GLOBAL X ETFs INSIGHTS

Introducing the Global X S&P 500 Covered Call UCITS ETF (XYLU LN)

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Topic: Income

Related ETFs

Please click below for fund holdings and important performance information.

Global X S&P 500 Covered Call ETF (XYLU LN)

On July 13, 2023, we listed the Global X S&P 500 Covered Call UCITS ETF (XYLU LN) in the UCITS market.

The Global X S&P 500 Covered Call ETF (XYLU LN) is Global X's second covered call strategy in the UCITS market, which is designed to offer investors an alternative income solution, while potentially avoiding risks seen in the traditional income-oriented investments like fixed income and dividend stocks.

Key Takeaways

- The S&P 500 is a market-capitalisation weighted index of 500 leading publicly traded companies in the United States. The S&P 500 is regarded as the best gauge of the US large cap equity market.
- The S&P 500 has exhibited strong returns for most of the past decade, due to low interest rates and strong growth-oriented sector exposure. However, returns in the US equity markets are beginning to slow with the Federal Reserve in the midst of its rate hiking cycle.
- Covered call strategies on major indexes are a powerful solution for investors to generate income and monetise volatility amid choppy markets. XYLU LN represents Global X's second UCITS covered call strategy in the European market, after the Global X Nasdaq 100 Covered Call ETF (QYLD LN's) launch last quarter.

The S&P 500 Characteristics

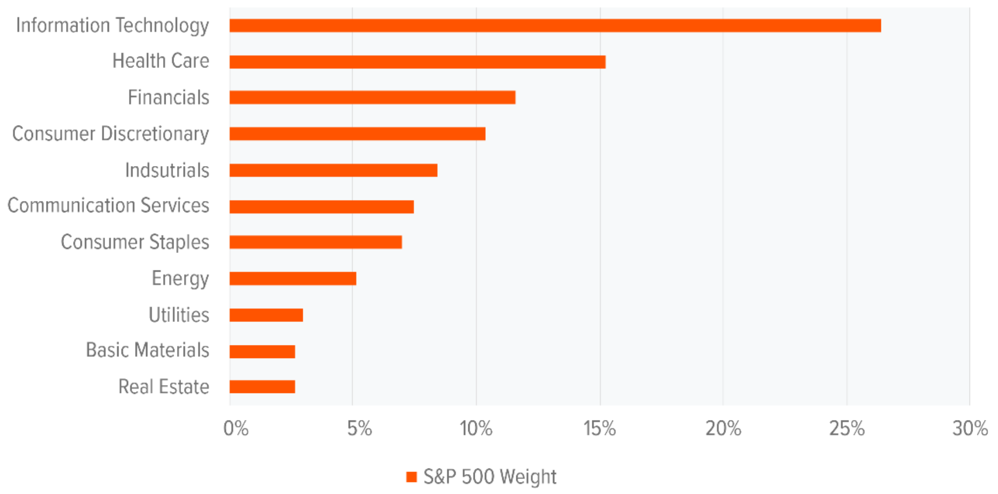
The S&P 500 (SPX) has generally performed well this past decade, largely due to its higher weighting towards the Technology sector and an environment of low interest rates. While performance has lagged recently due to the rising interest rate environment, there is reason to believe the Fed's rate hiking regime will start to slow in the foreseeable future based on Fed Funds futures. However, rising rates have proved to be a headwind more broadly for equity valuations, causing volatility lately. While few investment strategies thrive in volatile markets, we believe that covered call approaches could be well positioned.

The S&P 500 has often become a preferred choice for investors to express US equity market views given its diversified sector exposures and large cap tilt. The increasing popularity over the years of companies in various sectors such as Apple, Microsoft, and Amazon has also led investors to gravitate towards the S&P 500, as market valuations of those companies rose.

But after a decade-plus of strong performance, a hawkish Federal Reserve policy stance is creating headwinds for companies in the S&P 500 index. This impact of rising interest rates resulted in the 10-year treasury yield moving to 3.44% as of 30/04/2023 after sitting below 3% for most of this cycle. As economic conditions normalise, there remains a degree of uncertainty regarding the trajectory of interest rates.

