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XA's DiBernardo On Why Investors Should Consider Covered Calls Now

Madison Investments' portfolio manager explains why elevated valuations make now a good time to consider the downside protection and income covered-call strategies provide.

Ray Di Bernardo
Analyst & Portfolio Manager
Madison Investments

Chuck Jaffe, in this episode of The NAVigator podcast, interviewed Ray DiBernardo, Portfolio Manager for the XAI Madison Equity Premium Income fund. Ray says he's concerned about the market's valuation levels — noting that it "has been expensive for quite some time" — and while he is not expecting "dark clouds and a horrible environment," there's more downside risk, which could lead to market compression that puts covered-call strategies back into the spotlight as a defensive play. DiBernardo, an analyst at Madison Investments, says the proliferation of options strategies should make investors more diligent about exploring strategies, and he discusses single-stock options versus index options, and the risk-reward picture with each. DiBernardo notes that covered-call strategies aren't right for people "who believe the market will keep going straight up from here," but he notes that for nervous investors, the options strategy acts like portfolio insurance, and the discount on a closed-end fund can help to make up for the upside potential that the strategy trades for that protection.

TOPICS DISCUSSED

- How covered-call strategies perform in up markets versus down markets, and the income-for-upside trade-off investors make
- What distinguishes covered-call writing from other options strategies, like buffer funds and defined-outcome ETFs
- Why MCN favors single-stock options over index options, and the higher premiums that approach can generate
- How investors should weigh risk tolerance and market outlook when deciding if covered-call strategies fit their portfolio
- The relationship between closed-end fund discounts and market conditions, and why buying at a discount can enhance returns
- DiBernardo's outlook on market valuations heading into 2027 and the risk of a valuation-driven correction

The discussion is educational in nature and intended to help investors and advisors better understand the tools, trade-offs, and data points involved in evaluating income-focused strategies.

THE CONVERSATION

CHUCK JAFFE

We're talking about covered call strategies with Ray DiBernardo, portfolio manager for the XAI Madison Equity Premium Income fund, this is The NAVigator.

Welcome to The NAVigator, where we talk about all-weather active investing and plotting a course to financial success with the help of closed-end funds. The NAVigator is brought to you by the Active Investment Company Alliance, an industry organization that represents the entire closed-end fund business from investors and users up to fund managers, sponsors, and creators. If you're looking for excellence beyond indexing, The NAVigator will point you in the right direction.

And today, we're pointing in the direction of covered call strategies with Ray DiBernardo, he's an analyst with Madison Investments who serves as portfolio manager for the XAI Madison Equity Premium Income fund. It trades under ticker symbol MCN, it has a track record of more than 20 years in the space, and you can learn more about it at XAInvestments.com/MCN.

And if you want to learn more about closed-end funds, interval funds, and business-development companies generally, you'll find plenty of helpful information at AICAlliance.org, the website for the Active Investment Company Alliance.

Ray DiBernardo, thanks for coming back to The NAVigator.

RAY DI BERNARDO

Hi Chuck, good to be back with you.

CHUCK JAFFE

Covered call strategies, as a basic explainer for any of the audience members who are not entirely familiar, they're used by investors who want income while managing downside risk and maintaining exposure to equity markets. The last time you and I talked, it was early October last year and you were pointing out how well covered call strategies did when the market was struggling in 2022. But this isn't that market, we've climbed the wall of worry to record high levels, so how can covered call funds really shine in this environment? How do they work? Would they benefit from a downturn, a possible recession, some trouble on the horizon, or would an increase in volatility be enough?

RAY DI BERNARDO

It's a question we get asked a lot, Chuck. Clearly when markets struggle and volatility goes up, it's because typically the market is going down and investors are looking for some sort of protection and covered writing strategies typically will protect pretty well on the downside. Now the flip side of not participating fully on the downside when the markets are struggling is that you're not going to fully participate in the upside when markets are roaring as they have been recently.

That's part of what you're giving up, there's no free lunch really out there, so in order to get downside protection, if that's what's important, and income, if that's what is important, you have to give up some potential upside. Now covered call writing will participate in up markets, just not to the full extent of being long-only in the market.

