# Madison Covered Call & Equity Income Fund Investment Strategy Letter

## Third Quarter 2019

*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 U.S. equity markets.*

Ray Di Bernardo, CFA
Portfolio Manager
Industry since 1987

Drew Justman, CFA
Portfolio Manager
Industry since 2001

## Review of Period

Against a backdrop of heightened domestic and geopolitical uncertainty fueled by shifting tariff policies, U.S. economic growth expanded at a moderate pace during the third quarter. The average consensus gross domestic product (GDP) forecast is for a growth rate of 2.0% in the quarter, driven largely by consumer spending. Yet despite the steady pace of domestic growth, concerns about an economic downturn have intensified. Citing slowing global growth and uncertainties around trade, the Federal Reserve Bank (Fed) lowered the federal funds rate by 0.25% at each of their July and September Federal Open Market Committee (FOMC) meetings, leaving the current target range at 1.75%-2.00%.

The stock market's sprint slowed to a crawl in the quarter with large caps up a little, small caps down a little, and mid caps mostly flat. Although we never claim to know exactly what is driving the market in the short-term, it seems likely that the recent pause stems from a combination of trade concerns, recession concerns, and high valuations. We are now over a decade into the economic expansion that began in 2009, breaking the previous record for the longest period of positive growth in our country's history, 1991 to 2001. The longer an expansion lasts, the more our team begins to think about a possible downturn approaching. However, there is no rule that states that expansion must die of old age. Canada had a 17-year expansion in the 1990s and 2000s. Australia has gone 27 years without an official recession. Given the relatively slow pace of our current expansion (2.3% average annual GDP growth, compared to 3.6% averaged in the 1990s growth period), it's entirely possible that it continues for another several years. Our feeling is that careful stock selection with the added protection of covered call income makes particular sense in this environment.

## Quarter Review

For the third quarter, the Madison Covered Call and Equity Income Fund's (Class Y shares at net asset value (NAV)) returned 0.12% , compared to the CBOE S&P 500 Buy-Write Index's 0.09% return. The S&P 500® Index rose 1.70%.

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The writer of a covered call option 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.

Past performance does not predict future results. Please refer to the final two pages of this piece which contain current performance information for the fund, the risks of investing in the fund and a complete list of the fund's individual portfolio holdings as of quarter end. Individual portfolio holdings are identified to illustrate our approach to investing the fund's portfolio and are not intended to represent a recommendation to buy or sell any such security.

The S&P 500 experienced considerable volatility during the quarter due to macroeconomic events yet managed to add to what has so far been a banner year for the broad stock market. Defensive areas of the market performed the best including the Utilities and Consumer Staples Sectors, along with Technology. Trade tensions continued to play a major role in overall volatility with a noteworthy impact on economically cyclical sectors such as Energy and Materials. In addition, there was a drone attack on Saudi Arabia's oil production facilities, which added to the energy market uncertainty. Over the past year, the Fund increased its holdings in these sectors given historically low valuations relative to other sectors and the potential that reflationary efforts in China would boost demand for many industrial metals and energy products. The Fund's positioning in these areas are relatively small, yet they are larger than the Index weightings and as such can result in added tracking error. During the third quarter, the Energy Sector lagged the overall market in light of a slowing global economy and supply risks highlighted by the Saudi attack. The Materials Sector performed better, yet also trailed the overall market. We continue to believe that the significant monetary and fiscal easing in China over recent quarters will have the desired effect, and that historically low valuations make this an attractive area of the market for patient investors.

With all of the uncertainty and macroeconomic events during the quarter, market volatility remained relatively high. The CBOE Volatility Index (VIX) started the quarter around the 14 level, dipped in July with the strong market and then moved above 24 as the market corrected in August. In September, the VIX moved lower as the market rallied, and ended the quarter somewhat elevated, ending slightly above 16.

Given our concerns that slowing economic growth would negatively impact earnings and sales growth for U.S. companies, we have remained defensively postured. The Fund ended the quarter with call option coverage at 77.1% of portfolio holdings, slightly lower than the prior quarter. Although cash levels were brought lower by quarter end, the market's rally in September caused us to allocate funds cautiously. Given the market's net increase during the quarter despite a highly variable path, call option coverage and cash holdings were a headwind to relative returns.

