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Topic: [Income](#)



Related ETFs

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[QRMI- Global X Nasdaq 100 Risk Managed Income ETF](#)

[XRMI- S&P 500 Risk Managed Income ETF](#)

GLOBAL X ETFs RESEARCH

The Case for Risk Managed Income ETFs

On August 26th, 2021, we listed the [Global X Nasdaq 100 Risk Managed Income ETF \(QRMI\)](#) on the Nasdaq stock exchange and the [Global X S&P 500 Risk Managed Income ETF \(XRMI\)](#) on the New York Stock Exchange (NYSE). In this piece, we explain why investors may want to consider risk managed income strategies and how QRMI and XMRI can be efficient ways of gaining this exposure.

Key Takeaways

- Risk managed income strategies typically own the securities in an equity index, while also selling a covered call option on that index and buying an out-of-the-money (OTM) protective put. This is a net credit collar strategy, meaning it expects to generate positive option premium income, while protecting against market selloffs.
- Risk managed income strategies are typically used as long-term strategic allocations in income-oriented portfolios, given that they have negligible inflation risk and seek to provide a diversified source of income.
- In exchange of pursuing net option premium income, risk managed income strategies forfeit upside participation in their underlying equity index and may experience some albeit limited, downside risks.
- XRMI and QRMI sell one month at-the-money (ATM) call options and purchase one month 5% OTM put options on their respective equity indexes.

What Are Risk Managed Income Strategies?

Today, investors face a difficult challenge in managing their investments: how to generate enough income amid a low interest rate environment, while mitigating the risks of rising rates or major market selloffs. Traditional fixed income instruments, like government, corporate, and municipal bonds, tend to preserve capital, but currently offer historically low yields and are sensitive to rising rates and inflation. Meanwhile high dividend stocks, REITs, and MLPs are often less sensitive to rates and generate high yields, but can be susceptible to drawdowns.

One potential solution for investors to consider are risk managed income strategies, which utilize options to generate an alternative source of portfolio yield, while mitigating downside risks. To strike a balance between these outcomes, risk managed income strategies couple a covered call with a protective put. A covered call involves purchasing securities, such as equities, and then simultaneously selling a call option on those securities. A call option gives the buyer the right, but not the obligation to buy a security at a pre-determined strike price within a given time frame. Selling covered calls can generate high income that has little or no interest rate risk, in exchange for forfeiting the upside potential of the underlying equity securities. By buying a put option for the same securities, a protective put can mitigate losses if the market sells off. A



put option gives the buyer the right, but not the obligation to sell a security at a pre-determined strike price within a given time frame in exchange for paying a premium.

Such strategies are also considered ‘net credit collars’ where the premium received from selling the call option exceeds the cost of purchasing the put, resulting in a positive income stream to the investor. To achieve this outcome, a risk managed income strategy typically must write the call option at or close to at-the-money (meaning the strike price equals the current price of the underlying security), while purchasing a further out-of-the-money put option. This way the price of the put option costs less than the call option sold. To illustrate how this ‘net credit collar’ aspect works, we can use the example of stock XYZ and the difference between purchasing an ATM vs. OTM put option. An investor buying stock XYZ and an at-the-money (ATM) put option at XYZ’s current share price effectively hedges against downside moves. But ATM put options are also more expensive than OTM put options and could expire worthless if XYZ rises. Buying an OTM put option that is 5% below XYZ’s strike price will likely cost less, but will only begin to protect against losses in excess of 5%. The less costly 5% OTM put option, as opposed to the more costly ATM put option is how this risk managed income strategy becomes a ‘net credit collar’.

