Aston Funds

Spotlight

September 2, 2010

Covering Your Bases

The Aston/M.D. Sass Enchanced Equity Fund offers a potential hedge against market uncertainty.

Amid a period of heightened volatility within equity markets, investors can't be faulted for seeking an alternative to traditional long-only stock strategies. Stock prices have swung wildly the past three years as investor sentiment has shifted back and forth between euphoria, panic, and even indifference as a result of the financial crisis and stalled economy. Still, it's hard to give up the upside potential of stocks. While a number of alternative solutions have delivered lower volatility during this period, many have done so by sacrificing potential returns. A possible middle ground for investors still wishing to participate in the equity market but worried about heightened volatility is the Aston/M.D. Sass Enhanced Equity Fund, which writes call options against a portfolio of underlying stocks as a principle investment strategy. The Fund's covered call strategy combines both participation in the equity market with an alternative hedge in an effort to dampen some of the volatility of a traditional portfolio.

Enhanced Equity

Portfolio manager Ron Altman writes covered calls on a carefully selected portfolio of dividend-focused, large-cap stocks. The strategy relies as much upon Altman's skill and experience picking stocks to enhance returns as it does the use of company-specific call options to aid in managing volatility. The portfolio is typically concentrated in 35 to 40 holdings, mostly blue-chip dividend-paying companies chosen based on a fundamental, bottom-up stock picking process centered on long-term revenue growth and relative valuations. The potential income generated from the dividends of the underlying stocks combined with premiums earned from selling call options may help cushion against downside swings in the market.

A distinctive feature of the Fund is how it uses call options to enhance total returns and aid in managing volatility. Instead of viewing option premiums as merely a way to generate cash, Altman matches them up with individually researched stocks in an attempt to dampen risk at the security level. He believes that this offers fund investors better protection from large swings in the market than a more mechanical or quantitative index-based approach.

Don't Try This At Home

While the Fund's approach sounds appealing in theory, the nuances and execution of such a strategy can be quite complex. Getting it right in the long run across an entire portfolio requires skill and experience, not only in writing options but in understanding and selecting the underlying portfolio. Although the cash premiums from the options can help to cushion the blow on the downside and add to returns on the upside, losses in the underlying stocks are not prevented. In addition, gains on holdings in the Fund may be limited when a stock appreciates above the option strike price, forcing Altman to sell the stock for less than the current market price. Whether the options are exercised or not, however, the overall effect is to earn cash from the sale of the options, partially offsetting any potential depreciation in the stock.

Altman's style is flexible. The length and terms of the calls he writes for the Fund are critical to his ability to manage volatility and determines how much of the upside potential of an underlying security is capped. Altman seeks the most advantageous combination of strike price and option premium that seeks to maximize the cash generated by the calls without limiting the upside too much. Furthermore, the Fund will occasionally use company-specific or index put options for potentially greater downside protection.

Taxes

The Fund does require that investors consider their personal tax situation, as the use of options can make it relatively tax inefficient. The premiums from call options that expire unexercised or are exercised on underlying stocks held for less than a year may be treated as ordinary income, not a capital gain, and distributed from the Fund as such. Overall, the Fund's tax-inefficiency over time typically makes it best-suited for tax-deferred accounts.

That said, a mutual fund that writes covered-call options in the hands of a skilled and experienced manager such as Ron Altman can hedge some of their exposure to stocks without giving away too much potential upside. The influence of Modern Portfolio Theory, especially in the wake of the bull market of the 1990s, convinced many investors that to achieve higher returns they must take on more risk (as measured by standard deviation, a measure of volatility). That isn't necessarily the case, however, as the underlying assumptions of MPT have become increasingly challenged in recent years. Successful hedging strategies and a keen eye on valuation can help limit the actual risk of losing money, which many consider a better definition of risk than volatility, without sacrificing too much return potential. A fund focused on long-term fundamental stock-picking supplemented by the use of carefully employed call options, such as that by Ron Altman and the Aston/M.D. Sass Enhanced Equity Fund, can help mitigate the risks of owning stocks and serve as a less-correlated diversifier to traditional long-only equity strategies.

Article written by:

Kerry O'Boyle is an Investment Strategist with Aston Asset Management. Prior to joining Aston he wrote on a variety of investment topics as a mutual fund analyst for Morningstar, Inc. Kerry is a graduate of the U.S. Naval Academy, and holds an M.A. in Liberal Arts from St. John's College, Annapolis, MD.

Note:The Fund may use aggressive investment techniques and financial instruments that are considered risky and may cause more volatility and less liquidity. By selling covered call options, the Fund limits its opportunity to profit from an increase in the price of the underlying stock above the exercise price, but continues to bear the risk of a decline in the stock. A liquid market may not exist for options held by the Fund. If the Fund is not able to close out an options transaction, it will not be able to sell the underlying security until the option expires or is exercised. While the Fund receives premiums for writing the call options,the price it realizes from the exercise of an option could be substantially below a stock's current market price. Premiums from the Fund's sale of call options typically will result in short-term capital gain taxes, making it ill-suited for investors seeking a tax efficient investment. The performance of the Fund is dependent upon the portfolio manager's skill in making appropriate investments. As a result, the Fund may underperform its benchmark or its peers. Derivatives risk and market risk also may apply. Past performance is no guarantee of future results. For more information about Aston Asset Management LP and its subadvi¬sors, please call 800-597-9704, or visit www.astonfunds.com

Investors should consider the investment objectives, risks, charges, and expenses of the Aston Funds carefully before investing. Please call 800-992-8151 for a prospectus, which contains this and other information about the Funds. Read it carefully before you invest or send money. Distributed by BNY Mellon Distributors Inc., which is not an advisor affiliate.