Generating Yield in a Tax Efficient Way

The search for yield is a continuing challenge for Canadian investors

Investors want additional income either for consumption or debt repayment or further investment purposes, however they don't want to increase the risk of their portfolios to take on securities that would generate high yield. Often, high yielding securities have leverage, are considered higher risk or can be more volatile than lower yielding securities, whether those securities are dividend-paying equities, preferred shares or bonds.

Since its inception in 2002, the team at Faircourt Asset Management has, at its core, been successful at finding ways to generate equity yield for its investors in a tax efficient manner.

One of the most compelling ways to generate additional yield beyond the traditional dividend yield while managing our equity portfolios has been to utilize options. Options can also help reduce the volatility of the underlying portfolio and assist us in rebalancing portfolios.

Our Portfolio Managers are experienced in using both Covered Call Writing as well as Cash Secured Put Writing strategies to lower volatility and enhance returns

Covered Call Writing:

Covered call writing allows the holder of an equity security to consider selling a security sometime in the future, when the equity price of that security has appreciated. Our Portfolio Managers may decide that a security is more fully valued than when we invested when there has been appreciation in the price of that holding. Our decision to sell within an option strategy allows us to set the price at which we are willing to sell, and for that, someone else on the other side of this option contract will pay us a premium for the option to buy that equity. When we do that, we earn a premium upfront, regardless of whether that investor ends up buying it or not. That is their decision at the time when the option contract expires, typically weekly or monthly up to a year in the future. By earning that premium, income is earned for our Fund and forms the basis of our monthly distributions to investors.

One way to think about this is that we are selling the potential growth in the stock for a predetermined period of time to someone else in exchange for receiving the actual premium up front. Sometimes the stock will not reach the strike price we sold the option contract at (in which case we might write the same strike again). Other times, the stock will appreciate and the buyer of the option will exercise their right to buy the stock. Either way, we keep the premium we received.

When do we use Covered Calls:

Covered Calls are used when select equity names within our portfolios have appreciated in value over time and our Portfolio Manager believes it to be fully valued. In that case, we don't mind selling a name where we have already been rewarded with significant growth.

Cash Secured Puts:

A Cash Secured Put is another strategy that we have effectively used over the last decade, to lower volatility and increase the amount of income we generate from our portfolios. In this scenario, there is an equity security that our Portfolio Manager wants to own. He will decide the price he is willing to pay, and write a put contract that allows him to buy at a pre-determined price – typically lower than the current market price. For that contract, we once again earn a premium upfront selling another investor

the option to have us buy this security in the future. We will set aside capital to cover the purchase of the equity (in case the option is exercised), but we have effectively reduced the overall cost of the equity by earning a premium upfront before we even own the security.

When do we use Cash Secured Puts:

Cash Secured Puts are used when we see an equity that we want to own, but want to wait for it to revalue to the target price that we feel comfortable owning it at. In that case, we will write a put, earn a premium upfront and we will choose the price of the put at a price lower than where the equity is trading. If assigned, we get to own the security at a price lower than where it was trading and we earn a premium that further reduces our cost base on the equity.

The Faircourt Portfolio Team:

Doug Waterson, CPA, CA, CFA & Portfolio Manager

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Tax Treatment:

Option Premiums on covered call contracts whether assigned or expired and expired cash secured put contracts are generally treated as capital gains for tax purposes (which are taxed at 50% of the investors normal tax rate) and as such will generate a higher after tax return than earning a similar yield from a Bond or Debenture that pays interest income that is fully taxed at the investors marginal tax rate. Option Premiums received on cash secured put contracts which are assigned further reduce the adjusted cost base of the equity acquired and only realized for tax also as a capital gain when that equity position is ultimately sold in full.