On a net basis, sector allocation was slightly detractive to relative performance in the quarter. The most significant headwind came from the Fund's overweighting in the Energy Sector as noted above. Somewhat less punitive was an underweighting in the Technology Sector which performed well overall but was highly volatile due to trade concerns for with significant China exposure. On the positive front, the Fund's underweighting in Health Care was additive versus the index. Telecommunications and gold-related securities also contributed nicely to relative performance. We believe our allocation to gold and select gold stocks provides attractive portfolio diversification and could be a defensive place to be in a down market environment should that come to fruition.

Individual stock performance was a negative contributor during the quarter. Underperformers were led primarily by energy and materials stocks. Within the Energy Sector, Range Resources, Transocean and EOG Resources lagged the market. In Materials, companies affected by trade concerns also trailed the index including industrial metals companies such as Freeport-McMoRan and Alcoa. On the positive side, in Health Care, CVS Health outperformed and was the best performing stock in the portfolio. Baxter International was another health care stock that performed well. In Communication Services, internet search firm Alphabet (formerly Google) contributed nicely to relative performance. In addition, two Consumer Discretionary

*Performance data shown represents past performance. Investment returns and principal value will fluctuate, so that fund shares, when redeemed, may be worth more or less than the original cost. Past performance does not guarantee future results and current performance may be lower or higher than the performance data shown. Visit madisonfunds.com or call 800.877.6089 to obtain performance data current to the most recent month-end.*

stocks were strongly additive to results including Whirlpool and Lowe's. Texas Instruments was another notable outperforming stock in Technology. It is also worth mentioning that gold prices increased 4.5% during the quarter from $1384 up to $1472, which outperformed the S&P 500. As discussed previously, the fund maintains exposure to gold stocks, which tends to negatively correlate to the equity market and acts as a defensive holding and portfolio diversifier.

## Outlook

In 2019, as U.S. economic data has worsened, the S&P 500 has continued to move higher. In the month of September, many leading economic indicators declined and/or missed expectations. Yet the market kept moving higher. The Fed has already cut rates two times this year, and the market now expects additional rate cuts in October and then into 2020. Many view this as positive for equities but we have to question the solidity of an economy where a Fed Funds rate of 2% is not already low enough. Globally, there are still several developed world markets that have negative 10-year bond yields. Also, U.S. earnings announcements run the risk of underwhelming with much attention focused on uncertainty surrounding earnings expectations for 2020. With the trade dispute unlikely to be resolved immediately, how much optimism can be expected given the economic backdrop? Despite the broadly negative scenario, our view continues to be that China will improve thanks to their enormous stimulus despite the trade friction. This could be the saving grace for the global economy this year and next. This is also what we believe keeps the candle burning for the later cycle sectors of the economy that would be beneficiaries of a resurgent China. Our view has been to maintain our positioning in sectors such as Energy and Materials while also increasing exposure to more defensive domestic sectors such as Utilities, selective Telecommunications companies, gold and other lower volatility holdings…a barbell approach within a diversified portfolio. It is very likely market volatility will continue for the foreseeable future and we remain defensively positioned overall.

*Ray Di Bernardo* *Drew Justman*

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.

Chicago Board Options Exchange (CBOE) Volatility Index (VIX) measures market expectations of near-term volatility conveyed by S&P 500 stock index option prices.

An investment cannot be made directly into an index.