RISK MANAGED INCOME (1-MONTH 5% OUT-OF-THE-MONEY PUT OPTION AND 1-MONTH AT-THE-MONEY CALL OPTION)

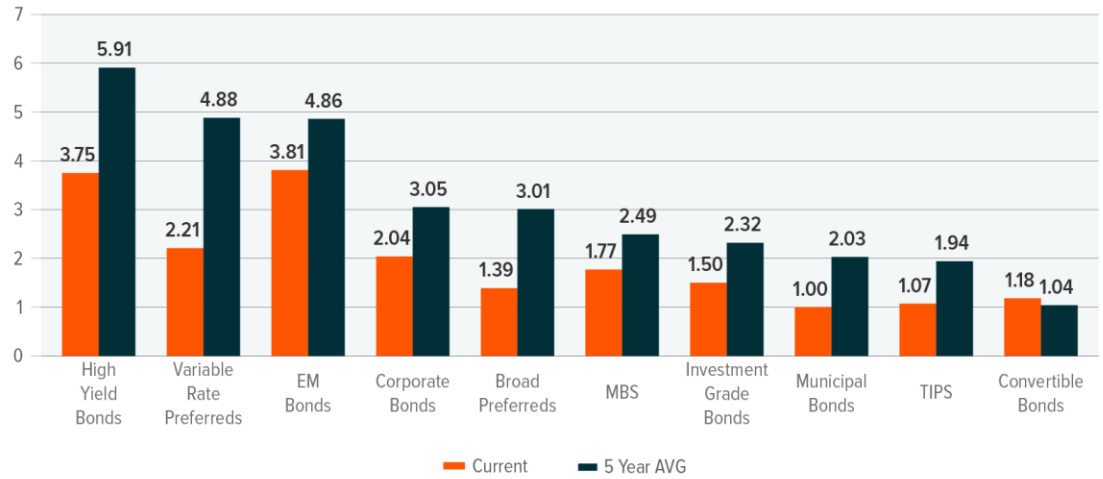


Why Should Investors Consider Risk Managed Income Strategies

Central banks in many developed markets have set policy rates at zero, or negative levels, presenting challenges for investors who rely on their portfolios for income. The fixed income space, traditionally a mainstay in retiree portfolios, is in the midst of a three-decade-long rally with unprecedented levels of central bank support. As such, yields across nearly all major fixed income sectors are trading well below historical averages. This dynamic is often forcing investors into higher credit risk or longer duration areas in the hunt for more meaningful yields. But if rates rise or economic conditions weaken, risks could quickly materialize.



