Covered Calls:
An Equity Solution for Enhanced Income

In an era of low yields, elevated inflation, and choppy equity markets, some investors are turning to non-traditional methods to generate income and mitigate volatility. Covered call option writing, also known as a "buy-write" strategy, can offer a steady stream of incremental income while reducing downside risk for a portfolio.

Covered Calls: Understanding the basics

Before diving into the benefits of this type of investment strategy, it is important to first understand the mechanics of stock options. A call option is a contract by which the **buyer** owns the right to purchase a security at a predetermined price on or before a specified date. This is known as the strike price. The **seller** of the call option has an obligation to sell the underlying security to the contract owner at the stated strike price.

Another type of contract is a "put option." Unlike call options, put options give the buyer the right to sell an underlying security at a predetermined price on or before a specified date.

Investors engage in the buying and selling of call and put options contracts for a number of reasons, such as if they believe a security's price will rise or fall and wish to benefit from anticipated price movement, to generate income, or to hedge the risk of a portfolio or position. In the case of call options, the seller (or writer) of the call option receives a premium for offering the contract. If the underlying stock rises to or above the strike price, the writer would be obligated to sell the stock at the specified price if the buyer exercises the option or allows for automatic exercise — enabling the buyer to potentially get the stock at a discount, hence the benefit to the buyer. The writer in this instance has forgone the upside beyond the strike price in exchange for the premium generated by the sale of the option.

> “If the stock does not rise to or above the strike price, the option contract expires worthless, and the buyer is only out the premium that was paid, which the seller keeps.”

Options can be written on a wide array of assets, including stocks, exchange-traded funds (ETFs), currencies, and commodities. For covered call strategies, stock and ETF options are most common.

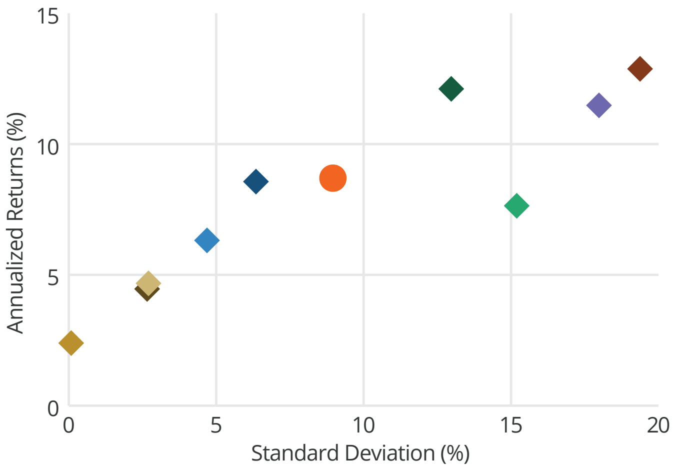
Definitions	
Option	The right to buy or sell a specified amount or value of a particular underlying interest (or security) at a fixed exercise price by exercising the option on or before its specified expiration date.
Call option	An option that gives the right to buy an underlying security.
Put option	An option that gives the right to sell an underlying security.
Strike price	Price at which the option holder has the right to purchase or sell the underlying security.
Premium	The price that the holder of an option pays and the writer of an option receives for the rights conveyed by the option. It is the price set by the holder and writer, or their brokers or the overall market, in a transaction in an options market where the option is traded. It is not a standardized term of the option and does not constitute a “down payment.”
Exercise	The holder of an option wishes to buy (in the case of a call) or sell (in the case of a put) the underlying security at the exercise price.
Expiration date	The date on which the option expires. If an option has not been exercised before its expiration, it ceases to exist — that is, the option holder no longer has any rights, and the option no longer has any value. An American option may be exercised at any time before the expiration date, while a European option may only be exercised on the expiration date.
Long and Short	The word Long refers to a person’s position as the holder of an option, and the word Short refers to a person’s position as the writer of an option.
At the money	The current market value of the underlying security is the same as the exercise price of the option.
In the money	The current market value of the underlying security is above (call options) or below (put options) the exercise price of the option.
Out of the money	The current market value of the underlying security is below (call options) or above (put options) the exercise price of the option.

