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Buy-Write Funds: A Blast From the Industry's Past

By TIM GRAY

INVESTMENT vagues seldom die. They just hibernate until market conditions change and investors are ready for them again.

Consider mutual funds using "covered-call" strategies, which involve the sale of call options on stocks held in a portfolio. About two decades ago, a clutch of these funds appeared, pitching themselves to income-hungry investors. But most of them soon disappeared as their performance flagged.

Lately, though, funds based on covered-call strategies have re-emerged like cicadas, creating a stir after a long slumber. Now they are generally called "buy write" funds and sold as closed-end rather than open-end mutual funds; 21 of them have popped up in the last two years, according to Lipper, the fund tracker.

Bill Sickles, a senior research analyst at Lipper, says investment firms hope the funds' combination of equity exposure and current income may entice aging baby boomers. "There's a big marketing push on," he said.

A covered-call fund sells options to generate cash and thus guarantees itself a modest return from them, but, in doing so, it also limits its possibility of big gains. (The option buyers, for their part, get the right to "call away" the fund's shares if they hit or exceed agreed-upon prices. That lets these buyers speculate on the possibility of stocks rising without having to shell out the full price of the shares.) Fund shareholders must still bear the risk of losing money from large stock-market losses.

When the market treads water, "people look for added returns," Mr. Sickles said. "Covered-call funds can give you a little additional return in a sideways market."

Wall Street, never shy when it comes to promoting new strategies or repackaging old ones, has helped with that search, introducing a variety of tweaks to the basic covered-call approach. Merrill Lynch underwrote more of the new funds than any other firm, raking in tens of millions in fees, which were pulled out of the offering proceeds, as is typical. Eaton Vance, based in Boston, has rolled out five covered-call funds in the last two years, while BlackRock in New York has floated two and recently acquired two more when it merged with Merrill's asset management division.

At Eaton Vance, the Tax-Managed Buy-Write Income fund aims to beat the total return of the Standard & Poor's 500, while its Tax-Managed Buy-Write Opportunities fund splits its money, aiming to beat the S. & P. with one pool and the Nasdaq 100 with the other. The BlackRock World Investment Trust, by contrast, roams the world and can invest as much as 25 percent of its money in debt.

"We take an active approach on the options side," said Kyle G. McClements, BlackRock's head of equity derivative strategies. "That's a little different than most of what the competition has done. They'll do a stock index and sell index options. With our legacy BlackRock funds, we do actively managed portfolios and sell single stock options."

Covered-call funds aren't just marketing razzle-dazzle. They can have a legitimate, if limited, place in many portfolios, Mr. Sickles said. What's more, conservative investors have long sold call options on individual stocks in their portfolios as a way to generate income while waiting to sell the shares.

"If you're an equity investor and you're willing to take the volatility of full equity exposure, this isn't for you," said Ronald M. Egalka, an options specialist who advises the five Eaton Vance buy-write funds and is chief executive of Rampart Investment Management in Boston. "Anytime you do anything that hedges and the asset moves up dramatically, you're going to have an opportunity cost. That's the risk in the strategy."

(Opportunity cost, an economics term, equates to the anguish of wondering, "What if I'd kept those Google shares?")

A 2004 study by Ibbotson Associates in Chicago found that, for 16 years starting in the late 1980's, a covered-call portfolio would have slightly beaten the S. & P. 500, while its returns would have zigzagged less. Ibbotson's report gave the strategy a boost, as did the creation in 2002 of a covered-call index by the Chicago Board Options Exchange. The index, called the BuyWrite Benchmark Index, tracks the performance of a passive investment in the S. & P. 500 paired with a monthly sale of an S. & P. 500 index call option. The "buy write" name is shorthand for the approach: an investor buys stocks and then writes call options on them.

The covered-call strategy has plenty of detractors. Even one fan points out that the sorts of returns documented by Ibbotson could disappear as more investors piled on. Robert E. Whaley, a professor at the Owen Graduate School of Management at Vanderbilt, helped the Chicago Board create its index. In a 2002 study, he showed that from 1988 to 2001, the strategy would have had about the same return as the S. & P. 500 but only two-thirds the risk. Ibbotson built on his work by stretching the time frame.

While doing his research, Professor Whaley discovered that index options sold for more than financial theory says they should. Heavy demand by institutional investors for options pushes up their value, and that premium plumps the return of the covered-call strategy.

But as new funds crowd into the market, they may gobble up the premium, Professor Whaley said. "What you have is all these funds jumping in and systematically selling calls, and maybe that will bring the prices back into alignment," he explained. "That could destroy the strategy, though that hasn't happened yet."

Faced with these findings, Alan Marcus, a finance professor at Boston College, remains skeptical of the covered-call approach. He faults what he calls "the peculiar and not particularly attractive risk profile."

He zeroes in on these funds' willingness to sacrifice big gains. Sure, they collect income from the options they sell, and that helps cushion them when stocks stagnate or fall modestly, he said, but they are still exposed to big drops in stock prices. "This isn't the way that most people would choose to hedge -- that is, keeping all the risk of a downturn while getting rid of all the opportunity of a major market upside," he said.

Any complex strategy -- and writing options is knottier than, say, buying and holding the S. & P. index -- imposes additional costs that eat into an investor's return. The covered-call funds tracked by Lipper have an average expense ratio of 1.3 percent, whereas the ratio at big index funds typically is much lower: 0.18 percent at Vanguard's 500 Index stock fund, for example, and 0.2 percent at its Total Bond Market Index fund.

Another potential difficulty of the current covered-call funds is that they typically operate with a closed-end structure. In a closed-end fund, an underwriter sells all the fund's shares at once; then they trade just as stocks do. Sometimes, the shares trade at a discount, that is, for less than the value of the fund's investments, and other times at a premium. As a result, investors must determine not only whether a fund fits their needs and risk tolerance, but also whether its shares are cheap or expensive compared with the value of the fund's investments. Lipper has cautioned against buying closed-end funds at their initial public offerings, finding that, on average, their value typically falls in their early months because of start-up and sales fees.

Many fund managers like the closed-end setup because it frees them from wrestling with daily inflows and outflows of money caused by the customer purchases and withdrawals common in open-end funds. That lets them focus on picking investments.

"We felt that if you were dealing with inflows and outflows of money, it'd be a disruption of not only the portfolio and but also adverse to the operations of the fund," said Walter A. Row III, director of equity research at Eaton Vance. "When you're thinking about options, you're talking about a fast-moving market, and you want to deploy a reasonable trading strategy."

PROFESSOR MARCUS recalls that in the 1980's, after the earlier covered-call vogue subsided, brokers pitched another strategy: the sale of deep out-of-the-money put options. Puts require sellers to buy shares at an agreed-upon price. If the stock falls to or below that price, the option buyer can "put" his stock onto the seller.

"You had all of these brokers telling people to write these out-of-the-money put options because there was supposedly no way the market would go down more than 15 percent in a single day," he recalled. "Many small investors were wiped out by these sorts of positions in the 1987 crash."

Granted, investing directly in options differs from buying shares in a covered-call fund. But Professor Marcus still wonders whether covered-call funds might lead unsophisticated investors to speculate inadvertently on the options market, when they'd be better off investing in straight stock and bond index funds.

Chart: "Return of a Strategy"

In the past two years, covered-call, or "buy write" funds have had slightly lower monthly returns, on average, than the S.&P. 500.

Graph tracks the monthly average total return of S.&P. 500 and Covered-call funds from 2004 through September 2006.

S.&P. 500

MONTHLY AVG.: +0.93%

Covered-call funds

MONTHLY AVG.: +0.77%

(Source by Lipper)

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