CHUCK JAFFE

We've seen an evolution, especially in the ETF space, with a lot of option overlay ETFs, and it changes the competitive picture because they've got a bunch of different strategies to consider. So what sets covered call strategies apart from the other option strategies that investors can use these days?

RAY DI BERNARDO

First of all, it's important for investors to know what they're buying, do your due diligence and understand what the strategy is trying to accomplish. There are option strategies like covered-call writing, like cash-secured put writing, that are geared towards income-oriented investors. There are other option strategies such as buffer funds or defined outcome strategies, which are more geared towards hedging toward the downside.

Now covered call writing gives you a little bit of both, I would say primarily investors will participate in this kind of strategy because they want a higher level of income than they could get from just owning stocks. That income can also provide a buffer to the downside as well, but the primary goal of covered writing is to provide equity exposure with a higher level of income, and that could be done in a number of different ways.

So you have passively invested underlying portfolios which replicate an index such as the S&P 500, and then passively investing on the options side by using index options. Or you have the opposite of that, which is an active underlying equity portfolio and utilizing single stock options, which is a very active way to provide that additional income. So there are different ways to get to the same result, it's what investors feel most comfortable with, and they should really try and do their best to understand how the strategy is working.

CHUCK JAFFE

If I'm not mistaken, at MCN you're focused a little bit more on the single stock approach. What are the benefits or the advantages to the single stock approach as opposed to index-based options?

RAY DI BERNARDO

We really think there's a couple of key benefits. First off is that typically the option premium that you receive from selling a call option will be higher on a single stock option than an index option. As an example, even a high-quality stock like Microsoft, if you were to go out to September with a call option, which is 65 or 66 days out into the future, you could get a 5% option premium for being 3% out of the money, so you participate in 3% of the upside but you get a 5% premium paid to you. A similar option on the S&P 500 index would only pay you half of 1% in an option premium.

So there's clearly more volatility these days in Microsoft even though it's an AAA-rated balance sheet company, one of the highest quality companies in the market, so you're not taking at ton of risk by buying a poor quality company but there's volatility with owning a single stock versus 500 stocks which diversify away some of that risk. So that's one of the benefits, is getting a higher premium by still investing in good companies.

The second one that we find really important is that we can tailor the characteristic of each option that we sell against our view of each individual stock that we own in the fund. Instead of selling an index option that gives you umbrella coverage over the whole portfolio, we can now again tailor specifically what strike prices we want to use, what expirations we want, given our view of each position in the portfolio.

Now that's a lot more labor intensive than just buying one big umbrella coverage with an index option, but we think there's a lot of benefit. Because in some cases companies you want to be a little tighter to the money with the options to give you more downside protection, others you want to participate more on the upside by being further out of the money, and we get that flexibility by using single stock options.

CHUCK JAFFE

I talk to a lot of experts right now who are not particularly concerned that a bear market or a recession is coming, yet we also know that the soft data says that investors are freaked and nervous about what happens next.

Help somebody understand the trade off and why they would want to make that trade off now. Is it simply this is what you want to do to calm the emotions if you're that emotional side? Of if you're one of those folks who's like, "No, I don't see bear market, I don't see recession," than the answer might be you're not the ideal shareholder for covered call strategies right now?

RAY DI BERNARDO

Right, it's an important discussion for investors to have with their advisors and determine what their risk preferences are, because if you really believe that the markets are going to go straight up from here, then do you really want to be in a more conservative hedged type of product? I would suggest that you probably would have part of your portfolio in something that's a little bit more conservative, but you may lean towards being more aggressive if you really have a strong belief that markets are going to keep going up.

As is typically the case when we have hiccups in the market, people don't anticipate them very well ahead of time and they're always looking to be hedged after the fact. So I think it's important for people to have more of a balanced approach, always have something in their portfolio that will counteract the effects of a down market, and I think covered writing is something that people should consider for that.