FIXED INCOME YIELDS (YIELD TO WORST) - 5 YEAR AVERAGE

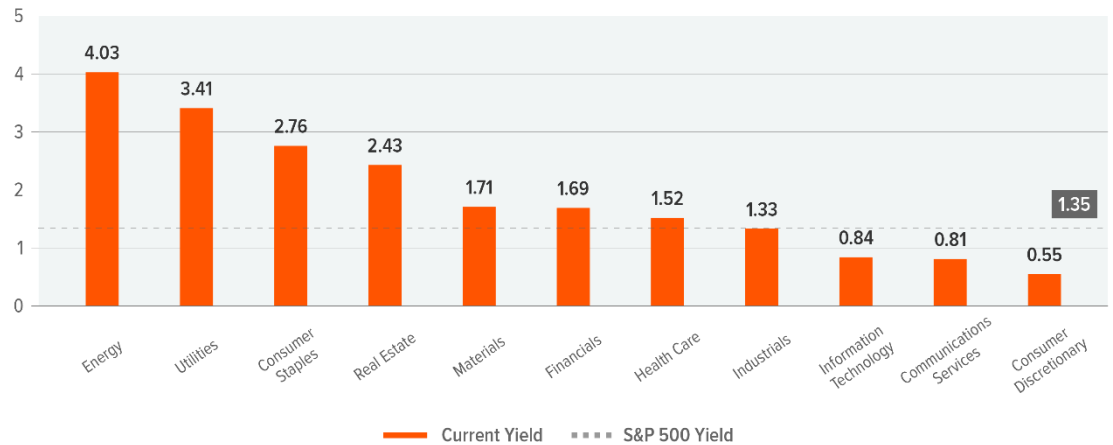


Source: Bloomberg as of 6/30/2021. Asset class representations are as follows, Convertible Bonds, Bloomberg Barclays US Convertible Bond Index; Variable Rate Preferreds, ICE US Variable Rate Preferred Securities Index; MBS, Bloomberg Barclays US MBS Index; High Yield Bonds, Bloomberg Barclays US Corporate High Yield Total Return Index; Broad Preferreds, ICE BofAML Diversified Core US Preferred Securities Index; Municipal Bonds; Bloomberg Barclays Municipal Bond Index; Investment Grade Bonds, Bloomberg Barclays US Aggregate Bond Index; Emerging Market (EM) Bonds, Bloomberg Barclays EM USD Aggregate Total Return Index; TIPS, Bloomberg Barclays US Treasury Inflation Notes TR Index; Corporate Bonds, Bloomberg Barclays US Corporate Total Return Index.

Similarly, within the equities space, dividend yields are low, even in areas that typically used to offer meaningful yields, like Real Estate and Utilities, resulting in inadequate income opportunities from the asset class.

S&P 500 SECTOR YIELD (%)

Source: Bloomberg as of 6/30/2021



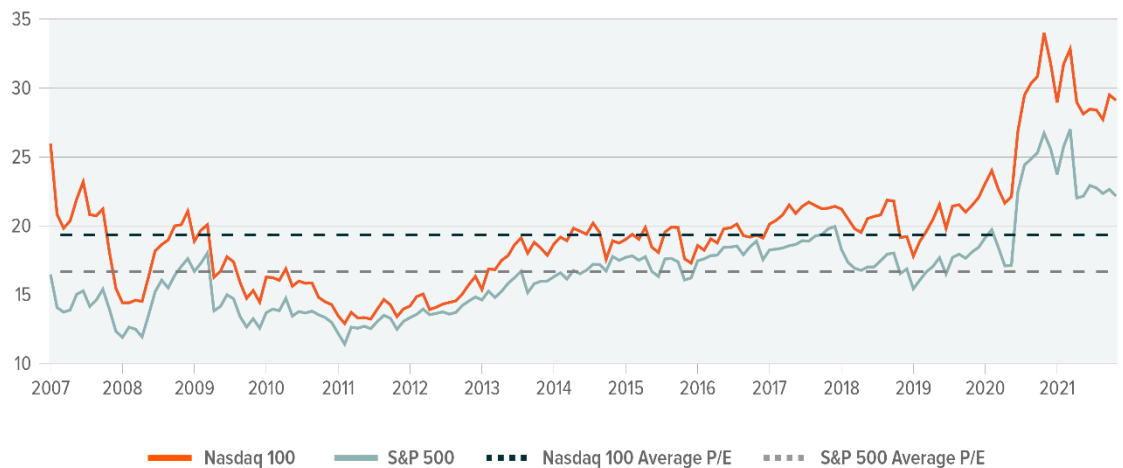
One area that has thrived in the current market environment are covered call strategies.¹ Covered calls aim to generate high income by selling call options that forfeit some or all of the upside potential of an underlying asset in exchange for a premium. This can be a particularly helpful strategy in sideways or upwards trending markets as investors can collect premium income, while volatility is low. They can also be useful if investors are concerned about rising rates, because the income generated from covered calls has a negligible relationship with interest rates.

But for many retirees, income generation can be just as important as protecting their principal amid selloffs. Covered call strategies offer limited downside protection (to the extent that options premiums received would offset some or all of the decline) and therefore may not meet particularly risk-sensitive investors' needs. Risk managed income strategies seek to address this by combining a covered call with a protective put. When designed correctly, a risk managed income strategy should generate income (albeit less than a similar covered call strategy), while limiting downside risks.

Investors may be wise to consider protecting against downside risks given that U.S. equity markets have been in a decade-plus long bull market. Both the Nasdaq 100 and S&P 500 are trading at valuations well above historical averages, which can introduce greater downside risk potential if valuations normalize.

NASDAQ 100 AND S&P 500 FORWARD PRICE-TO-EARNINGS (P/E) VALUATIONS

Source: Bloomberg. Data from 12/31/07 to 7/31/21.