S&P 500 SECTOR WEIGHTINGS

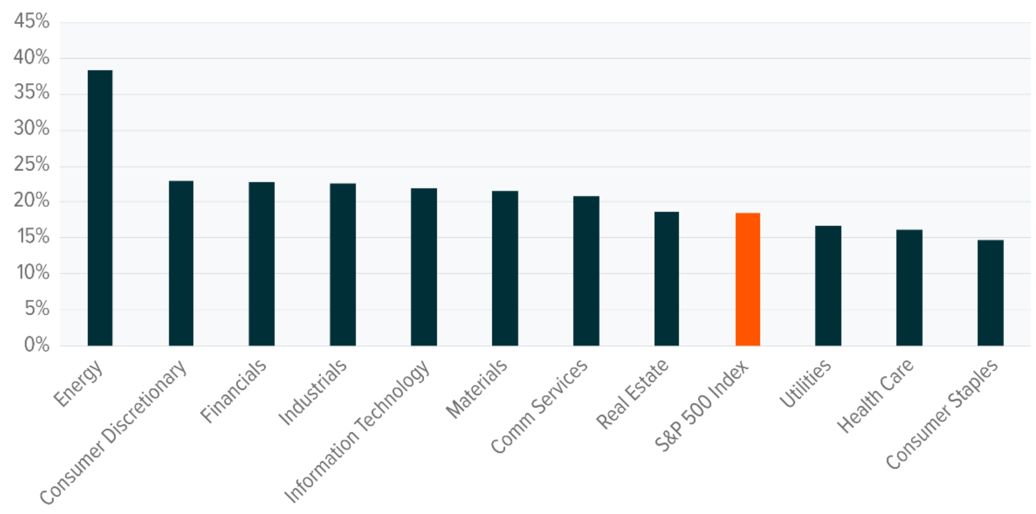
Source: Global X ETFs with information derived from: Morningstar (n.d.) [Data Set]. Data as of 30/04/23 and was accessed on May 15th, 2023 from Global X ETFs Morningstar Direct license.



Over the past 5 years, the diversified nature of the S&P 500 led to a lower level of volatility relative to other more concentrated indexes. Given the sector diversification of the S&P 500 and comparatively less weighting to the information technology sector than an index like the Nasdaq 100, there may be less overall volatility than those concentrated indexes. In general, this level of volatility in a security or index may be harnessed with the utilisation of options. Options premiums are often most highly correlation to levels of implied volatility of the underlying asset, in this case the index.

5-YEAR VOLATILITY BY SECTOR

Source: Global X ETFs with information derived from: Morningstar (n.d.) [Data Set]. Data as of 30/04/23 and was accessed on May 15th, 2023 from Global X ETFs Morningstar Direct license.

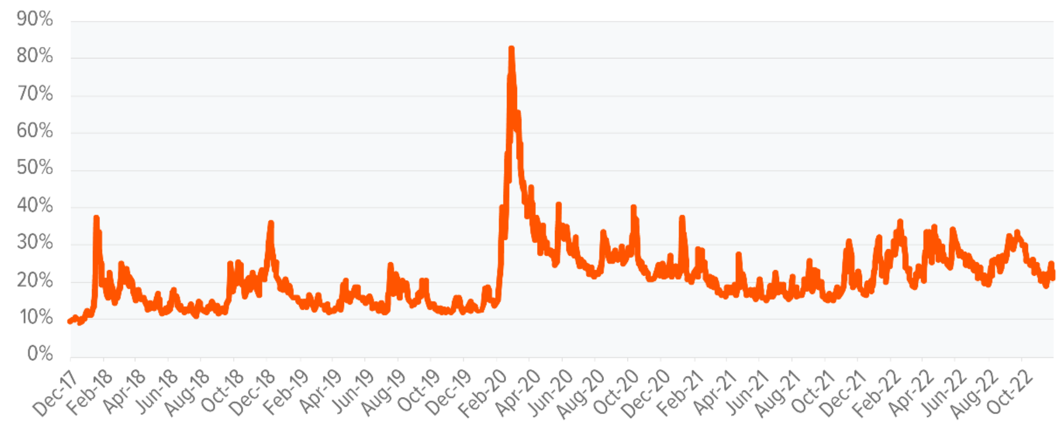


Covered Call Strategies May Thrive in Volatile Markets

This strategy involves purchasing the stocks in the underlying index, such as the S&P 500, and then subsequently writing covered calls on the index. Covered call strategies limit potential upside participation but generate income through collecting premiums through the covered calls. In volatile markets, premiums tend to be higher and therefore, covered call strategies tend to perform best in choppy or sideways markets rather than in major bull or bear markets.