What is a covered call strategy?

A covered call strategy owns underlying assets, such as shares of a publicly-traded company, while selling (or writing) call options on the same assets. Selling call options produces a stream of cash flow for the portfolio. This income can act as a source of yield for the investor or be reinvested to help offset losses in a market decline. Adding to the appeal for income-seeking investors is the possibility of dividends and potential capital gains generated from portfolio activity, distributed regularly.

From a risk and return perspective, covered call strategies tend to perform in line with the S&P 500® during periods of steadily up, declining, or flat markets, and lag when the market rises rapidly. All with less volatility, as measured by standard deviation. Over long periods of time and spanning all types of markets, covered call strategies offer a balance of market participation, risk mitigation, and income generation.

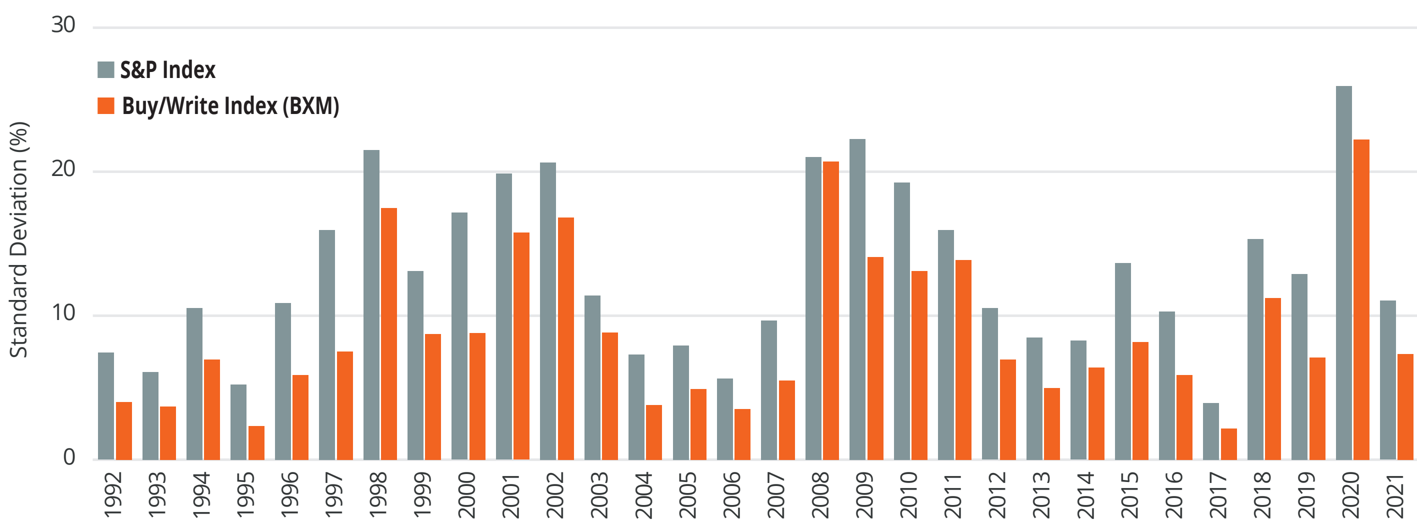
30-Year Risk/Return Average



Asset classes represented by the indices shown:

- **Corporate Bonds** Bloomberg US Credit TR USD
- **Government Bonds** Bloomberg US Govt Interm TR USD
- **High Quality Govt/Corp** Bloomberg US Govt/Credit A+Interm TR USD
- **Covered Call** CBOE S&P 500® BuyWrite BXM
- **3-Month Treasury** FTSE Treasury Bill 3 Mon USD
- **High Yield Bonds** ICE BofA US High Yield TR USD
- **International Stocks** MSCI ACWI Ex USA NR USD
- **Emerging Markets Stocks** MSCI EM NR USD
- **Small Cap Stocks** Russell 2000® TR USD
- **Large Cap Stocks** S&P 500® TR USD

Lower Volatility



EXAMPLE

Consider a portfolio that consists of 100 shares of XYZ stock at a current price of $70. Call options with a strike price "out-of-the-money" at $75 have a premium valued at $3.00 per share. The portfolio manager implements the covered call strategy on 100 shares and receives $300 of income in premium.

