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Put Spread Selling Overlays in Municipal Bond Portfolios



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Rethinking Traditional Municipal Bond Exposure

Financial advisors seeking tax-focused income potential for clients often turn to broad-based, low-cost national municipal bond index funds. Yet while index funds provide broad market exposure to varied degrees of credit and interest rate (duration) risk, they do not take advantage of a persistent market inefficiency called the **Volatility Risk Premium (VRP)**. The VRP occurs due to investors consistently overpaying for downside protection, meaning that the cost of options (implied volatility) is often higher than the actual market movement (realized volatility). By systematically selling put options in liquid underlying markets (like large-cap US equities), investors can collect this potential excess premium and enhance returns overtop their existing municipal bond beta exposures.

A well-designed put spread writing overlay can **generate a supplemental income source and enhance long-term returns**. This approach capitalizes on the fact that **put options are chronically overpriced** due to sustained demand for downside protection. While manually managing such a strategy presents complexities, the Overlay Shares Municipal Bond ETF (OVM) provides a systematic, risk-managed solution that allows advisors to capture these potential benefits efficiently in a turnkey solution.

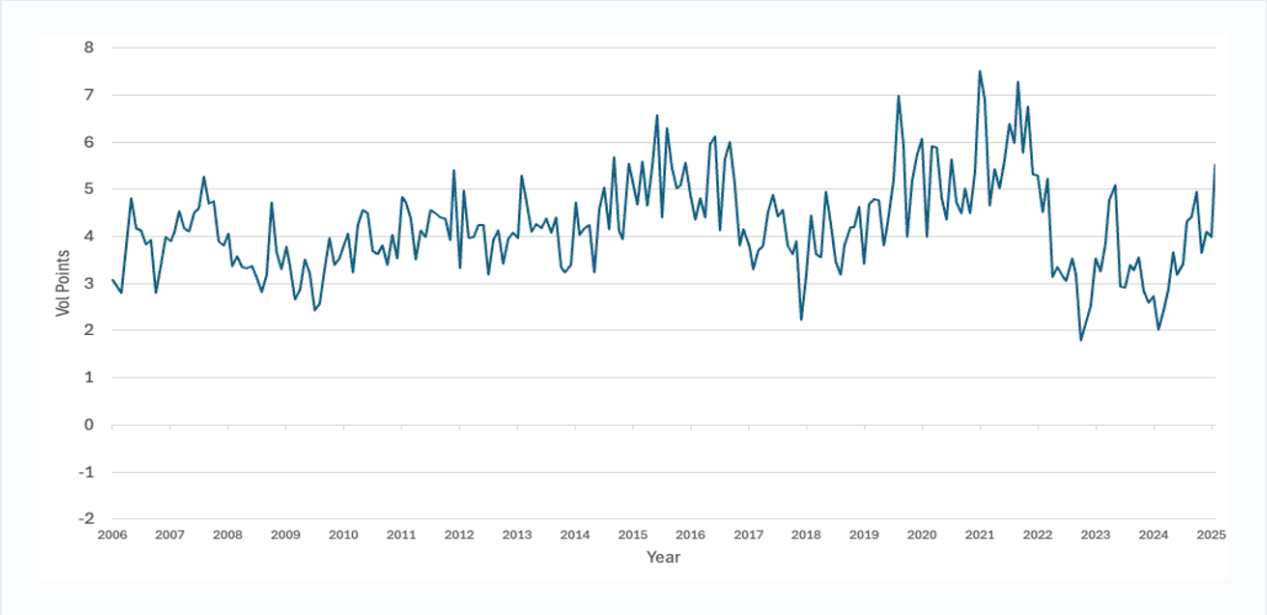
The Case for a Put Spread Writing Overlay

Investors often overpay for put options, just like people tend to pay more for car insurance than the actual cost of claims. A put writing strategy works like an insurance company: by selling put options, an investor collects premiums from buyers who seek downside protection. **Over time, this provides a steady income stream because put options tend to be overpriced.**

Over the past 20 years, investors have paid more for downside protection (put options) than for upside speculation (call options). This pricing imbalance means that, all else being equal, **selling puts generates more premium than selling calls,** making put writing a more attractive strategy. And while listed options trade on core bond indexes, trading volume and liquidity in listed large-cap options (S&P 500 Index) dwarfs these markets.

