# MADISON COVERED CALL & EQUITY INCOME FUND

1Q 2023 Investment Strategy Letter

Tickers: MENRX | MENYX | MENAX | MENCX | MENIX

*Covered Call strategies, by their nature, are defensive. They are structured to knowingly sacrifice a portion of upside growth potential in order to provide additional downside protection. The Madison Covered Call & Equity Income Fund does exactly that by owning a very high quality portfolio of individual equities and selling equity call options on the portfolio holdings. The Fund offers a solid total return platform which includes capital appreciation and a high distribution rate which is primarily sourced from call option premiums and realized capital gains on the underlying portfolio. It is a relatively concentrated, actively managed portfolio providing a risk-reduced way to participate in US equity markets.*

Ray Di Bernardo, CFA
Portfolio Manager/Analyst
Industry since 1986

Drew Justman, CFA
Portfolio Manager/Analyst
Industry since 2000

## WAITING ON THE "LAG"

Since March of last year, the Federal Reserve (Fed) has raised its Fed Funds target rate nine times from 0.25% to 5%, representing the most aggressive tightening regime since the hyperinflationary early 1980s. While the last two hikes of 25 basis points appear to signal that we may be nearing the end of the rate hike cycle, there is little evidence yet to suggest that a "pivot" to lower rates is in the cards soon. Higher rates have certainly caused inflation to recede but not yet down to acceptable levels. The immediate impact of the aggressive Fed action on the equity market was to depress price/earnings multiples. Virtually all the market decline in 2022 can be attributed to the compression of P/E multiples. However, the full economic impact of the rate hikes has yet to show its fangs. There is typically a 12 to 18-month lag from the beginning of Fed rate changes to their impact being felt in the real economy. We are now entering that period and are beginning to witness some of the negative repercussions. Employment has generally remained resilient, but layoff announcements have significantly increased in recent months. The weight of the highest mortgage rates in over 20 years has caused the real estate market to roll over. More recently, evidence of fractures in the banking system have come to light, not only exposing poorly managed banks but highlighting the unrealized capital losses of the entire banking system due to higher interest rates. Confidence has been shaken and, in a rush to restore confidence, the bailouts have begun… yet again. Rate hikes have contributed to and exposed weaknesses in our economy and things are beginning to break. Unfortunately, the lag effect is just getting started.

So far this year, equity markets are doing their best to whistle past the graveyard. In fact, there has been a resurgence in the performance of mega-cap growth

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companies under the assumption that the worst is behind us and that we will go back to the go-go liquidity-driven exuberance of the pre-2022 period. The NASDAQ 100, representing the largest non-financial innovative companies in the U.S., rose 20.8% in the first quarter of 2023 while the Russell 2000 Index, representing U.S. small-cap companies that are typically more sensitive to the domestic economy, rose only 2.7%.

Equities continue to be buoyed by the avalanche of money that was pumped into the system post-Covid. Although M2 money supply growth has normalized and may be shrinking somewhat, there remains an estimated $4 trillion of excess money in the system which has supported nominal economic growth and corporate revenue and earnings growth. It is also the reason that the Fed is unlikely to cut rates this year. With the impact of this excess liquidity beginning to diminish and other headwinds becoming more impactful (tightening bank lending standards, weakening housing market, employment trending lower, growing consumer debt, etc), the market's rosy outlook is, in our view, overly optimistic.

The lagged effect of monetary tightening is nearer than most believe and could lead to a deeper recession than many expect. We believe that corporate revenues and earnings growth expectations are likely to be reset lower as the year progresses and markets will follow.

Although the market has gotten off to a very strong start this year, we do not believe that a new bull market has begun. Just as there has been very unsettled stormy weather in much of the U.S. in recent months, storm clouds are gathering over the equity market. It's best to be prepared.

## Q1 2023 PERFORMANCE REVIEW

The "risk-on" trade became popular again in the first quarter as mega-cap growth stocks led the S&P 500 to a 7.5% return. The initial surge occurred in January as investors believed the Fed would pivot to a more lenient monetary stance. As the Fed repeatedly signaled otherwise and stress fractures threatened the banking system, the market sold off. However, as it appeared that the government would bail out and protect the banking system and potentially force the Fed's hand toward easing rates, the market rallied strongly in the last few weeks of the quarter. The Madison Covered Call & Equity Income Fund (Class Y) managed to participate well in such a volatile environment, gaining 5.5% which was slightly below the 6% return of the CBOE S&P 500 Buy-Write Index (BXM).