XYZ Stock

100 shares

Currently trading at $70/ share

Starting portfolio: $7,000

Portfolio covered by call options:
$7,000 + $300 premium = $7,300

- If the stock price remains at $70 when the option expires, the portfolio's value would be $7,300 and the option would not be exercised.
- If the stock price drops, the loss of value is lessened because it received a premium for the call option.
- If the stock price drops to $67/share when the option expires, the new portfolio value would be back to $7,000. (100x$67=$6,700 +$300=$7,000). This is the break-even point.
- If the stock price rises, the contract may be exercised, and the portfolio would have to sell the security for less than its current market value while retaining the premium received from selling the call option.
- Let's say the stock rises to $80/share, the option is exercised, and the writer is obligated to sell the 100 shares at $75/share. With the premium, the portfolio's new value would be $7,800. (100x$75=$7,500+$300=$7,800).
  The portfolio would then be able to invest in the same or a different security to begin the process all over again.

Shares	Share price	Value of stock	Value if called	Action on Expiration	Option proceeds	Total portfolio value	Stock return	Covered Call return	
100	65	6500	6500	Not Called	300	6800	-7.1%	-2.9%	
100	67	6700	6700	Not Called	300	7000	-4.3%	0.0%	← Breakeven point
100	68	6800	6800	Not Called	300	7100	-2.9%	1.4%	
100	70	7000	7000	Not Called	300	7300	0.0%	4.3%	
100	73	7300	7300	Not Called	300	7600	4.3%	8.6%	
100	75	7500	7500	Called	300	7800	7.1%	11.4%	
100	80	8000	7500	Called	300	7800	14.3%	11.4%	← Opportunity cost of $300
100	85	8500	7500	Called	300	7800	21.4%	11.4%	← Opportunity cost of $700

BENEFITS

Diversification

Adding a covered call strategy to a portfolio can provide added diversification for most investors.

Growth participation

Selling "out-of-the-money" call options allows the portfolio to benefit from rising stock prices if they occur.

Dampen downside risk

Income generated from call premiums received can help offset price depreciation.

Supplemental income

In addition to dividends and capital gains (if any), call premiums can provide an income stream.

RISKS

Market risk

As with any strategy involving stock ownership, price decline risk is real. Some managers may try to mitigate this risk by purchasing put options.

Opportunity risk

If the stock price appreciates beyond the strike price, the covered call writer is obligated to sell the security and no longer participate in the rising price. While the manager may purchase additional call options to help limit this opportunity risk, the upside will likely always be lower when the stock price appreciates rapidly.

How a covered call strategy offers diversification

Investors diversify their portfolios to spread their assets among many different sources of risk. While much of the risk in a covered call strategy is tied to equity market risk — or the rise and fall of stock prices — it also gives investors diversification in the source of returns and income. For investors comfortable with equity and option risks, the stream of income distribution in the form of option premiums can complement a fixed income portfolio that may otherwise be comprised mostly of bonds, bond-like instruments, or dividend-generating equities.

- **Source of return**
  Capital appreciation from equity market exposure
- **Source of risk**
  Equity market risk; option-related risk, heightened market volatility can benefit the strategy with elevated premiums but with risk to the underlying positions
- **Source of income**
  Stream of cash from option premiums, without interest rate risk

	BXM	S&P 500
Standard Deviation (3-yr)	14.0	17.7
Standard Deviation (5-yr)	12.0	15.8
Beta (3-yr)	0.7	1.0
Beta (5-yr)	0.7	1.0

> "Selling "out-of-the-money" call options allows the portfolio to benefit from rising stock prices if they occur."