S&P 500 30-DAY IMPLIED VOLATILITY

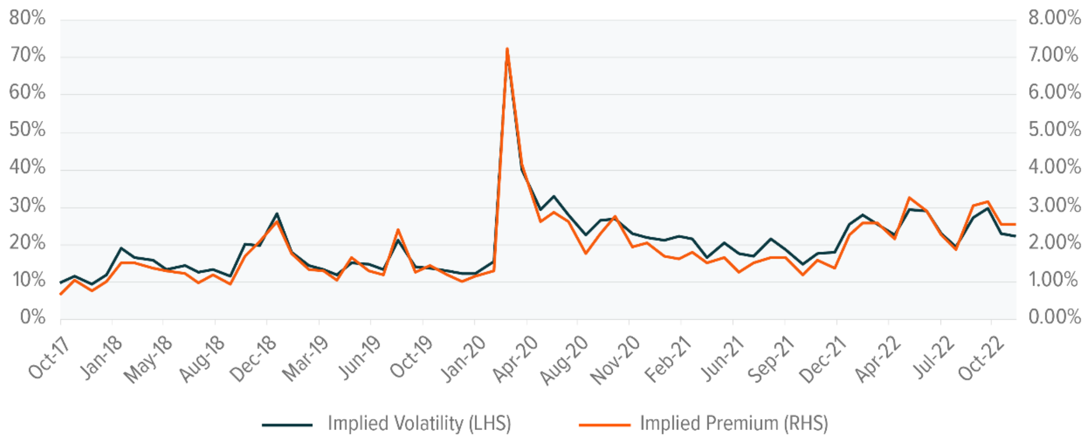
Source: Global X ETFs with information derived from: Morningstar (n.d.) [Data Set from 01/05/18 to 30/04/23]. Data was accessed on May 15th, 2023 from Global X ETFs Morningstar Direct license.



In the case of XYLU LN, the fund is essentially writing a 1-month at-the-money (ATM) 100% covered call on the S&P 500 Index. To give an idea of what the premiums for a strategy like this could look like, the below chart tracks levels of implied volatility on the S&P 500 Index and what modeled Black Scholes premiums would look like on those respective dates when the roll dates monthly would have occurred.

S&P 500 PREMIUMS VS. IMPLIED VOLATILITY

Source: Global X ETFs with information derived from Bloomberg as of 21/04/23. Data measured from 17/05/18 to 21/04/23 using the data from the 3rd Friday of each month, when the options are written. Premiums are a hypothetical measurement since it is an index. These are calculated options premiums using the Black-Scholes options pricing model. Actual premiums may have varied.



Implementing a Covered Call Strategy

Despite strong returns for the S&P 500 over the last five years, the market is at a bit of a crossroads as yields in the 10-year treasury have increased. If yields continue to rise, it could cause challenges for the S&P 500 and broad equity markets as well as other traditional sources of income with duration risk. However, long-term, we believe the transition to the New Normal Economy and US economic leadership bodes well for the S&P 500.

Monthly distributions[1] for this strategy are capped at half of premiums received or 1% the of fund's NAV; with any excess premiums reinvested into the fund. When adding to a portfolio, covered call strategies could be considered as a partial replacement to equity and fixed income as the yield on these strategies is typically higher than fixed income alternatives. Covered call strategies may come with higher volatility than fixed income, but may have lower volatility than the underlying stocks in the reference index tracked. Covered call strategies, such as the Global X S&P 500 Covered Call UCITS ETF (XYLU LN), could be valuable in an uncertain market environment like the one we are in today. Higher volatility tends to increase the income received, which may enhance returns even in a trendless market. Moreover, the income from index focused covered call strategies may help diversify an income portfolio away from traditional sources such as dividend paying stocks or fixed income investments.

[1]For distributing share classes only

Capital at risk: The value of an investment in ETFs may go down as well as up and past performance is not a reliable indicator of future performance.

Prospectus and Key Investor Information Documents (KIIDs) for this ETFs is available in English at https://globalxetfs.eu/funds/XYLU/