

Investment perspectives



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Key highlights:

- There are some indications that inflation could be increasing, but economic fundamentals remain strong.
- Volatility has been above long-term averages, which can be a positive for covered call strategies as it enables investors to take advantage of higher call premiums.
- The First Investors Covered Call Strategy Fund is positioned for success given the levels of call premiums and the downside protection that the Fund offers.

Using a covered call strategy in today's market

The First Investors Covered Call Strategy Fund offers a core equity solution based on writing covered calls on the Fund's holdings that aims to provide smoother, more consistent returns and is offered by Foresters Investment Management Company, Inc. Wiley Angell, Senior Portfolio Manager, Ziegler Capital Management, LLC (the Fund's subadviser), recently provided some interesting observations on the Fund relative to today's market environment.

Can you provide some insight as to what happened in the equity markets at year end?

Wiley Angell (WA): As shown in *Exhibit 1*, on December 24, 2018, the stock market bottomed out and our portfolio management team concluded that the equity market was pricing in a recession. The S&P 500 Index declined -19.7% from the market highs in mid-September through December 24, 2018, which is close to the 20% decline commonly viewed as an indicator of an upcoming recession. But, technically speaking, we never entered a true bear market. Equity market volatility jumped higher in October and December and the subsequent December market decline resulted in a sudden, sharp spike in volatility. Causes included a more aggressive Federal Reserve (Fed) stance than anticipated by investors and fears surrounding the ongoing trade negotiations with China. Since then, the Fed has pulled back on its tightening rhetoric, creating some clarity and, as a result, market volatility has declined.

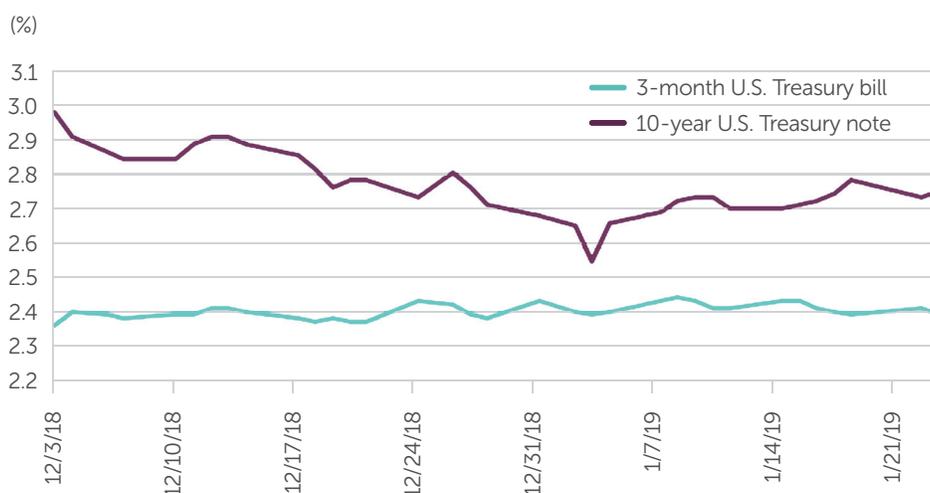
Exhibit 1: Stock market tumbles at year-end
S&P 500 index since January 2018



Source: Morningstar, 1/31/19.

Turning to 2019, do interest rates suggest a hint of the U.S. nearing a recession?

WA: Conventional market wisdom says that if the 2-year U.S. Treasury yield is higher than the 10-year, we are probably heading towards a recession, but that can be a false indicator. Our team's preference is to look at the 3-month U.S. Treasury bill versus the 10-year because, historically, that has never given a false recession signal. That spread, shown in *Exhibit 2*, got down to less than 30 basis points (bps) toward year-end, but it never inverted, which would have suggested a looming recession.

Exhibit 2: 3-month and 10-year U.S. Treasury yields narrowed in early 2019

Source: Federal Reserve Bank of St. Louis, FRED, 1/23/19.

So, how does your team prepare the Fund for a possible recession?

WA: The strategy is designed to reduce volatility through capturing call premiums written on the stocks in the portfolio. These premiums generate cash which acts as a buffer in market declines. It also tends to invest in a value-tilted equity portfolio, which can dampen market value declines if value stocks outperform in a negative market. The combination of these two factors can reduce the strategy's downside risk during periods of recession. That said, we do not position the Fund specifically to avoid a recession. Instead, we focus on economic and market fundamentals, along with valuations, to guide our stock selection and call option characteristics.