Covered call strategies in varying markets

The benefits of a covered call strategy are evident in all types of markets, some market environments more than others. This is why many equity investors seeking income allocate a portion of their portfolio here, while others seeking growth will carve out a portion of their more risky equity holdings to balance out their equity risk. This section explains how covered call strategies have performed in different market scenarios and why.

DOWN MARKETS

Covered call writing has tended to outperform against the broader equity market in down-market environments due to the income generated from selling call options. The portfolio continues to hold the underlying stocks when prices go down, but call premiums received help offset the falling prices and can potentially be reinvested in the same securities at a lower price point or another opportunity. An active manager in this environment can also benefit from security selection, where the portfolio can be managed to reduce risk and pursue excess returns over the market (alpha). In steep down market environments, such as was experienced in 2008, the result from a covered call strategy can be a negative total return.

FLAT MARKETS

In flat markets, a covered call strategy can be a powerful alternative for both capital appreciation and income. Writing calls with a strike price out-of-the-money (ex: $55 on a $50 stock) allows room for capital appreciation while earning a call premium. As volatility increases, the value of the call premium also increases, giving the portfolio the potential for even more income.

UP MARKETS

A covered call strategy can still be effective when markets are up, as long as prices aren't increasing so quickly that call options are exercised. Out-of-the-money calls will keep the premium income and capital appreciation as long as the stock price does not exceed the strike price. The least conducive environment is a steeply advancing market since much of the gain of the underlying holdings is truncated by the securities getting called away at prices below the current market.

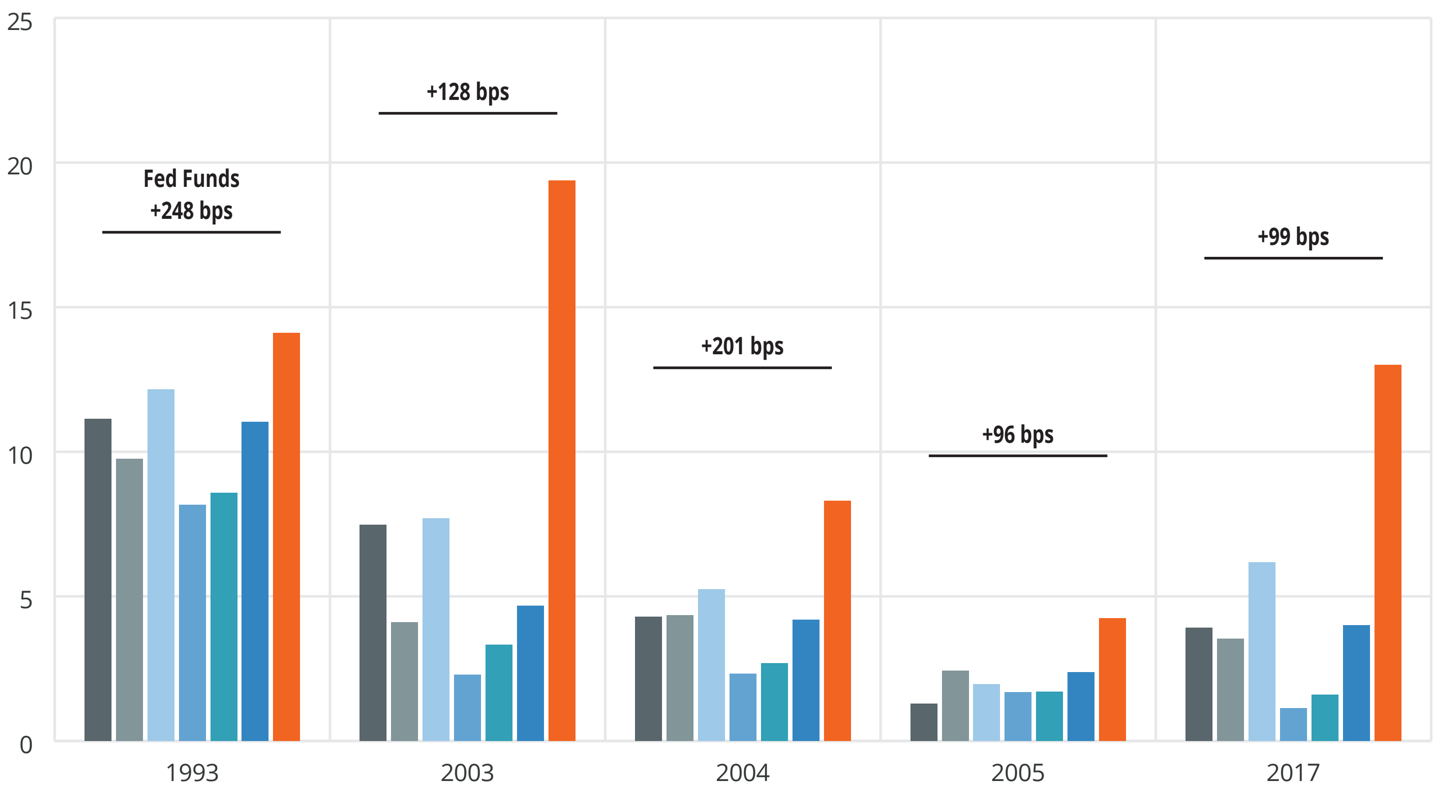
Covered call strategies in varying market environments (S&P 500)

