increase financing costs.

10-YEAR TREASURY RATES

Source: Global X ETFs with information derived from: Bloomberg, L.P. (n.d.). [10-year treasury rates as of August 31, 2022] [Data set]. Data retrieved on September 1, 2022 from Global X Bloomberg terminal.



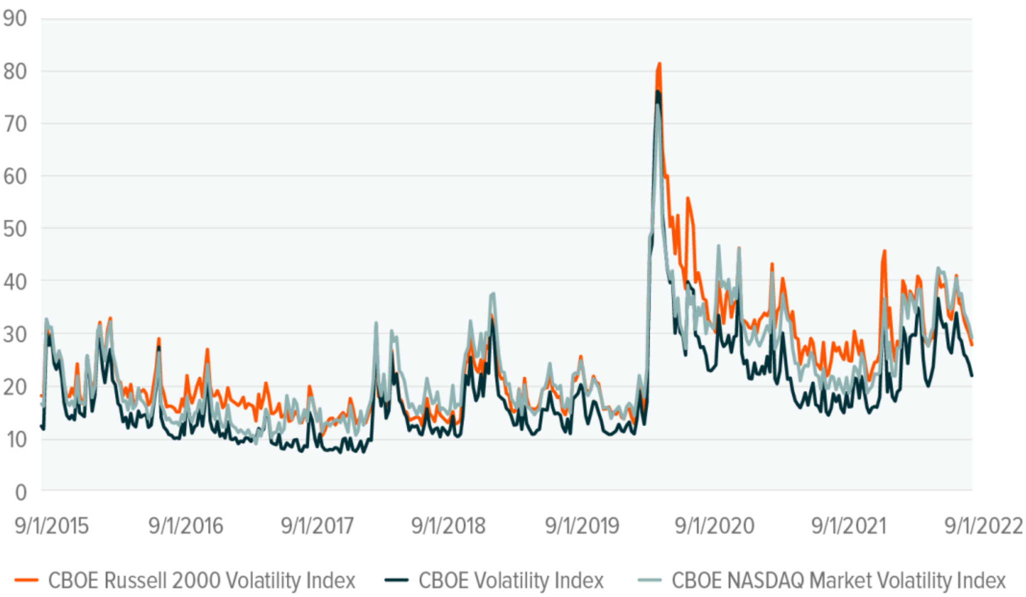
Covered Call Strategies Can Help Navigate Volatility

With rising interest rates presenting headwinds for the Russell 2000, one way to potentially enhance returns is to generate income from a covered call strategy. This involves purchasing the stocks in the Russell 2000 Index and subsequently writing call options on the index. Covered call strategies limit upside participation but can collect premiums from option writing. In volatile markets, option premiums tend to rise and therefore, covered call strategies tend to perform better in choppy or sideways markets rather than in major bull or bear markets.

From the chart below, we can see that Russell 2000 has produced higher levels of volatility compared to the Nasdaq 100 and S&P 500. As the future US economic data becomes more uncertain amid lower earnings growth, higher inflation, and unexpected geopolitical tension arising, a strategy like employing covered calls on the Russell 2000 can offer a buffer from the premiums collected during these periods.

RUSSELL 2000 PRODUCING HIGHER LEVELS OF VOLATILITY COMPARED TO THE S&P 500 & NASDAQ 100

Sourcs: Global X ETFs with information derived from: Bloomberg, L.P. (n.d.) [Russell 2000 compared to S&P 500 and NASDAQ 100 from September 1, 2015 to September 1, 2022] [Data set]. Data retrieved on September 1, 2022 from Global X Bloomberg terminal.



The premiums received are positively correlated to implied volatility. Thus, as implied volatility on the index increases, generally so does the price of the option leg.

The futures market is currently pricing a shift in monetary policy, shown by the Fed futures market betting on the Fed cutting rates in early 2023. While a long-term shift in policy could produce increased revenue for cyclical and sensitive sectors within the Russell 2000, in the short-term, historically small cap risk premiums traditionally accelerate as the cost of borrowing for small caps increases compared to larger companies.

