TD Asset Management

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Does Higher Income Always Mean Lower Growth?

Ben Gossack, CFA, MBA
Vice President & Director
TD Asset Management

Jacky He, MBA
Vice President
TD Asset Management

At a glance

- Investors that traditionally relied heavily on bonds for income returns are now facing increased challenges to generate enough income as yields continue to be suppressed
- In the search for yield from equites, investors could run the risk of eroding capital upside by chasing yields on low growth equities
- TD Active Global Enhanced Dividend ETF (TGED) is in a unique position to tilt the balance of income and growth in the investors' favour by generating highly attractive income through a differentiated option overlay strategy without sacrificing total return

In the world of investing nothing is static. Theories and strategies that brought us to today may not always provide prosperity in the future. This year global investors faced volatility of epic proportions as markets plunged to depths unseen in many years, only to recover many of the losses. With central banks around the world providing enormous amounts of stimulus to help the economy, asset managers need to pivot and think about new ways to generate returns. This includes evaluating and rethinking the traditional relationship between growth and income.

The Balance Of Growth And Income

Investors that traditionally relied heavily on bonds for income returns are now facing increased challenges to generate enough income as yields continue to be suppressed and are expected to stay lower for even longer. Against this backdrop, negative yielding bonds now account for 20% of total bonds outstanding (as seen below on next page), which means they are guaranteed to lose capital if held to maturity.

Negative Yielding Debt as % of Total Debt

Source: TDAM, Bloomberg Finance L.P. Data as of May 31, 2020.

On the equity front, higher yielding stocks don't often offer growth, and high growth stocks don't often pay dividends. Therefore, investors could run the risk of eroding capital upside by chasing yields on low growth equities.

In the face of COVID uncertainties and geopolitical tensions, how does one balance growth and income? The answer could be found in an enhanced dividend strategy offered by TD Asset Management ("TDAM").

TD Active Global Enhanced Dividend ETF (TGED)

Launched just over a year ago, TGED was designed to resolve the specific challenges of balancing growth and income in the search for yield. The strategy behind addressing this challenge is to generate highly attractive income through a differentiated option overlay strategy. TGED, unlike many competitor products, uses a completely active approach in both selecting stocks and writing options.

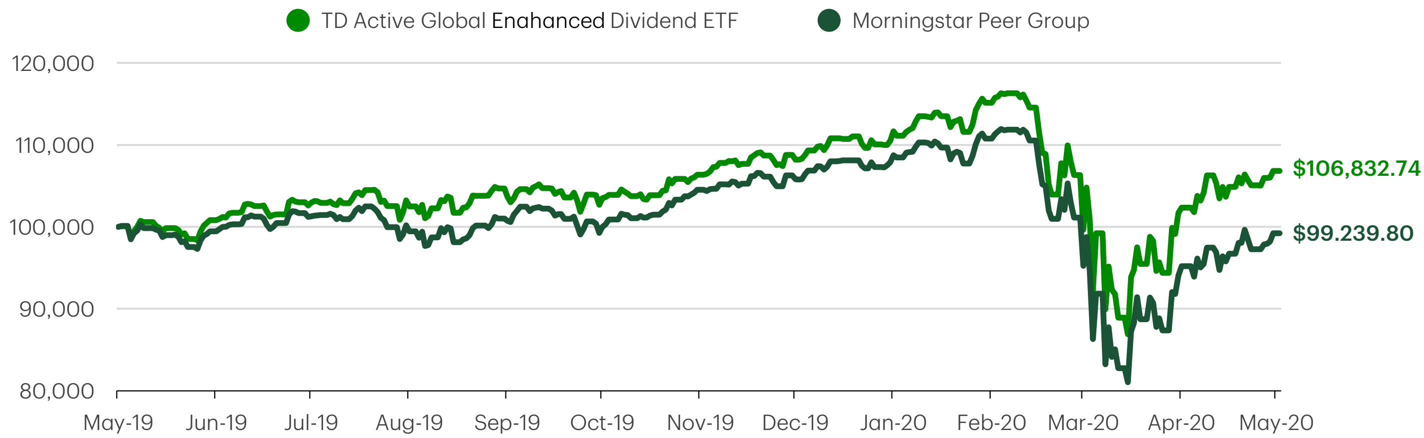
This approach not only allows TGED to enhance income on high quality underlying stocks, regardless of whether they pay dividends, but does so without sacrificing long-term capital growth. Having said that, the ETF does not simply replace growth with yield, but rather focuses on total return. What's more, investors may benefit from a tax perspective as the collected option premiums are generally characterized as capital gains rather than income, which could be advantageous from a tax standpoint.

TGED seeks to deliver 4%+ annual yield to investors while investing in global high-quality businesses that are tied to secular growth trends and can compound free cash flow over time.