RISING RATES

As covered call strategies are designed to produce income, we should also analyze their behavior during rising-rate environments. Typically, the rise of interest rates tends to favor covered call strategies over traditional fixed income investments from both an income and growth perspective. Looking at the mechanics of options, one important factor in pricing options is the risk-free rate. As the risk-free rate (as measured by short-term treasuries) rises, the opportunity cost of owning lower-risk assets also rises, putting upward pressure on stock options premiums.

From a performance perspective, returns from a covered call strategy (as measured by the BXM) are largely uncorrelated with returns from fixed income. And, in periods of rising interest rates, where bonds underperform due to negative price action, the uncorrelated covered call strategy can help provide portfolio diversification.

Calendar Year Returns When Rates Rise



Asset classes represented by the indices shown:

- **Intermediate Corporate**
  Bloomberg Intermediate Corporate TR
- **Aggregate Bond**
  Bloomberg US Aggregate Bond TR
- **US Credit**
  Bloomberg US Credit TR
- **Intermediate Government**
  Bloomberg US Govt Intermediate TR
- **High Quality Government/Corporate**
  Bloomberg US Govt/Credit A+ Intermediate TR
- **US Government/Corporate**
  Bloomberg US Govt/Credit TR
- **Covered Call**
  MCBOE S&P 500 BuyWrite BXM

How to invest in a covered call strategy

Individuals can invest in stocks and ETFs and write call options against their holdings in just about any brokerage account. However, between understanding the pricing structures of options, knowing what constitutes the best value, and measuring the level of risk, many investors prefer to leave it to a professional money manager. Covered call strategies are available in a variety of vehicles, including opened- and closed-end mutual funds, ETFs, and separately managed accounts. And they come in a variety of investing styles, philosophies, and approaches. The balance of this guide will explore the benefits and considerations of actively managed covered call strategies.

COVERED CALL AND INVESTOR OBJECTIVES

A covered call strategy has something to offer for many types of investors. Let's examine the potential use cases.

Investors seeking income

In addition to dividends and capital gains, options premiums provide another stable source of cash flow for investors and diversification from bonds. Generally speaking, call writing on individual stocks tends to offer higher premiums than writing on an index.

— **Portfolio idea:** Complement fixed income and dividend strategies to diversify sources of income generation if equity risk is appropriate.

Investors in a conservative risk allocation

Covered call strategies offer the diversification benefits of equity market exposure with typically less risk. While income from options premiums can dampen the effect of equity market risk, an actively managed portfolio can also help mitigate risk through security selection and investment discipline.

— **Portfolio idea:** Include in equity allocations to reduce a portfolio's beta to the broader equity market.

Investors in a moderate risk allocation

Covered call strategies provide a balance of equity market exposure, income, and risk mitigation. Depending on your unique tax situation and investment objective, an allocation to a covered call could provide the U.S. equity base to explore higher-risk assets in other areas

— **Portfolio idea:** Pair an actively managed covered call strategy with a growth-oriented long-only fund to participate in steep market inclines while maintaining a cash flow during declines.