Puts Relatively Rich vs Calls
S&P 500 Index 97.5/102.5 Moneyness Implied Volatility Spread
Positive Readings Favor Put Selling, Negative Favor Call Selling

1/31/2005 - 1/31/2025



Source: Bloomberg. Past performance is no guarantee of future results. Option volatility historical pricing and spread is not illustrative of fund performance.

Moreover, equity volatility harvesting strategies can provide an alternative risk premium to traditional bond risk factors such as duration (interest rate risk) or credit risk.

Most advisors are familiar with covered call strategies that harvest equity volatility risk, but the shortfall of these strategies is that they **limit potential upside gains** because you sell calls at a fixed price. In contrast, a **put spread writing strategy** allows investors to keep **full upside exposure** in the municipal bond portfolio while collecting premiums from **put options that sit below current underlying option strike prices**. The risk is **controlled** by simultaneously buying another put option to cap potential losses.

When paired with an outright long position in an underlying exposure, such as an index-based municipal bond ETF, investors can expect to receive **full upside participation in the municipal market**. This approach allows investors to generate positive returns in a variety of market environments, including flat or moderately declining markets, while slightly increasing downside participation during fast large-cap equity market selloffs.

This combination of selling relatively expensive downside (put) large-cap equity options volatility while maintaining uncapped municipal bond upside also benefits from the fact that large-cap stocks, on average, tend to have **more positive months than negative months**. In other words, the put-writing strategy tends to win more often than it loses.

S&P 500 Index Monthly Returns
1/31/2005 - 1/31/2025

Total Months	Positive Months	Negative Months	Percentage Positive (%)	Percentage Negative (%)	Percentage Positive > 2.5% (%)	Percentage Negative > 2.5% (%)
240	138	102	57.5%	42.5%	33.3%	20.0%

> *Source: YCharts. Past performance and is no guarantee of future results. Index performance is not illustrative of fund performance. One cannot invest directly in an index.*

Taxes in Focus

Municipal bond investors are often highly sensitive to tax considerations. With federal tax exemption a staple of most municipal bond investments, supplemental income from an option overlay strategy can give investors pause. Fortunately, an index-based option selling strategy benefits from Section 1256 of the U.S. Tax code, which offers beneficial tax treatment for index options versus ETF or stock options. In simple terms, index option income is treated as 60% long-term capital gains and 40% short-term capital gains, regardless of the holding period. This tax treatment is afforded to index option holders regardless of the holding period. ETF and stock options, however, must be held for over one year to benefit from a more favorable long-term capital gains rate.

Feature	SPX Index Options	ETF or Stock Options
Underlying Asset	**Cash-settled index (e.g., S&P 500 - SPX)**	**Shares of an ETF (e.g., SPY, IVV, VOO)**
Tax Treatment	**60/40 rule applies (60% LT gains, 40% ST gains)**	**100% short-term capital gains if held <1 yr**
Section 1256 Contract?	**Yes (beneficial tax treatment)**	**No (ordinary tax treatment)**

> *Source: IRS. Nothing in this table or research piece is to be construed as tax advice. Please consult a tax professional before making any tax decisions.*

Not only does an investor in OVM benefit from municipal bond tax treatment, but also from the 1256 treatment of index options utilized in the income overlay.