Global X Risk Managed Income Strategies, Explained

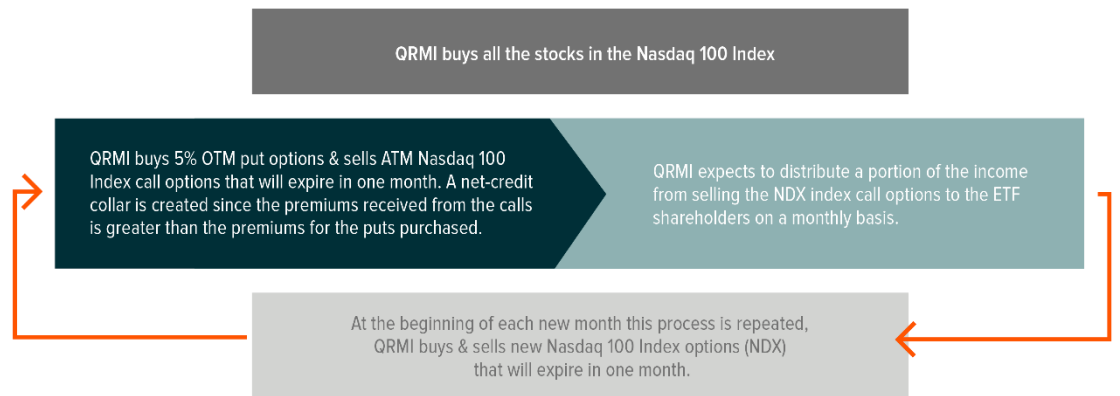
The QRMI and XRMI ETFs are designed to provide a monthly source of income to investors, combined with a measure of downside risk mitigation. Both funds follow similar processes, but have different underlying indexes: the Nasdaq 100 and the S&P 500, respectively. Using QRMI as an example, Global X portfolio managers replicate the Nasdaq 100 Index by purchasing each of the stocks in their assigned weights. They



then sell an at-the-money (ATM) call with an expiration date in one month. They couple that position with the purchase of a put option that is 5% OTM with an expiration date in one month. QRMI expects to settle the previous month's options on their expiration dates and distribute a portion of the net income from the options premiums. Portfolio managers then enter into new one month options positions and the process repeats.

RISK MANAGED INCOME PROCESS EXPLAINED

As an example of how an ETF implement a net-credit collar strategy, the Global X Nasdaq 100 Risk Managed Income ETF (QRMI) maintains exposure to the stocks in the Nasdaq 100, while buying put options & selling call options on the index each month.