CHUCK JAFFE

Given that there's the advent of all these ETFs that are doing options overlay strategies and the rest, is part of the other side of the case here, buy covered calls in a closed-end fund because there's a discount; and that discount helps you to recapture some of what you're giving up in terms of I'm giving up some upside potential but, oh by the way, I'm adding some upside potential on the discount? And how do options in covered call funds typically perform and what happens to their discounts historically when we see market conditions change?

RAY DI BERNARDO

I think discount and premium on closed-end funds is more a function of supply and demand by the marketplace, so when markets are kind of tearing to the upside and not as many investors are looking for income or a hedged vehicle, there are fewer buyers and there may be more sellers, so the discount might widen. That provides an opportunity, because that environment obviously is cyclical and will change, and being able to buy a fairly conservative high-quality product at a discount is always a good thing. Now it may take time for that discount to narrow and potentially turn into a premium, but you'd always rather to buy something at a discount than a premium if at all possible.

That doesn't change how we do things in terms of running the fund every day. We manage the fund to perform on an NAV basis and then the market will determine whether our fund trades at a discount or a premium. Now performance matters, so if your performance is very, very good, more people will typically want to be buyers, if your performance is not good, more people might want to be sellers.

So that's a factor that we focus on, is trying to provide consistent performance over time, and I think we've been able to do that. And the whole class of funds is now trading at a discount, so we're kind of being lumped in with everyone else, and potentially this could provide an interesting opportunity for investors to buy at a discount before the market collapses, if it does collapse, rather than wait until after when it's too late.

CHUCK JAFFE

Last question. You talk about the prospect of a market collapse, obviously you have to prepare for it. What is your base case for what happens with the market moving into '27?

RAY DI BERNARDO

Running a hedged equity product, an income-oriented product, as I've been doing for the last 20 years, we tend to be maybe a little more cynical about the market than many because we're always looking to protect against downside risk. So we're concerned about valuation levels, the market has been expensive for quite some time, when they change and come down, they can come down very quickly and you don't really need a big fundamental decline or recession for that to happen.

If the market's trading at 21-22x forward earnings, even if earnings don't come down, if there's an event that occurs that causes valuations to compress down to 16 or 17x earnings, that could lead to a 20-25% decline in the market just from valuation compression, so you don't need to have dark clouds and a horrible environment for that to happen. We've seen that, we saw that in 2022 when the market declined significantly, and we've seen it obviously in the past with other big macro shocks to the system.

When the market is this expensive, it's more at risk to that type of event happening because it's already expensive and there's more risks to the downside than there is potential to the upside in our view. So the whole AI bubble, which has flared up again in the second quarter of this year, it cooled off in the first quarter because of the Iran conflict and energy prices going up, now it's rebounded, things have gotten very expensive again, we think there's just more risk to the downside.

Not suggesting the market will have a 30% decline or anything, it may, but we think valuations are suggesting that it may be time to get a little bit more protection out there. And that's why people are getting more jittery and looking for ways to reduce their exposure and reduce their risks somewhat, and that's where we come in.

CHUCK JAFFE

It's where you come in, it's where covered call strategies come in, and we really appreciation you taking the time to talk with us about what you see happening and how it all works. Ray, great stuff, we'll talk to you again down the line.

RAY DI BERNARDO

Thanks, enjoyed it, Chuck.

CHUCK JAFFE

The NAVigator is a joint production of the Active Investment Company Alliance and Money Life with Chuck Jaffe, and yeah, I'm Chuck Jaffe, love it if you would check out my show on your favorite podcast app or you can just go to MoneyLifeShow.com. To learn more about closed-end funds, interval funds, and business-development companies, go to AICAlliance.org, the website for the Active Investment Company Alliance.

Thanks to my guest, Ray Di Bernardo, portfolio manager for the XAI Madison Equity Premium Income fund, it's ticker symbol MCN and you can get more details about it at XAInvestments.com/MCN.

The NAVigator podcast has something new for you every Friday, so plan to join us again next week for more closed-end fund fun. And until then, happy investing, everybody.

Click the link below to go to the home page of Active Investment Company Alliance to learn more: https://AICalliance.org/

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