The S&P 500 sectors that led during the quarter were the homes of the largest growth companies in the country. They were the Technology and Communication Services sectors, which each returned over 20%. The Consumer Discretionary sector followed close behind with a 16% return. These three sectors represent just over 45% of the total S&P 500 and just six companies make up almost half of that weighting (Apple, Microsoft, Alphabet, Amazon, Tesla, Meta). Market performance was very narrowly focused. Traditionally defensive sectors such as Health Care, Utilities, and Consumer Staples lagged during the quarter. The energy sector also lagged as crude oil prices trended lower on concern of slowing demand due to global recessionary fears. Despite these concerns, demand remains strong and supply growth challenged. Even with the recent weakness in crude prices, most energy companies are able to continue to generate strong free cash flow returns. We believe that crude prices will move higher as the year progresses. The weakest sector within the S&P 500 was the Financial sector, which collapsed in early March due to revelations surrounding the deposit runs, asset problems, and ultimate shuttering of two mid-sized regional banks. Government-guaranteed support for depositors alleviated the concerns about a growing contagion, however, the small and medium-sized banking group has been sharply derated.

The Fund performed well in such a volatile period despite its defensive positioning. Given the net positive trend for the market during the quarter, the Fund's cash holdings were a drag on performance while the option coverage was additive. Cash levels remained relatively high during the period as option assignment activity was high given the market rally and Fund inflows were strong. We have continued to be cautiously opportunistic in reinvesting cash given our concerns that the market still has some rough seas ahead. Option coverage remained high, opening the period at 82% and ending at 86%.

From a sector positioning standpoint, the Fund's primary headwinds were an underweighting in the Technology sector and an overweighting in the Energy sector. Sector allocation detracted from overall performance during the quarter, mainly due to these two factors. A portion of these headwinds was countered by the Fund's underweighting in weaker-performing sectors such as Financials, Health Care, and Consumer Staples.

Underlying equity positions performed relatively well during the quarter as stock selection was additive to overall performance. Oil services company Transocean was the leading relative performer despite the Energy sector's weakness. As the global leader in ultra-deepwater and harsh environment drilling, the company continues to benefit from elevated drilling day rates and a growing order book. Other top performers included Fedex, CME Group, Fiserv, and Paypal. Interestingly, the largest detractor was global oil producer Apache, which was negatively impacted by the declining crude price. Other relative weakness came from T-Mobile, CVS, Lumen, and Ciena.

## OUTLOOK

Zero interest rate policies and massive fiscal stimulus are a thing of the past. They supported risk-taking behavior for many years and asset prices ballooned higher as a result… investors were happy. We are now faced with the repercussions of the cessation of those activities. Interest rates are significantly higher than 12 months ago and will likely remain higher than expected for longer than expected. Asset valuations compressed in 2022 but the real headwinds remain in front of us. Although inflation levels should subside over time, many business costs will remain elevated. As inflation trends lower, corporate revenues should also decline, profit margins will compress, and earnings expectations will likely adjust lower. Employment levels have remained very resilient, mainly due to employers' reticence to lose employees given the recent struggles they have had in filling vacant positions. As earnings decline, however, businesses will be forced to de-staff and employment levels could roll over. The housing market has already stalled due to higher mortgage rates and could undergo more stress if employment decelerates sharply. The lag effect of tightening monetary conditions is only now beginning to take hold. It seems to us that we are not yet close enough to determine whether the light at the end of the tunnel is sunshine or an oncoming train. Until we have a clearer picture, we believe that it is best to remain defensively postured despite the occasional risk-on rally.

*Ray Di Bernardo* *Drew Justman*

## DISCLOSURES

Indices are unmanaged. An investor cannot invest directly in an index. They are shown for illustrative purposes only, and do not represent the performance of any specific investment. Index returns do not include any expenses, fees or sales charges, which would lower performance.

The CBOE S&P 500 BuyWrite Index (BXM) is a benchmark designed to track the performance of a hypothetical buy-write strategy (i.e., holding a long position in and selling covered call options on that position) on the S&P 500 Index.

The S&P 500® is an unmanaged index of large companies, and is widely regarded as a standard for measuring large-cap and mid-cap U.S. stock-market performance. Results assume the reinvestment of all capital gain and dividend distributions.