Investors in an aggressive growth allocation

With historical distribution rates higher than the broad market index, a covered call strategy gives investors the potential to reinvest gains at a higher rate, compounding their portfolio while participating in all markets.

— **Portfolio idea:** Include an actively managed covered call strategy to pursue above broad market dividend yield and allow the manager to write further out-of-the-money calls for increased participation in rising markets.

EXAMPLES OF CALL WRITING STRATEGIES

Just as there are several styles and approaches to investing in the stock market, several methods exist to implement a call writing strategy.

Active Underlying / Active Call Overlay	
Actively selecting the underlying holdings, then writing call options on those same holdings.	— Underlying securities within the portfolio actively reflect the philosophy and conviction of the manager. — Volatility tends to be greater for individual stocks as opposed to a broad index. This volatility is conducive to options demand and premium value.
Active / Index	
Actively selecting the underlying holdings, then writing call options on an index.	— Underlying securities within the portfolio actively reflect the philosophy and conviction of the manager. — Diversification within the index tends to bring volatility down, which can detract from options premiums. — When options are exercised, the portfolio must come up with the cash to settle. This may force the manager to hold more cash or sell other securities before they want to.
Index / Active	
Investing in an index and writing call options on individual stocks within the index.	— Typically track the performance of an index very closely, with alpha (or excess return) coming from option premium. — When options are exercised, portfolio must come up with the stock holdings, which could force the manager to hold more cash and buy the necessary stocks at the market price.
Index / Index	
Investing in an index and writing call options on that index.	— The passive approach to covered calls tends to track an index (like the S&P500) closely, with additional income in the form of call premiums.

Single stock options

Writing options on individual names instead of an index-tracking ETF tends to provide significantly higher option premiums. To illustrate this occurrence, we'll look at options pricing data from three well-known companies in different industries and compare to an index-tracking ETF.

Security	Stock Price (April 2022)	Call Option (June 2022)	% Out of the Money	Option Price	Option Premium	Annualized
Apple Inc.	$174.61	$180.00	3%	4.1	2.35%	13.60%
Amazon.com, Inc.	$3,259.95	$3,360.00	3%	79.85	2.45%	14.19%
Berkshire Hathaway Inc. Class B	$352.91	$365.00	3%	4.54	1.29%	7.45%
S&P 500 (SPY)	$451.64	$466.00	3%	3.64	0.81%	4.67%

Source: Sample Data Only. Call options have 63 days to expiration in this example. Securities identified for illustrative purposes only represent the largest companies by market cap in three distinct sectors; not intended to be a recommendation to buy or sell any security. At any given time there may be greater opportunities for option writing on individual securities than on indices, however not every individual security produces potential option premiums in excess of index options.

Sample data does not include transaction costs, which would lower returns.

If managed actively, this strategy allows the manager to tailor the option characteristics (strike price, expiration) directly to their view of the underlying stock holding. If the manager believes the company is trading at a discount and that the stock is set to rise in the short-term, they may write an "out-of-the-money" call to capture more of the upside participation, though it will earn less option income. Conversely, a manager may write an "at-the-money" call if they believe the stock will remain at or below its current price. At-the-money calls offer more income from a higher option premium in exchange for forgoing any potential upside of the stock. Single stock options are more labor-intensive and may require a higher investment minimum or management fee.

Another critical factor investors should consider is how much the portfolio is covered. Meaning, what percent of all underlying shares of the stock owned in a portfolio have call options been written for. A portfolio that is 30% covered will earn significantly less premium income than a portfolio at 70% covered. However, the opportunity for stock price appreciation is lower the more the portfolio is covered.

> "Knowing which underlying stocks to write call options for and at what strike price and premium is why many investors choose an active money manager to run an active/active strategy."