Using a covered call strategy can help give a premium buffer for an investor while achieving income potential as groups such as fixed income investors see elevated reinvestment risk when rates fall, and principal risk as rates rise.

While covered call strategies can be implemented on a variety of indexes or underlying assets, selling calls on the Russell 2000 offers a couple of distinctive features. First, historically the RUT has consistently exhibited higher volatility than the S&P 500, which can fuel greater premiums from selling options.

Currently, broad market implied volatility levels remain higher than they were prior to the pandemic. This means that option premiums are higher than they are usually, thus providing greater income potential to investors.

For the Russell 2000 compared to the S&P 500, the Russell 2000 has a wider band of returns compared to the S&P. These wider return distributions leads to the larger volatility, which ultimately allows for RYLD to potentially receive higher premiums for the options it writes than XYLD. Investors face challenges in managing their investments: how to generate enough income amid a low interest rate environment, while mitigating the risks of rising rates or major market selloffs.

Secondly, another distinctive feature of the Russell 2000 covered call strategy is to potentially help diversify an income-oriented portfolio. The RUT (Russell 2000 Index) has diverse small cap exposure; thus, its performance can differ from traditional dividend focused fund that may have a large cap and/or mid cap tilt. Using covered calls allows investors to mitigate downside risk by monetizing volatility, thus offering a source of inverse exposure to volatility, something that traditional equity and fixed income markets do not.

Implementing a Russell 2000 Covered Call Strategy

Despite strong returns over the last decade, the Russell 2000 is at a bit of a crossroads. As yields have continued to rise, value stocks have seen outperformance. While small caps have some of the higher rates of growth among stocks, they are also more volatile which poses a greater risk to investors. While the Russell 2000 has underperformed the Nasdaq 100 and S&P 500 over longer periods, the RUT has produced higher levels of volatility. Covered call strategies such as RYLD can take advantage of this volatility which has led to higher premiums compared to QYLD and XYLD.

Covered call strategies such as RYLD could be valuable in an uncertain environment. Higher volatility tends to increase the options premiums received from selling calls, which can potentially enhance returns even in a trendless market. While some investors may suggest purchasing put options to mitigate downside risk, put option premiums have become more expensive to purchase now because of higher volatility. In addition, the distributions from value-based covered call strategies can help diversify an income portfolio away from traditional sources like dividend paying stocks or fixed income. A Russell 2000 covered call strategy may be an alternative way for investors to generate potential income and remain invested in the equity markets.

Related ETFs

RYLD – Global X Russell 2000 Covered Call ETF

QYLD- Global X Nasdaq 100 Covered Call ETF

XYLD- Global X S&P 500 Covered Call ETF

Click the fund name above to view current performance and holdings. Holdings are subject to change. Current and future holdings are subject to risk.

Footnotes

1. Bloomberg L.P. (n.d.) [Russell 2000 and Nasdaq 100 return data as of August 15, 2022] [Data set]. Retrieved on August 10, 2022 from Global X Bloomberg terminal.
2. Ibid.
3. Bloomberg L.P. (n.d.) [MSCI USA Value and MSCI USA Growth historical prices from January 1, 2022 to July 31, 2022] [Data set]. Retrieved on August 10, 2022 from Global X Bloomberg terminal. Bloomberg.
4. Mutikani, L. (2022, September 13). Stubbornly high rents, food prices boost U.S. inflation in August. Reuters. https://www.reuters.com/markets/us/monthly-us-consumer-prices-unexpectedly-rise-august-core-inflation-picks-up-2022-09-13/
5. Yoshimoto, C. (2022, April 29). Revenues without borders: Tracking US companies' cashflows. FTSE Russell. https://www.ftserussell.com/blogs/revenues-without-borders-tracking-us-companies-cashflows
6. Bloomberg, L.P. (n.d.) [10-year treasury rates as of August 31, 2022] [Data set]. Data retrieved on September 1, 2022 from Global X Bloomberg terminal.