The Nasdaq-100 Index is comprised of 100 of the largest and most innovative non-financial companies listed on the Nasdaq Stock Market based on market capitalization.

The Russell 2000® Index measures the performance of the 2,000 smallest companies in the Russell 3000® Index, which represents approximately 11% of the total market capitalization of the Russell 3000® Index.

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A basis point is one hundredth of a percent.

M2 money supply as defined by the Saint Louis Federal Reserve consists of M1 money supply plus (1) small-denomination time deposits (time deposits in amounts of less than $100,000) less IRA and Keogh balances at depository institutions; and (2) balances in retail money market funds less IRA and Keogh balances at money market funds.

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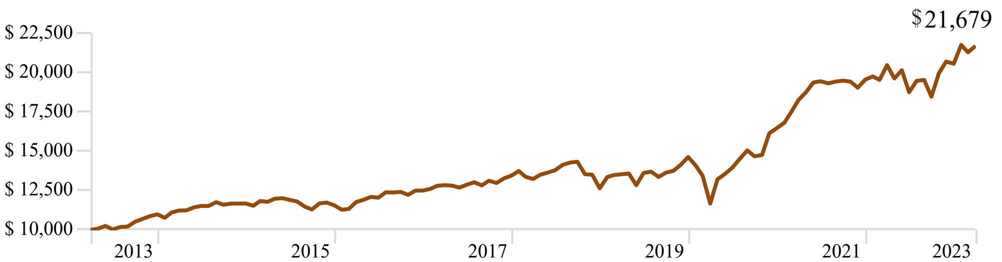
# MADISON COVERED CALL & EQUITY INCOME FUND

March 31, 2023

## Growth of $10,000 Class Y Shares, Trailing 10 Years[1]




## Average Annual Total Returns[2] (%)

| | | Three Months | YTD | 1 Yr | 3 Yr | 5 Yr | 10 Yr | Since Inception |
|---|---|---|---|---|---|---|---|---|
| Class R6 | | 5.52 | 5.52 | 6.09 | 23.09 | 10.54 | 8.19 | 8.49 |
| Class I | | 5.52 | 5.52 | 5.97 | - | - | - | 10.15 |
| Class Y | | 5.52 | 5.52 | 5.95 | 22.93 | 10.37 | 8.05 | 7.99 |
| Class A | Without Sales Charge | 5.43 | 5.43 | 5.60 | 22.61 | 10.10 | 7.78 | 7.74 |
| | With Sales Charge | -0.61 | -0.61 | -0.42 | 20.21 | 8.80 | 7.15 | 7.26 |
| Class C | Without Sales Charge | 5.20 | 5.20 | 4.94 | 21.77 | 9.32 | 6.99 | 7.29 |
| | With Sales Charge | 4.20 | 4.20 | 3.97 | 21.77 | 9.32 | 6.99 | 7.29 |
| S&P 500® Index | | 7.50 | 7.50 | -7.73 | 18.60 | 11.19 | 12.24 | - |
| CBOE S&P 500® BuyWrite Index | | 5.95 | 5.95 | -6.86 | 12.25 | 4.25 | 5.83 | - |

## Calendar Year Returns[2] (%)

| | 2013 | 2014 | 2015 | 2016 | 2017 | 2018 | 2019 | 2020 | 2021 | 2022 |
|---|---|---|---|---|---|---|---|---|---|---|
| Class Y | 13.88 | 6.25 | -0.97 | 8.07 | 7.56 | -5.96 | 15.72 | 12.54 | 18.70 | 5.12 |
| S&P 500® Index | 32.39 | 13.69 | 1.38 | 11.96 | 21.83 | -4.38 | 31.49 | 18.40 | 28.71 | -18.11 |
| CBOE S&P 500® BuyWrite | 13.26 | 5.64 | 5.24 | 7.07 | 13.00 | -4.77 | 15.68 | -2.75 | 20.47 | -11.37 |

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## Annual Distribution History Breakdown - Class Y, per share

| | Year-end NAV | Total Distribution | 30-Day SEC Yield[3] | Distribution Yield[4] |
|---|---|---|---|---|
| 2022 | $9.60 | $0.67 | 0.33% | 6.91% |
| 2021 | $9.80 | $0.63 | 0.63% | 6.82% |
| 2020 | $8.80 | $0.56 | 0.66% | 6.49% |
| 2019 | $8.40 | $0.59 | 0.70% | 7.33% |
| 2018 | $7.80 | $0.77 | 1.93% | 9.07% |