Understanding yield from a covered call strategy

By now, you should recognize that a covered call strategy is often more of an income solution than a hedged equity solution. Income from equities and equity options can help income seekers who are comfortable with the related risks add diversification and enhanced return potential to what may otherwise be a primarily bond portfolio.

When researching covered call mutual funds or other investment products, advisors and investors often look at the historical distribution yield(s) reported by the fund manager. This helps the investor understand how the fund has delivered on income needs in different market environments. But, it is important to understand where that yield comes from and the impact the types of income may have on an individual's tax situation. This section will examine the sources of yield in a covered call strategy.

Madison and its affiliates do not provide tax or legal advice. Please consult with a qualified professional for questions in these areas.

Net Investment Income	
Interest + Dividends Less fund expenses *Note: This is the only component used in calculating the SEC Yield*	— Interest is typically taxed as ordinary income, while dividends are subject to the dividend tax rate associated with an individual's tax bracket.
Net Option Premiums	
Premium received from selling (writing) options Less premium paid from option buying.	— With a few exceptions like Long Term Equity Anticipation Securities (LEAPS), options are taxed as short-term gains. — Index options are taxed at 60% long-term and 40% short-term.
Net Realized Gains and Losses from Equity Sales	
Gains and losses generated from direct sales of the underlying equity positions. *Note: Does not include gain/loss from equity sales associated with option assignments.*	— Long-term or short-term capital gains, depending on the holding period of the underlying equity. — For covered call mutual funds, realized capital gains are required to be distributed.
Net Realized Gains from Equity/Option Assignments	
If an option assignment results in the sale of an equity holding, calculate the "option adjusted cost basis" by deducting the full option premium from the cost basis of the equity holding. *OAJC = cost basis – option premium*	— Long-term or short-term capital gains, depending on the holding period of the underlying equity. — The option premium portion takes on the character of the underlying equity holding.

Madison's approach to covered call investing

Madison Investments has been a pioneer in covered call management since 2004. Our active stock selection with active option management investment approach provides the opportunity to manage risk while exploiting the higher premiums available for individual stocks.

Portfolio Managers Ray Di Bernardo, CFA, and Drew Justman, CFA, bring an average of more than 25 years of industry experience. Ray has been managing the Madison Covered Call Strategy since its inception in 2004.

ACTIVE STOCK SELECTION

Madison's bottom-up stock selection process begins with rigorous fundamental analysis and culminates in a high-conviction portfolio of 30-50 stocks.

— Growth-at-a-reasonable-price (GARP) approach

— Avoid over-priced and speculative stocks through valuation discipline

— Focus on companies with a history of excellent return on capital, strong long-term growth, and positive cash generations

ACTIVE OPTIONS OVERLAY

Madison writes individual stock options rather than index options because we believe individual stock options can offer higher premiums.

— Typically write out-of-the-money calls, allowing for upside participation

— Options trades consider our views of the individual stock and overall market

— Typically 75-80% covered, with average option expirations of 45-60 days

GROWTH & INCOME

We believe the output of our investment strategy is a high-quality equity portfolio that offers market-like growth potential with high levels of income.

— Income generation from a "best ideas" approach

— Out-of-the-money calls to participate in strong markets

— At-the-money or in-the-money calls for downside protection

To learn more about Madison's Covered Call Strategy, visit madisoninvestments.com/investment-strategies.

INDEX DEFINITIONS

Indices are unmanaged. An investor cannot invest directly in an index. They are shown for illustrative purposes only, and do not represent the performance of any specific investment. Index returns do not include any expenses, fees or sales charges, which would lower performance.

CBOE S&P 500 BuyWrite Index (ticker: BXM) is the passive representation of a covered call strategy. The BXM Index is an unmanaged (passive) total return index based on buying the S&P 500® stock index portfolio and "writing" (or selling) the near term S&P 500® Index "covered" call option (SPX) every month with an exercise price just above the prevailing index level (i.e., slightly out of the money). Source: CBOE

S&P 500® is an unmanaged index of large companies and is widely regarded as a standard for measuring large-cap and mid-cap U.S. stock-market performance. Results assume the reinvestment of all capital gain and dividend distributions. An investment cannot be made directly into an index.