Addressing the Challenges of Direct Implementation

Despite its advantages, implementing a put writing strategy independently requires significant expertise in strike selection, contract duration, and risk mitigation. Managing a put writing strategy manually can be challenging. If the market drops sharply, investors can **face large losses** unless proper risk controls are in place. Additionally, managing cash to cover potential losses (collateral) and ensuring there's enough liquidity to trade options efficiently can add complexity.

As a result, most investors and advisors have historically gravitated toward covered call writing due to its perceived simplicity, even though **put writing offers higher Volatility Risk Premium capture**, lower reliance on equity appreciation, and a more attractive return profile. This underscores the need for a rules-based, professionally managed put-writing strategy that mitigates these operational challenges while delivering the full benefits of the approach.

How Overlay Shares Municipal Bond ETF (ovm) Delivers a Turnkey Solution

OVM provides a systematic put-writing overlay on top of a low-cost core bond allocation, allowing investors to efficiently access the potential advantages of options-based income generation without adding additional credit or duration risk.

Unlike indiscriminate put selling, OVM employs a **risk-defined approach**, incorporating **constant hedging mechanisms** to help protect against unexpected market volatility. The fund's methodology is designed to maintain **multiple layers of risk management**, including:

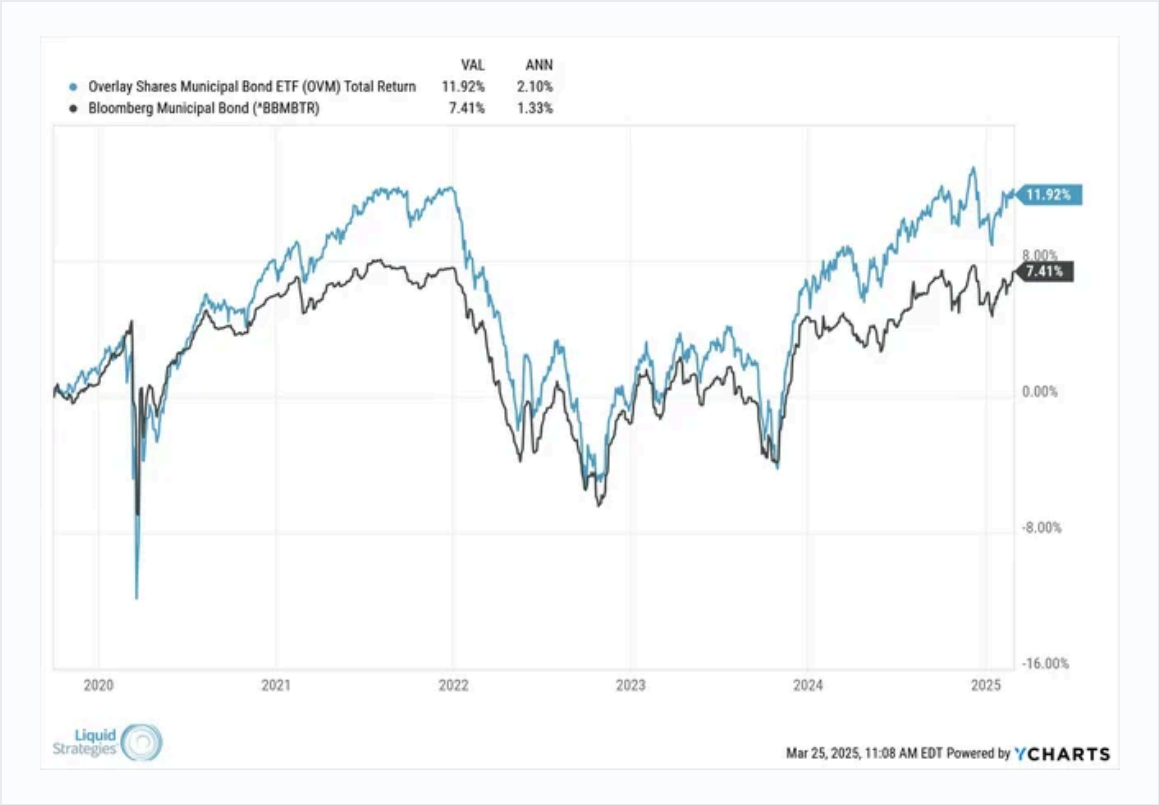
- **Clearly defined downside risk** through systematic hedging of sold puts
- **A diversified approach** across multiple positions, expirations, and strike prices
- **Active risk management in times of market stress**, adjusting exposures to mitigate adverse conditions

