Forget Dividend Stocks: This Ethereum ETF Has Yields of Over 18%

Description

Like many other risky asset classes, **Ethereum** (CRYPTO:ETH) had a rough start to 2022. Currently, the second-largest cryptocurrency by market cap trades around the US$2,500 range — a stark fall from its 52-week highs of US$4,891.

However, If you can stomach the volatility, the current low price could be an excellent buying opportunity. Ethereum's massive fluctuations tend to benefit swing traders, who can make a quick buck. However, a new ETF allows you to reap a fat yield from the high volatility by selling covered calls.

How does the ETF work?

Purpose Ethereum Yield ETF (TSX:ETHY.B) is a covered-call ETF. This is an options strategy where the seller of the call option (the ETF manager) owns an equal amount of the underlying Ethereum.

The ETF holds a long position on the underlying Ethereum and sells the right for someone else to buy it at a higher price (the strike), which is good until a certain date (expiry). For that, the ETF earns a cash premium.

Generally, the higher the volatility of the underlying asset, the more the premium will be. In this case, Ethereum is highly volatile, allowing ETHY to earn a large premium from writing calls. This is then paid out monthly as the ETF's yield.

ETHY can be held in a TFSA/RRSP, while Ethereum can't. However, it does also cost a management expense ratio (MER) of 1.10%. The annual distribution yield of 18.18% is very high and even outclasses preferred shares.

However, the yield is subject to fluctuation. Generally, the more volatile and upwards moving the Ethereum share price is, the higher the yield will be. During periods of low volatility, such as following a crash, the yield might drop.

What are the risks?

Covered-call ETFs like ETHY have the same downsides as holding the actual asset does. In this case, if Ethereum tanks, the value of ETHY will as well. However, ETHY will only participate in some of the upside of Ethereum.

When the price of Ethereum sharply shoots up, ETHY will comparatively underperform. If the price of Ethereum is higher than the strike price of the call sold, the buyer of the call will “exercise” the option to buy ETHY at the lower strike price.

This means that the ETF will have to sell ETHY at the strike price, despite being able to get a better price in the market. This causes ETHY to miss out on gains, and thus limits your return on a good day. If the price goes up substantially, not even the premium you received will make up for the lost gains.

Overall, the risk-return relationship is not favourable. You’ll fully feel the effects of any crashes, while missing out on the full extent of gains from an extended bull market. This is an example of an asymmetrical bet we generally want to avoid.

Who is this ETF right for?

I generally avoid covered-call ETFs because their downside risk is unlimited (the underlying could go to $0), while their upside is capped at the strike price. This makes them underperform in a bull market.

There is no free lunch with ETFs like ETHY — you’re simply selling future gains for an immediate premium. Over the long term, normal Ethereum will outperform substantially, especially with the momentum and volatility we’ve seen before.

ETHY is better suited to income-oriented investors who are seeking a high yield for some reason. This niche will likely be FIRE (financial independence, retire early) folks who want to live off distributions versus selling shares.

The other use case is if the crypto market trades sideways for an extended period. Being able to lock in a great yield on cost when the price of Ethereum is low can help your portfolio make gains, even in these conditions.

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