How has TGED fared in its first year, particularly during the pandemic?

Since inception, TGED has outperformed 90% of its competitors. This 1 year period has been a great trial as we went through one of the worst quarters in global equity history, with the MSCI World Index down 20% in Q1, 2020.

TGED Performance Since Inception



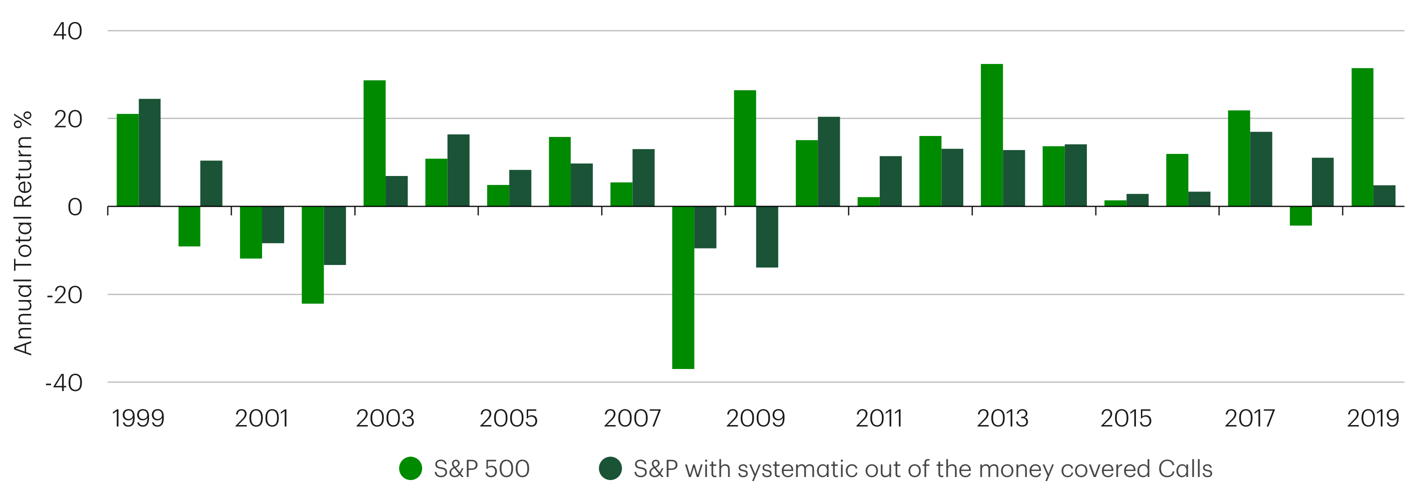
Source: TDAM. Morningstar Direct. Data as of May 10, 2020. Note: Morningstar Peer Group refers to the average of the Canada Fund Global Equity category.

If we break down the period by the pivot date of February 19, 2020, when global equities reached their record high, TGED comfortably outperformed the peer group during both the rise and decline of the market. During the rise, from inception to February 19, TGED captured more upside by returning 16% vs. 12% from its peers, and from March 23 to May 10, TGED rebounded 23% vs. 22% from its peers. During the historic plunge in markets from February 19 to March 23, TGED outperformed its peers on the downside by returning -25% vs. -28%.

The benefit of the covered call strategy

If history is a guide, the covered call strategy can continue to drive outperformance in the current environment. The chart below helps illustrate this. It depicts the yearly performance of the S&P 500 Index versus the index overlaid by a systematic covered call strategy, with the assumption of writing 2% out of money covered calls and resetting the options every month.

S&P 500 Index Without vs. S&P 500 Index with systematic 2% out of the money covered calls



Source: TDAM. Factset. Data as of Dec 31, 2019. Note: The CBOE S&P 500 2% out of the money BuyWrite index is used as the proxy of a systematic covered call strategy.

Essentially, the covered call strategy could provide up to a 2% monthly gain and give up any upside above that in exchange for income (option premiums). As such, when the market had outsized returns (>20%), the covered call strategy also had strong returns, but mostly lagged. When the market had more modest or negative returns, the covered call strategy mostly outperformed because the premiums collected more than offset the upside it gave up. Over time, the covered call strategy has seen lower volatility year over year.

Based on this dynamic, investors would naturally expect a covered call strategy would add value in a weak market but would underperform in a strong market. This turned out not to be the case for TGED, which continued to add value in both the market increases and decreases since its inception.

How TDAM does it differently

At its core, TGED leverages the TDAM time-tested philosophy and process when selecting underlying stocks. The ETF would only own high-quality businesses that have sustainable competitive advantages, solid balance sheets, compounding free cash flows and be set to better weather difficult times like Q1, 2020, and thrive in the long run.