This structure allows OVM to deliver enhanced income potential while maintaining prudent risk constraints, making it a compelling alternative for financial advisors seeking to increase portfolio efficiency without requiring direct options trading expertise.



Since launching in 2019, OVM has outperformed its benchmark of the Bloomberg US Aggregate Bond Index, demonstrating the power of its systematic put writing strategy.

Overlay Shares Municipal Bond ETF (OVM) vs. Bloomberg Municipal Bond Index, TR (NAV) 9/30/2019 - 2/28/2025



> *Source: Ycharts. Performance data quoted represents past performance and is no guarantee of future results. Investment return and principal value of an investment will fluctuate so that an investor's shares, when redeemed, may be worth more or less than their original cost. Current performance may be lower or higher than the performance data quoted. For the most recent month-end performance, please call 1-866-704-OVLS. For standardized performance and expenses https://lsfunds.com/ovb*

Conclusion

For advisors looking to enhance client portfolios with an innovative, income-generating overlay strategy, a risk-defined put spread writing approach presents a powerful solution. By capitalizing on the persistent Volatility Risk Premium to generate consistent income, put writing offers a differentiated return stream that complements traditional fixed income allocations.

With Overlay Shares Municipal Bond ETF (OVM), advisors can access this strategy in a **liquid, tax-efficient, and professionally managed ETF structure**, allowing them to help **improve client outcomes while maintaining disciplined risk management**.

By incorporating **OVM**, advisors can position portfolios to take advantage of market inefficiencies in a **transparent, efficient, and cost-effective manner**, ensuring that clients may benefit from a smarter, more resilient investment approach.

For more information on option overlay strategies or OVM, please contact info@lsfunds.com or call 770-350-8700.

Schedule a Call

Glossary of Terms

Overlay Shares are bought and sold at market price (not NAV) and are not individually redeemed from the Fund. Total Returns are calculated using the daily 4:00pm EST net asset value (NAV). Market price returns reflect the midpoint of the bid/ask spread as of the close of trading on the exchange where Fund shares are listed. Market price returns do not represent the returns you would receive if you traded shares at other times.

Investors should consider the investment objectives, risks, charges and expenses carefully before investing. For a prospectus or summary prospectus with this and other important information about the Fund, please visit the Documents section of this website or call (866) 704-OVLS. Read the prospectus carefully before investing.

RISK FACTORS: The Fund invests in options that derive their performance from the performance of the S&P 500 Index. Selling (writing) and buying options are speculative activities and entail greater than ordinary investment risks. The Fund's use of put options can lead to losses because of adverse movements in the price or value of the underlying asset, which may be magnified by certain features of the options. When selling a put option, the Fund will receive a premium; however, this premium may not be enough to offset a loss incurred by the Fund if the price of the underlying asset is below the strike price by an amount equal to or greater than the premium. Purchased put options may expire worthless and the Fund would lose the premium it paid for the option. The Fund may lose significantly more than the premiums it receives in highly volatile market conditions.

The Fund will invest in short term put options which are financial derivatives that give buyers the right, but not the obligation, to sell (put) an underlying asset at an agreed-upon price and date. The Fund's use of options may reduce the Fund's ability to profit from increases in the value of the underlying asset. The Fund could experience a loss or increased volatility if its derivatives do not perform as anticipated or are not correlated with the performance of their underlying asset or if the Fund is unable to purchase or liquidate a position.

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