ICE BofA U.S. High Yield Bond Index tracks the performance of below investment grade, but not in default, U.S. dollar denominated corporate bonds publicly issued in the U.S. domestic market, and includes issues with a credit rating of below BBB, based on an average rating by Moody's, S&P and Fitch.

Bloomberg U.S. Aggregate Bond Index is a broad-based flagship benchmark that measures the investment grade, U.S. dollar-denominated, fixed-rate taxable bond market. The index includes Treasuries, government-related and corporate securities, mortgage backed securities, asset-backed securities and corporate securities, with maturities greater than one year.

Bloomberg U.S. Credit Index measures the investment grade, US dollar-denominated, fixed-rate, taxable corporate and government related bond markets. It is composed of the US Corporate Index and a non-corporate component that includes foreign agencies, sovereigns, supranationals and local authorities.

Bloomberg Intermediate US Government/Credit Bond Index is a broad-based flagship benchmark that measures the non-securitized component of the US Aggregate Index with less than 10 years to maturity. The index includes investment grade, US dollar-denominated, fixed-rate treasuries, government-related and corporate securities.

Bloomberg Intermediate Government Corporate A+ Index measures the performance of United States dollar-denominated United States Treasuries, government-related and investment-grade United States corporate securities that have a remaining maturity of greater than or equal to one year and less than 10 years.

MSCI ACWI EX USA INDEX: Captures large and mid cap representation across 22 of 23 Developed Markets countries (excluding the US) and 23 Emerging Markets countries. With 1,843 constituents, the index covers approximately 85% of the global equity opportunity set outside the US.

MSCI EMERGING MARKET INDEX: The MSCI Emerging Markets Index captures large and mid cap representation across 24 Emerging Markets (EM) countries. With 1,138 constituents, the index covers approximately 85% of the free float-adjusted market capitalization in each country.

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DEFINITIONS

Standard Deviation is a statistical measurement of dispersion about an average, which, for a portfolio, depicts how widely the returns varied over a certain period of time. Investors may use the standard deviation of historical performance to understand the range of returns for a portfolio. When a portfolio has a higher standard deviation than its benchmark, it implies higher relative volatility. Standard deviation has been calculated using the trailing monthly total returns for the appropriate time period. The standard deviation values are annualized.

Beta is a statistical measure of volatility for a security or portfolio compared with that of the overall market. The market as a whole has a beta of 1. Securities with a value greater than 1 are more volatile than the market (meaning they will generally go up more than the market goes up, and go down more than the market goes down).

SEC Yield equals Net Investment Income (Gross Investment Income less Operating Expenses) divided by average asset value (average shares outstanding less net asset value).

DISCLOSURES

Consider the investment objectives, risks, and charges and expenses of Madison Funds carefully before investing. Each fund's prospectus contains this and other information about the fund. Call 800.877.6089 or visit madisonfunds.com to obtain a prospectus and read it carefully before investing.

Performance data shown represents past performance. Investment returns and principal value will fluctuate, so that fund shares, when redeemed, may be worth more or less than the original cost. Past performance does not guarantee future results and current performance may be lower or higher than the performance data shown. Visit madisonfunds.com or call 800.877.6089 to obtain performance data current to the most recent month-end.

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This report is for informational purposes only and is not intended as an offer or solicitation with respect to the purchase or sale of any security.

An investment in the fund is subject to risk and there can be no assurance that the fund will achieve its investment objective. The risks associated with an investment in the fund can increase during times of significant market volatility. The principal risks of investing in the fund include: equity risk, mid-cap company risk, option risk, tax risk, concentration risk and foreign security and emerging market risk. More detailed information regarding these risks can be found in the fund's prospectus.

The writer of a covered call option forgoes, during the option's life, the opportunity to profit from increases in the market value of the security covering the call option above the sum of the premium and the strike price of the call, but has retained the risk of loss should the price of the underlying security decline.

The preceding examples are based on American-style options. Other variations exist.

Diversification does not assure a profit or protect against loss in a declining market.

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