In addition, TGED outperformance was attributable to our active approach to writing options. Unlike systematic option strategies, we are very selective on timing, underlying holdings, strike prices, expiry dates and contract sizes. Each of these factors are analyzed based on thorough fundamental research of a particular business at that moment in time. In scenarios like February 2020 when volatility spiked, we could terminate an option contract earlier than maturity and start a new one at a much more attractive yield. While it requires significantly more work than a systematic approach, we aim to generate high income for investors today while keeping their long-term capital growth in mind.

On balance, TGED is in a unique proposition to tilt the balance of income and growth in the investors' favour. The ETF only holds high-quality businesses and uses an active approach to enhance income without sacrificing total return. Looking ahead, when facing the uncertain impact of COVID-19 on the global economy and the ongoing geopolitical risk, TGED can stand to benefit from a volatile environment as, generally speaking, the higher the volatility, the higher the option premiums and by extension, the more opportunities for an active investor.

"Following the success of TGED, we are excited to have recently launched the TD Active U.S. Enhanced Dividend ETF (TUED), that uses the same active strategy and focuses purely on U.S. equities.

Growth

A case study on the options strategies within TGED

In March 2020, we intentionally did not write calls on select Health Care companies, like Abbott Laboratories, as the risk-reward prospects were unattractive at the time. This enabled TGED to participate in 100% of the stock rebound.

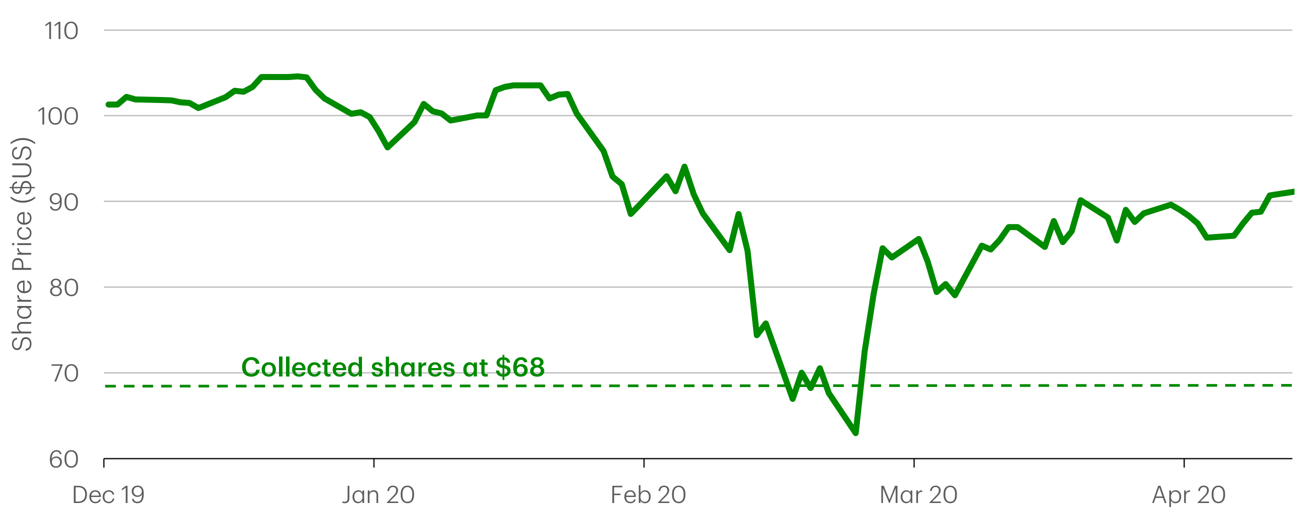
Abbott Laboratories - Price

Source: TDAM. Factset. Data as of May 10, 2020.

In addition to the active covered call strategy, we opportunistically write put options, which can generate even more income. This strategy is similar to a limit buy order when investors wait for a stock price to drop to a target entry point. If the share price hits our target, we would buy the shares at the target price. The key difference is that we earn option premiums while waiting.

Moreover, we write put options only on stocks that we are willing to own at cheaper prices based on fundamental research. A good example is Nike. On March 11, 2020, we collected significant premiums by writing put options on Nike at a strike price of $68 (20% down from the market price) as our research indicated that Nike's long-term value was worth much more. When the stock price dropped to $68 amid the indiscriminate market selloff, we were glad to collect Nike shares at a discount. Even if the price did not drop to $68, we would be happy to collect the option premiums.

Nike, Inc.



Source: TDAM. Factset. Data as of May 10, 2020

Balance

Fund performance data as of May 31, 2020. Returns for periods over one year are annualized, net of expenses.

Fund Name	3m	6m	1y	3y	5y	10y	S.I.	Inception Date
TD Active Global Enhanced Dividend ETF	6.31%	1.85%	12.75%	N/A	N/A	N/A	8.41%	5/3/2019

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