Glossary

Nasdaq 100 Index: The Nasdaq-100 Index includes 100 of the largest domestic and international non-financial companies listed on The Nasdaq Stock Market based on market capitalization. The Index reflects companies across major industry groups including computer hardware and software, telecommunications, retail/wholesale trade and biotechnology. It does not contain securities of financial companies including investment companies.
Russell 1000 Index: Represents the top 1000 companies by market capitalization in the U.S. market.
Russell 2000 Index: A small-cap stock market index that includes 2,000 smaller companies that focus on the U.S. market.
Credit Spreads: The difference in yield between a risky (i.e., non-government issued) security and a risk-free security.
Consumer Price Index (CPI): CPI measures the average change in prices that consumers pay for a defined basket of goods and services.
MSCI USA Value: The MSCI USA Value Index captures large and mid-cap US securities exhibiting overall value style characteristics. The value investment style characteristics for index construction are defined using three variables: book value to price, 12-month forward earnings to price and dividend yield.
MSCI USA Growth: The MSCI USA Value Index captures large and mid-cap US securities exhibiting overall value style characteristics. The value investment style characteristics for index construction are defined using three variables: book value to price, 12-month forward earnings to price and dividend yield.
Correlation: A measure that shows how two securities move in relation to each other. A correlation of 1 implies that the securities will exhibit the same price movements. A correlation of 0 means the securities demonstrate completely unrelated price movements. A negative 1 correlation implies that the securities move in same size and opposite directions from one another.
Small Cap Risk Premium: Refers to the premium small cap companies are expected to earn in comparison to large-cap companies.
VIX Index: The Chicago Board Options Exchange Volatility Index commonly referred to as VIX, reflects a market estimate of future volatility of the S&P 500 index options, based on the weighted average of the implied volatilities.
VXN Index: The Chicago Board Options Exchange Nasdaq Volatility Index commonly referred to as VXN, reflects a market estimate of future volatility of the Nasdaq 100 index options, based on the weighted average of the implied volatilities.
RVX Index: The Chicago Board Options Exchange Russell 2000 Volatility Index commonly referred to as RVX, reflects a market estimate of future volatility of the Russell 2000 index options, based on the weighted average of the implied volatilities.

SEI Investments Distribution Co. (1 Freedom Valley Drive, Oaks, PA, 19456) is the distributor for the Global X Funds.

Investing involves risk, including the possible loss of principal. Investments in smaller companies typically exhibit higher volatility. Concentration in a particular industry or sector will subject RYLD to loss due to adverse occurrences that may affect that industry or sector. Investors in RYLD should be willing to accept a high degree of volatility in the price of the fund's shares and the possibility of significant losses.

RYLD engages in options trading. An option is a contract sold by one party to another that gives the buyer the right, but not the obligation, to buy (call) or sell (put) a stock at an agreed upon price within a certain period or on a specific date. A covered call option involves holding a long position in a particular asset, in this case U.S. common equities, and writing a call option on that same asset with the goal of realizing additional income from the option premium. RYLD writes covered call index options on the Russell 2000 Index. By selling covered call options, the fund limits its opportunity to profit from an increase in the price of the underlying index above the exercise price, but continues to bear the risk of a decline in the index. A liquid market may not exist for options held by the fund. While the fund receives premiums for writing the call options, the price it realizes from the exercise of an option could be substantially below the indices current market price. Investment in the Fund is subject to the risks of the underlying fund.

Shares of ETFs are bought and sold at market price (not NAV) and are not individually redeemed from the Fund. Brokerage commissions will reduce returns.

Since the Fund's shares did not trade in the secondary market until several days after the Fund's inception, for the period from inception to the first day of secondary market trading in Shares, the NAV of the Fund is used to calculate market returns.

Carefully consider the funds' investment objectives, risks, and charges and expenses before investing. This and other information can be found in the funds' full or summary prospectuses, which may be obtained at globalxetfs.com. Please read the prospectus carefully before investing.

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