How do you approach a rising interest rate environment?

WA: A rising interest rate environment can impact both the stock selection and call option characteristics. As value stocks can tilt towards higher dividends, at times, rising rates can negatively impact value stocks. However, a rising interest rate environment can be a sign of strong economic fundamentals, favoring stocks more broadly. Rising short-term interest rates increase call premiums and can, therefore, enhance returns for covered call strategies. Rising interest rates can also be a sign of rising inflation expectations. In such a period we would look for companies with pricing power. These companies tend to be in industries with higher barriers to entry.

How does your team think about volatility?

WA: Changes in implied volatility create opportunities for our strategy as an active covered call manager. As volatility spikes above long-term averages, our strategy can take advantage of the subsequent higher call premiums by extending the duration of the call options, thus "locking in" the higher volatility. This is an advantage of active covered call management relative to index funds. Additionally, individual stocks offer higher call premiums than an index as the sum of the parts of an index are higher than the whole, in a volatility sense.

As *Exhibit 3* illustrates, volatility tends to spike up when the market declines. Such periods afford opportunities to extend call expirations.

**Exhibit 3: Historical volatility
VIX Index since January 2018**



Source: CBOE, 1/16/19. Closing prices shown.

How is the Fund currently positioned?

WA: We believe that the Fund is currently well positioned as we have solid upside capture potential. Often times we have to evaluate the tradeoff between maximizing call premiums by selling closer to the money—near the stock’s current price—versus selling a call above the stock’s current price. This tradeoff summarizes the covered call process. When volatility spikes up following a market decline, (such as the Christmas Eve spike shown in *Exhibit 3*) an investor can obtain upside capture. We started 2019 in just such a position as we felt market fundamentals were stable and valuations were attractive. Therefore, we left the call option strike prices out-of-the-money and also sold higher premiums than normal. This leaves the Fund currently well positioned from a risk/reward perspective.

How do you go about selecting stocks for the Fund?

WA: We utilize a combination of quantitative and fundamental stock analysis to identify companies that tend to have stable earnings, less sensitivity to the economy and less cyclicality of earnings. Those same characteristics tend to correlate with appealing option opportunities—a positive spread between market expectations of volatility (meaning, implied volatility) and realized volatility. We tend to look for industry leaders and growth drivers and then analyze a company’s valuation, management strategy and the financial position of its customers. Single-stock call options offer more attractively priced call premiums than index-based options. We tend to invest in those types of stocks where the spread between implied volatility and realized volatility is wider, the overvalued part of that component. If the absolute call premium isn’t high enough, even though the spread might appear to be attractive, we most likely would substitute a different stock that has the company characteristics we want along with attractive call premiums.

Have you ever considered adopting less of a value bias in your investment approach?

WA: No. Our style is to select stocks that fit our economic and fundamental outlook and that possess an attractive implied volatility versus realized volatility relationship. Our style tends to tilt towards value. Therefore, we’re going to remain faithful to our process.

Given the number of names in the portfolio, would you describe the Fund as a concentrated strategy?

WA: Yes, I think it is fair to characterize the Fund as a concentrated strategy. The Fund is focused on a relatively small number of stocks, with 40 issuers as of 12/31/18, but we think, at the same time, that it has a wide economic base. That said, our focus on large cap, or even mega-cap, stocks creates adequate diversification, in our opinion.

Can you sum up your final thoughts?

WA: If you're looking for an equity fund that provides some downside protection, we would encourage you to consider the **First Investors Covered Call Strategy Fund**. Our team has more than 20 years of experience managing funds during different types of market conditions which we think is one of our competitive advantages. Finally, we believe in our process and the composition of the Fund, and plan to stick to our investment philosophy which has served us well in the past.

Disclosure

The **Standard & Poor's 500 Index (S&P 500)** is a capitalization-weighted index of 500 stocks. The Index is designed to measure performance of the broad domestic economy through changes in the aggregate market value of 500 stocks representing all major industries.

The **CBOE Volatility Index (or VIX)** is a popular measure of the stock market's expectation of volatility implied by S&P 500 index options, calculated and published by the Chicago Board Options Exchange (CBOE).

It is not possible to invest directly in an index.

These views represent the opinions of the Senior Portfolio Manager and are not intended as investment advice or to predict or depict the performance of any investment. These views are as of the close of business on February 25, 2019, based on the information available at the time and are subject to change at any time based on market or other conditions. We disclaim any responsibility to update such views.

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