## Experienced Management

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Portfolio Manager
Industry since 1986

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## Fund Features

- Fund seeks total return with high level of income
- Focus on large and mid cap stocks
- Generates income from selling covered call options on stocks held and from dividends
- Premiums from call options help offset potential market losses

| Class | Ticker | Inception Date | Exp. Ratio |
|---|---|---|---|
| A | MENAX | 10/30/09 | 1.30% |
| C | MENCX | 7/31/12 | 2.05% |
| Y | MENYX | 10/30/09 | 1.05% |
| I | MENIX | 2/28/22 | 1.00% |
| R6 | MENRX | 7/31/12 | 0.92% |

*Expense ratios are based on the fund's most recent prospectus.*

Distribution Frequency - Quarterly

## 30-Day SEC Yields

| | |
|---|---|
| A | 0.05% |
| C | -0.67% |
| Y | 0.29% |
| R6 | 0.41% |
| I | 0.34% |

1 Growth of $10,000 is calculated at NAV and assumes all dividends and capital gain distributions were reinvested. It does not take into account sales charges (see Note 2) or the effect of taxes.

2 Average annual total returns and calendar year returns assume all distributions are reinvested and reflect applicable fees and expenses. Class A share returns without sales charge would be lower if sales charge were included. Class A share returns with sales charge reflect the deduction of the maximum applicable sales charge of 5.75%. Class C shares do not have an up-front sales charge, however, C shares are subject to a 1% CDSC on shares redeemed within 12 months of purchase. Class Y shares and Class R6 shares do not impose an up-front sales charge or a CDSC. Indices are unmanaged. An investor cannot invest directly in an index. They are shown for illustrative purposes only, and do not represent the performance of any specific investment. Index returns do not include any expenses, fees or sales charges, which would lower performance.

3 SEC Yield equals Net Investment Income (Gross Investment Income less Operating Expenses) divided by average asset value (average shares outstanding less net asset value).

4 Distribution Yield equals the Total Distribution amount divided by the average of the beginning and end of year Net Asset Value (NAV). Distribution yield includes net investment income plus both short- and long-term capital gain distributions.

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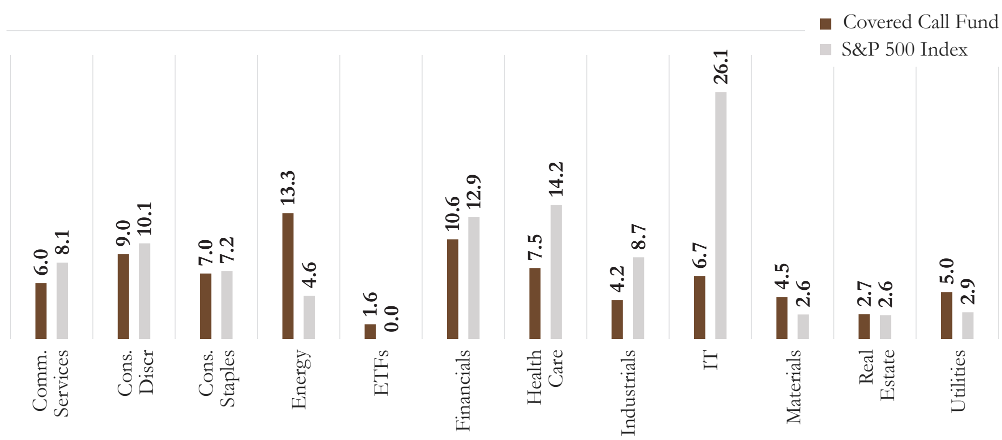
## Sector Allocation (%)




*ETFs (0.7%), short-term investments, cash (22.1%) and other net assets and liabilites are not represented above. Equity sector allocations are rounded to the nearest 0.1% and may not equal 100% due to option liability.*

## 5-Yr Risk Measures (%)

| | MENYX | S&P 500 |
|---|---|---|
| Std. Deviation | 14.46 | 18.64 |
| Down Capture | 60.28 | 100.00 |
| $R^2$ | 76.67 | 100.00 |

| | MENYX | BXM |
|---|---|---|
| Std. Deviation | 14.46 | 13.62 |
| Down Capture | 76.67 | 100.00 |
| $R^2$ | 69.54 | 100.00 |