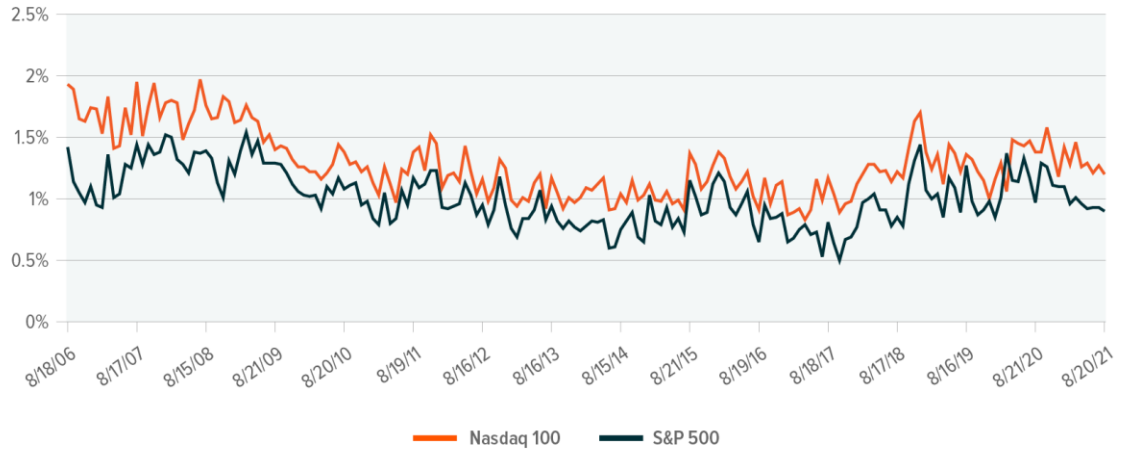


A key feature of risk managed income strategies is the expected net credit from the two options positions, which is expected to create an income stream for investors. Using the Black-Scholes options pricing model, we can see the simulated expected monthly premiums received for both Nasdaq 100 and S&P 500 strategies that sell ATM call options and buys 5% OTM put options. The frequency is measured every month for monthly options written and purchased. Monthly levels averaged approximately 1.30% and 1.01% for Nasdaq 100 and S&P 500 respectively, resulting in annualized figures of 15.6% and 12.12%. Given that options premiums are positively correlated to volatility, we can see net premiums spiked during more volatile periods like the global financial crisis in 2008 and the COVID-19 pandemic in 2020.




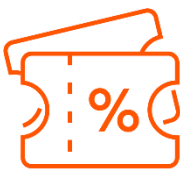

CALCULATED MONTHLY NET OPTION PREMIUMS FROM SELLING ATM CALL AND BUYING 5% OTM PUT

Source: Bloomberg. Data from 8/18/06 to 8/20/21. These are calculated options premiums using the Black Scholes options pricing model.² Options premiums are the combined net effect of a call option written ATM and a 5% OTM put option purchased. Actual premiums may have varied.



Using Risk Managed Income Strategies In a Portfolio

Risk managed income strategies can offer an alternative source of yield to income portfolios. While bond coupons are impacted by interest rates and credit spreads, and dividends are driven by earnings and economic strength, risk managed income from premiums is driven primarily by volatility. As volatility increases, option premiums become more expensive, resulting in a greater net credit between selling the ATM call option and buying the OTM put.

				
	Income	Dividends	Bond Coupons	Options Premiums
<i>Source of Income</i>		Equities	Fixed Income	Options Contracts
<i>Impacted By</i>		Economy, GDP, Earnings Growth	Economy, Credit Spreads, Interest Rates	Volatility



Given the unique source of income, risk managed income strategies can serve as a diversifier in an income portfolio, either in an alternatives bucket or by reducing exposure to equities. More specifically, income investors are often underweight tech exposure and may enhance diversification by adding a risk managed income strategy based on the tech-heavy Nasdaq 100.

Conclusion

In today's low yield environment traditional sources of income are simply not solving many investors' income needs – a situation that could be exacerbated by rising rates. We believe the Global X Nasdaq 100 Risk Managed Income ETF (QRMI) and the Global X S&P 500 Risk Managed Income ETF (XRMI) can be important diversifiers in income-oriented portfolios, by generating a source of income that is not tied to rates and has protections to mitigate downside risks.

Related ETFs

QRMI: The [Global X Nasdaq 100 Risk Managed Income ETF \(QRMI\)](#) invests in the securities of the Nasdaq 100 with a 1-Month 5% Out-of-the-Money (OTM) Put and 1-Month At-the-Money (ATM) Call net credit collar option overlay in an effort to generate income while providing a floor on potential losses.

XRMI: The [Global X S&P 500 Risked Managed Income ETF \(XRMI\)](#) invests in the securities of the S&P 500 with a 1-Month 5% Out-of-the-Money (OTM) Put and 1-Month At-the-Money (ATM) Call net credit collar option overlay in an effort to generate income while providing a floor on potential losses.

DEFINITIONS

Bloomberg Barclays US Convertible Bond Index: The index is designed to represent the market of U.S. convertible securities.

ICE US Variable Rate Preferred Securities Index: The ICE U.S. Variable Rate Preferred Securities Index tracks the performance of floating rate and fixed-to-floating rate exchange-listed U.S. dollar denominated preferred and convertible preferred securities publicly issued in the U.S. domestic market.

