The Yield Illusion: The Total-Return Cost of Covered-Call ETFs in Canada

Executive Summary

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Canadian investors hold roughly $57 billion in covered-call exchange-traded funds, and most of them bought in for the income. These funds advertise distribution yields that begin near five percent on the plain bank products and reach into the low double digits on the enhanced and leveraged versions. That headline rate is what marketing and fund screeners put forward, and it's what a retired or income-focused buyer tends to anchor on. This paper asks a plain question about it. Once everything is counted, how much of the advertised yield is a return the investor keeps, and how much is the investor's own capital coming back?

The question is worth answering because a distribution yield and a total return measure different things. When a fund writes call options on its holdings, it converts part of the portfolio's future appreciation into cash today, which caps how far the fund can climb. If the fund then pays out more than it earns, the excess comes back as return of capital and the unit price drifts lower. A fund can post an attractive yield while delivering a modest total return, and the gap is easy to miss, because the cash arrives every month while the erosion sits quietly in the price.

The study measures that gap with matched pairs of BMO ETFs. For several sectors BMO runs a plain index fund alongside a covered-call fund that writes options on the same basket. Comparing the two holds the underlying portfolio and the fee schedule steady and keeps the issuer the same, so what's left between them is the option overlay. The pairs cover Canadian banks, utilities, Canadian dividend stocks, and US dividend stocks, which is where most of the retail money sits. A wider test then extends the comparison to every Canadian covered-call fund that has a usable history and a sector benchmark.

Three data sources support the work, each with a defined job. The Canadian Financial Markets Research Centre database, reached through the CHASS platform, supplies research-grade TSX returns to December 2025 for the full-universe panel. The funds' audited Management Reports of Fund Performance provide year-end net assets and distributions per unit, along with the split of

each distribution into dividends, capital gains, and return of capital. A free public price feed supplies the long daily history that the income simulation and the risk measures need, and it doubles as an independent check on the panel. The computed returns line up with the issuers' own published figures, so the numbers hold across sources.

The central result is consistent across every cut of the data. In the matched pairs the covered-call fund earns less in total return than its plain twin, by about 2.5 percent a year, and the difference is statistically significant. On the research-grade CFMRC data the full universe of 31 funds shows a larger 3.5 percent a year, significant when the standard errors are clustered by fund and by month together. Twenty-six of the 31 funds trail their benchmark. The estimate survives fund and month fixed effects, so it isn't the work of a handful of funds or a few unusual periods.

The pattern is sharpest in the aggressive products. The enhanced funds, which write options on a larger share of the book, trail by wide margins, and one Hamilton financials fund lagged the plain bank fund by more than ten percent a year over a strong bank rally. The leveraged multi-sector funds run the other way, because their extra exposure offsets the capped upside in a rising market and lets them beat a plain comparator, which makes them a different bet rather than a clean read on the overlay. Taking the leveraged funds out of the panel raises the average drag rather than lowering it.

Risk-adjusted performance points the same way. The covered-call funds do run at lower volatility, which is what the strategy is built to do, yet their Sharpe ratio is lower in every pair. They give up more return than the risk they shed. Splitting returns by market direction shows why: the overlay costs the most in rising markets, where the written calls surrender the upside, and it gives back a smaller amount in falling markets, where the option premium acts as partial protection. Across a sample weighted toward rising years, the net effect is a cost.

The finding holds up under scrutiny. It appears on free public prices, on research-grade CFMRC data, and on audited net assets per unit taken straight from the annual reports, and the three agree closely. For the banks pair the audited and public-price estimates are almost identical, so the result isn't an artifact of one data vendor.

The audited reports show the other half of the result, which is where the yield turns out to be misleading. Return of capital made up 38 percent of distributions across the four funds over 2018 to 2022, and close to half for the utilities and Canadian dividend funds, whose unit prices barely

moved over the period. When much of the payout is the investor's own capital, the advertised yield describes cash flow rather than earnings, and the price erodes to match.

