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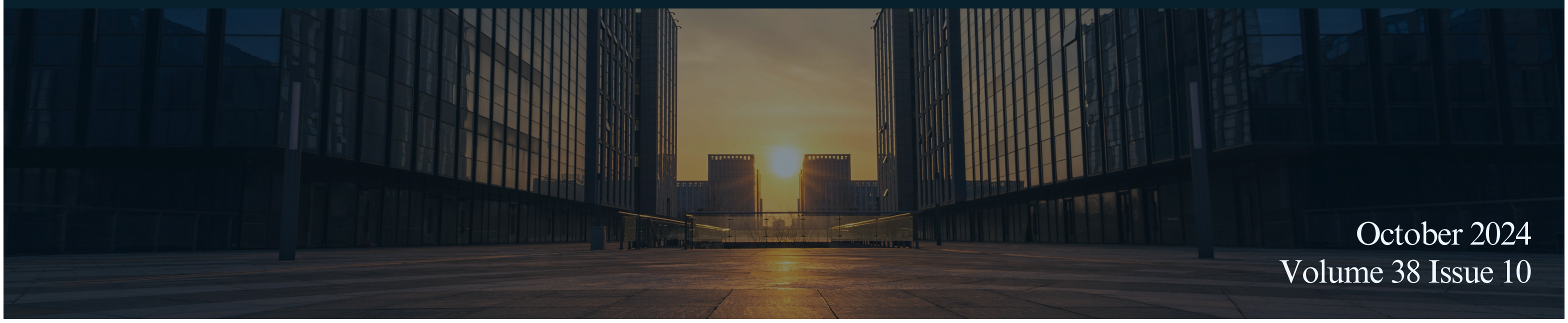

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HOW DO WE DEAL WITH THE UNCERTAINTY?

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There are three basic sources of uncertainty: the outlook for the economy, the status of inflation, and the big one -- The election.

The general consensus is that the Federal Reserve Board (Fed) has engineered a "soft landing" and the economy will continue to move along in a positive direction. The evidence of that is the favorable movement of the stock market. However, there is still a group of economists and money managers (although smaller in number) that believe we will wind up in a recession sometime in 2025.

The rate of inflation had been as high as 9% in June of 2022. Through aggressive interest rate increases, the Fed has brought inflation down to about 2.5%. Their target is 2%, which is not far away; however, potential war in the Mideast, China stimulating its economy, and some labor unrest (strikes) could put upward pressure on inflation which could be troublesome for the stock market.

The biggest uncertainty that we face is the outcome of the election. Seldom in history have we faced such a dramatic difference in the likely direction of our nation under the administration of the two opposing presidential candidates. The approaches to tax policy, regulation, and attitude toward business are virtually polar opposites.

The important question is: How are we going to deal with the uncertainty? The answer is a relatively new type of product called the equity premium ETF.

An equity premium ETF is an exchange traded fund (ETF) that generates income through a combination of investing in stocks and selling options on those stocks.

These equity premium ETFs offer two attractive features that make them suitable for dealing with uncertainty. First, being the high annual cash flow that they generate (usually 7% to 9%), and second, they are basically index funds that participate in 75% to 90% of the index gains.

The 7% to 9% cash flow will act as buffer against a market decline. It is not designed to provide total protection, but it will offset the bulk of a routine 10% market correction. Previously, we had used buffered ETFs that provided up to 15% downside protection, but they limited the upside participation.

Now let's look at a couple examples of funds that are currently in our portfolios.

Example 1: This fund uses a combination of the Nasdaq 100 index and the S&P 500 index.

1. The Nasdaq 100 is a tech heavy index.

2. The S&P 500 is a broad market index of large cap stocks.

3. The current distribution rate is slightly over 8%.

4. The current upside participation rate is at 85%.

5. The fund sells weekly call options on the indices in the fund. A call is a right to buy the ETF index shares at a specified price for a period of time (in this case - one week).


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In order to maintain the distribution rate at 8%, the fund has to generate enough premium from the sale of the options. The premium will fluctuate with the volatility in the markets - that is the reason the upside participation rate will vary, generally, between 75% to 90%.

6. To conclude, this approach answers the uncertainty dilemma by giving some downside protection (7% to 9%). If the market rises, then the fund will participate with the indices to the extent of 75% to 90% along with the cash flow that it generates. The concept is to have some downside protection yet, not sacrifice very much of the upside potential.

Example 2: This fund is based on the Russel 2000 index.

1. The Russel 2000 index is composed of small and midcap stocks.

2. The current distribution rate is slightly under 8.4%.

3. The current participation rate is slightly over 90%.

4. This fund sells weekly call options on the index or on ETFs based on the index. These funds use the weekly options versus the monthly options because they pay out relatively more premium than the longer maturities. This fund pays out more cash than the fund in example 1 and it also has a higher participation rate.

These funds represent two of the funds of this type that we are currently using. They represent different parts of the investment landscape in order to maintain a diversified portfolio.

Presently, in our investment portfolios, equity premium ETFs have an allocation of 25% up to 45% depending upon the client's selected portfolio objective. These products do have an unfavorable aspect for taxable accounts - the cash that they generate is taxable income, but, in our judgment, they still make sense because of the downside protection.

The Outlook

2024 has been a very good year for the stock market. The rate of inflation has been dramatically reduced without experiencing a recession. Corporate earnings have held up, which enables the PIE (Price to Earnings Ratio) to be supportive of stock prices. The inverted yield curve, which we covered in previous newsletters as often being a leading indicator of a recession, has since reverted back to a normal situation where shorter-term interest rates are lower than long-term interest rates.

Although the economic numbers have been pretty good, the overall economy is very uneven with the people that have money able to benefit from the rising stock market whereas the lower economic group is struggling, living paycheck to paycheck. This unhealthy economic situation cannot go on indefinitely. It must be dealt with by the next Administration.

Unfortunately, we do not possess the proverbial crystal ball to foresee the future: therefore, we are thankful to have the equity premium ETFs. Not only do they give some downside protection along with good upside participation, but the monthly cash flow enables a dollar-cost-averaging monthly investment.

As always is the case, changing circumstances may require changes in investment strategy.

PLEASE REMEBER TO NOTIFY US IF YOU HAVE HAD ANY MATERIAL CHANGES IN YOUR FINANCIAL CIRCUMSTANCES.

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