## Top Ten Holdings (%)

| | |
|---|---|
| TRANSOCEAN LTD | 3.2 |
| LAS VEGAS SANDS CORP | 3.2 |
| T MOBILE US INC | 2.8 |
| ADOBE INC | 2.8 |
| CME GROUP INC | 2.6 |
| AMERICAN TOWER CORP | 2.6 |
| APA CORP | 2.5 |
| AES CORP | 2.5 |
| BAKER HUGHES CO | 2.4 |
| NEXTERA ENERGY INC | 2.4 |

## Characteristics

| | |
|---|---|
| TTM P/E | 17.1x |
| P/B | 2.4x |
| ROE | 10.2% |
| Dividend Yield | 2.0% |
| Active Share (vs. S&P) | 88.7% |
| Equities covered by call options | 86.0% |
| Average days to expiration | 40.6 |
| Number of Equity Holdings | 40 |
| Wtd. Average Market Cap (billions) | $137.9 |
| Total Net Assets (millions) | $202.5 |

***This material is authorized for use only when preceded or accompanied by the current prospectus. Before investing, please fully consider the investment objectives, risks, charges and expenses of the fund. This and other important information is contained in the current prospectus, which you should carefully read before investing or sending money. For more complete information about Madison Funds® obtain a prospectus from your financial adviser, by calling 800.877.6089 or by visiting https://www.madisonfunds.com/individual/prospectus-and-reports to view or download a copy.***

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Standard Deviation: a statistical measurement of dispersion about an average, which, for a portfolio, depicts how widely the returns varied over a certain period of time. Investors may use the standard deviation of historical performance to understand the range of returns for a portfolio. When a portfolio has a higher standard deviation than its benchmark, it implies higher relative volatility. Standard deviation has been calculated using the trailing monthly total returns for the appropriate time period. The standard deviation values are annualized. Downside Capture Ratio measures a fund's performance in down markets relative to its benchmark. It is calculated by taking the security's downside capture return and dividing it by the benchmark's downside capture return over the time period. TTM P/E (Price-to-Earnings Ratio) measures how expensive a stock is. It is calculated by the weighted average of a stock's current price divided by the company's trailing 12-month (TTM) earnings per share of the stocks in a fund's portfolio. P/B (Price-to-Book Ratio) measures a company's stock price in relation to its book value (the total amount a company would be worth if it liquidated its assets and paid back all its liabilities). ROE (Return on Equity) is a profitability ratio that measures the amount of net income returned as a percentage of shareholders equity. Dividend Yield: the portfolio's weighted average of the underlying fund holdings and not the yield of the fund. R-squared (R2) is generally interpreted as the percentage of a fund's movements that can be explained by movements in a benchmark index. Active Share is defined as the percentage of a portfolio that differs from its benchmark index. Active Share can range from 0% for an index fund that perfectly mirrors its benchmark to 100% for a portfolio with no overlap with an index. 30-day SEC Yield (Class Y) is a standardized formula designed to approximate the Fund's annualized hypothetical current income from securities less expenses for the 30 day-period ended 12/31/22 and that date's maximum offering price. Wtd. Avg. Market Cap measures the size of the companies in which the fund invests. Market capitalization is calculated by multiplying the number of a company's shares outstanding by its price per share.

The S&P 500® is an unmanaged index of large companies, and is widely regarded as a standard for measuring large-cap and mid-cap U.S. stock-market performance. Results assume the reinvestment of all capital gain and dividend distributions. An investment cannot be made directly into an index. The CBOE S&P 500 BuyWrite (ticker: BXM) Index is the passive representation of a covered call strategy. The BXM Index is an unmanaged (passive) total return index based on buying the S&P 500® stock index portfolio and "writing" (or selling) the near term S&P 500® Index "covered" call option (SPX) every month with an exercise price just above the prevailing index level (i.e., slightly out of the money). Source: CBOE

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As a writer of a covered call option, the fund forgoes, during the option's life, the opportunity to profit from increases in the market value of the security covering the call option above the sum of the premium and the strike price of the call, but has retained the risk of loss should the price of the underlying security decline. In addition to its covered call strategy, the fund may pursue an option strategy that includes the writing of both put options and call options on certain of the common stocks in the fund's portfolio.

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