One test makes the cost tangible for an income investor. Picture two people who start with the same amount and draw the same monthly cash. The first holds the covered-call fund and spends its distributions. The second holds the plain fund and sells a few units each month to raise the identical cash. Because the withdrawals match by construction, the comparison comes down to who has more left at the end. The plain-fund investor finishes ahead in every pair, by 54 percent on average, on the same income. An investor who wants the cash can make it from the plain fund and keep more wealth doing it.

Taxes don't rescue the product. A common defence is that return of capital is tax-efficient, since it defers tax rather than triggering it. For a Canadian taxable investor at the Ontario top bracket, the deferral does help and it narrows the gap. The plain fund still wins after tax, by roughly 2.5 percent a year, because it defers tax through unrealized appreciation while the covered-call fund defers it through return of capital, and the two effects roughly offset.

A factor view explains where the drag comes from. Regressing each fund's return on its benchmark gives an average equity beta of 0.84, below one, so the funds hold less equity exposure than the portfolios they track. Their alpha averages about negative 1.25 percent a year and is only marginally significant. The shortfall is mostly reduced exposure plus a small fee gap, not weak security selection. Decomposing the drag confirms it. Forgone upside in rising markets, offset by the volatility-premium cushion in falling ones, accounts for the result, and fees add only about 0.2 percent a year.

The numbers scale to something material. Applied to the roughly $57 billion held in these funds, a drag of 2.5 to 3.5 percent a year works out to between $1.4 and $2.0 billion of forgone total return each year, for a product category sold on income.

For the investment industry the findings offer direct guidance. A portfolio manager or advisor should judge these funds on total return and risk-adjusted return, not on the distribution rate, which overstates what the investor keeps. Where a mandate needs income, the sell-units approach on a plain fund belongs in the comparison, because it produced the same cash and more wealth. An investor who wants lower equity exposure can buy it directly and more cheaply than through the overlay. In due diligence, the realized return-of-capital share is the number to inspect, since it reveals how much of a distribution is capital coming back. The overlay still suits

an investor who values the modest downside cushion and understands the capped upside, provided the choice is made on total return rather than on the yield.

The disclosure gap is specific and fixable. The regulated ETF Facts document already reports each fund's compound return and notes that distributions may include return of capital, so the underlying information exists. What the document leaves out is the distribution rate itself, the figure that marketing makes prominent, and it mentions return of capital only in general terms, without the realized share. A buyer anchors on a yield that the regulated document doesn't contain and can't reconcile to total return. Placing the distribution rate beside the total return and the realized return-of-capital share, wherever the rate is shown, would let a buyer read the yield for what it is.

The audience is not niche. These funds sit in the registered and taxable accounts of retirees and near-retirees across the country, sold on the promise of a steady monthly cheque. As the population ages and demand for income rises, the category keeps growing, which turns the distance between marketed yield and kept return into a question of investor welfare.

The Canadian covered-call ETF market is large, fast-growing, and, so far, absent from the academic record. Most published work on covered calls studies US index strategies and benchmarks against a separate index, which blends the overlay with differences in holdings. The matched-pair design removes that confound, and the focus on Canadian funds, Canadian tax, and Canadian disclosure places the evidence in the market where the product is actually sold.

The paper contributes evidence the Canadian literature has lacked. It gives the first matched-pair reading of a product that dominates the domestic income-ETF market, and it ties the marketed yield to the return an investor keeps using audited data and issuer figures. It also puts a dollar figure on the gap. The takeaway for a Canadian investor is that a covered-call ETF's yield and its return are two different numbers, and the distance between them is worth knowing before buying.

RESEARCH UPDATE · SEPTEMBER 17, 2026

The Covered-Call Yield Illusion

Independent research · CFA Society Toronto and Hillsdale

Reviewed on 17 September 2026. This is a methodology paper rather than a security recommendation: it decomposes a covered-call distribution into option premium earned and capital returned. It carries no price target and nothing in it is superseded by market moves since publication. The argument and the arithmetic stand as written.

Note. This page records a review dated September 17, 2026. The analysis above is unchanged.