Bloomberg Barclays US MBS Index: The index tracks fixed-rate agency mortgage-backed pass-through securities guaranteed by Ginnie Mae (GNMA), Fannie Mae (FNMA), and Freddie Mac (FHLMC).

Bloomberg Barclays US Corporate High Yield Total Return Index: Measures the USD-denominated, high yield, fixed-rate corporate bond market. Securities are classified as high yield if the middle rating of Moody's, Fitch and S&P is Ba1/BB+/BB+ or below. Bonds from issuers with an emerging markets country of risk, based on the indices' EM country definition, are excluded.

ICE BofAML Diversified Core US Preferred Securities Index: The ICE BofAML Diversified Core U.S. Preferred Securities Index tracks preferred securities in the United States. The Underlying Index includes



different categories of preferred stock, such as floating, variable and fixed-rate preferreds, cumulative and noncumulative preferreds, and trust preferreds.

Bloomberg Barclays Municipal Bond Index: Covers the long-term tax-exempt bond market. The index includes state and local general obligation bonds, revenue bonds, insured bonds and prefunded bonds.

Bloomberg Barclays US Aggregate Bond Index: The Bloomberg Barclays U.S. Aggregate Bond Index is a broad-based benchmark that measures the investment grade, U.S. dollar-denominated, fixed-rate taxable bond market. The index includes Treasuries, government-related and corporate securities, MBS (agency fixed-rate and hybrid ARM pass-through), ABS and CMBS (agency and non-agency).

Bloomberg Barclays EM USD Aggregate Total Return Index: A flagship hard currency Emerging Markets debt benchmark that includes fixed and floating-rate USD dollar-denominated debt issued from sovereign, quasi-sovereign, and corporate EM issuers.

Bloomberg Barclays US Treasury Inflation Notes TR Index: Measures the performance of the US Treasury Inflation Protected Securities (TIPS) market.

Bloomberg Barclays US Corporate Total Return Index: Measures the investment grade, fixed-rate, taxable corporate bond market. It includes USD denominated securities publicly issued by US and non-US industrial, utility and financial issuers.

Endnotes:

1. Based on Morningstar Derivative Income Category as of 7/30/2021.
2. The Black Scholes model is a flagship model to calculate the fair price for an option contract using current stock price, expected dividends, strike price of an option, expected interest rates, time to expiration and expected volatility. The model assumes that dividends are not paid, the option can only be exercised at expiration, risk-free rate and volatility of the underlying are known and constant, no transaction costs are involved in buying the option, markets are efficient, and the returns are log-normally distributed.

Investing involves risk, including the possible loss of principal. Diversification does not ensure a profit or guarantee against a loss. Concentration in a particular industry or sector will subject the Funds to loss due to adverse occurrences that may affect that industry or sector. Investors in the Funds should be willing to accept a high degree of volatility in the price of the fund's shares and the possibility of significant losses.

The Funds engages in options trading. By selling covered call options, the fund limits its opportunity to profit from an increase in the price of the underlying index above the exercise price. By purchasing put options, in return for the payment of premiums, the Fund may be protected from a



significant decline in the price of the underlying Index if the put options become in the money (index closes below the strike price as of the expiration date); but during periods where the Index appreciates, the Fund will underperform due to the cost of the premiums paid. A liquid market may not exist for options held by the Fund. While the fund receives premiums for writing the call options, the price it realizes from the exercise of an option could be substantially below the indices current market price. QRMI is not diversified.

Index returns are for illustrative purposes only and do not represent actual fund performance. Index performance returns do not reflect any management fees, transaction costs or expenses. Indices are unmanaged and one cannot invest directly in an index. Past performance does not guarantee future results.

Shares of ETFs are bought and sold at market price (not NAV) and are not individually redeemed from the Fund. Brokerage commissions will reduce returns.

Carefully consider the funds' investment objectives, risks, and charges and expenses. This and other information can be found in the funds' full or summary prospectuses, which may be obtained at globalxetfs.com. Please read the prospectus carefully before investing.

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