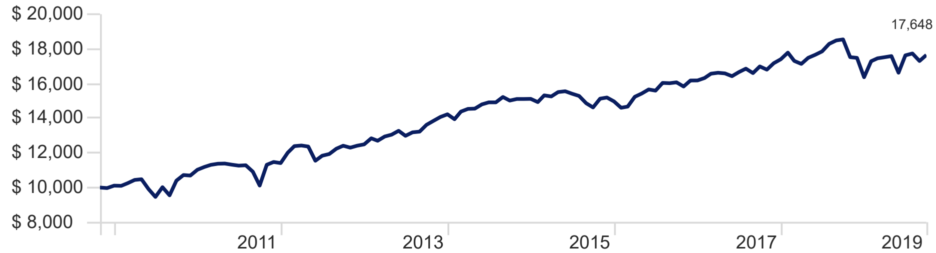
September 30, 2019

# Madison Covered Call and Equity Income Fund

Madison FUNDS®

**Growth of $10,000[1]**
Class Y Shares, Since Inception

## The Value of Long-Term Investing




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

| | | Three Months | YTD | 1 Yr | 3 Yr | 5 Yr | Since Inception |
|---|---|---|---|---|---|---|---|
| Class Y | | 0.12 | 7.84 | -4.84 | 3.17 | 3.28 | 5.89 |
| Class R6 | | 0.12 | 7.89 | -4.69 | 3.30 | 3.41 | 5.74 |
| Class A | without sales charge | 0.00 | 7.50 | -5.14 | 2.89 | 3.01 | 5.64 |
| | with sales charge | -5.73 | 1.37 | -10.60 | 0.89 | 1.80 | 5.01 |
| Class C | without sales charge | -0.14 | 7.13 | -5.77 | 2.15 | 2.25 | 4.56 |
| | with sales charge | -1.11 | 6.13 | -6.62 | 2.15 | 2.25 | 4.56 |
| S&P 500® Index | | 1.70 | 20.55 | 4.25 | 13.39 | 10.84 | - |
| CBOE S&P 500® BuyWrite Index | | 0.09 | 10.37 | -1.57 | 6.83 | 5.83 | - |

## Calendar Year Returns[2] (%)

| | 2010 | 2011 | 2012 | 2013 | 2014 | 2015 | 2016 | 2017 | 2018 |
|---|---|---|---|---|---|---|---|---|---|
| Class Y | 9.08 | 3.47 | 9.47 | 13.88 | 6.25 | -0.97 | 8.07 | 7.56 | -5.96 |
| S&P 500® Index | 15.06 | 2.11 | 16.00 | 32.39 | 13.69 | 1.38 | 11.96 | 21.83 | -4.38 |
| CBOE S&P 500 BuyWrite Index | 5.86 | 5.72 | 5.20 | 13.26 | 5.64 | 5.24 | 7.07 | 13.00 | -4.77 |

## Annual Distribution History Breakdown - Class Y, Per Share

| | Year-end NAV | Total Distribution | 30-Day SEC Yield[3] | Distribution Yield[4] |
|---|---|---|---|---|
| 2018 | $7.80 | $0.77 | 1.93% | 9.74% |
| 2017 | $9.08 | $0.69 | 1.29% | 7.59% |
| 2016 | $9.10 | $0.61 | 0.46% | 6.74% |
| 2015 | $9.00 | $0.67 | 0.60% | 7.14% |
| 2014 | $9.76 | $0.88 | -0.13% | 8.90% |
| 2013 | $10.02 | $0.94 | 0.14% | 9.55% |

## Experienced Management

Ray DiBernardo, CFA
Portfolio Manager
Industry since 1987

Drew Justman, CFA
Portfolio Manager
Industry since 2001

## Fund Features

- Fund seek 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 | 10/31/09 | 1.30% |
| C | MENCX | 7/31/12 | 2.05% |
| Y | MENYX | 10/31/09 | 1.05% |
| R6 | MENRX | 7/31/12 | 0.92% |

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

| Class | 30-Day SEC Yields |
|---|---|
| A | 0.00% |
| C | 0.92% |
| Y | 1.05% |
| R6 | 1.36% |

## Distribution Frequency

Quarterly

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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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). The SPX call is held until expiration and cash settled, at which time a new one-month, near-the-money call is written. Source: CBOE

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## Total Net Assets

$126.9 Million

## 5-Yr Risk Measures (%)

| | MENYX | S&P |
|---|---|---|
| Std. Deviation | 7.86 | 11.93 |
| Down Capture | 65.67 | 100 |
| $R^2$ | 80.56 | 100 |

| | MENYX | BXM |
|---|---|---|
| Std. Deviation | 7.86 | 7.55 |
| Down Capture | 94.77 | 100 |
| $R^2$ | 68.87 | 100 |

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800.877.6089

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Advisor Services
550 Science Drive
Madison, WI 53711
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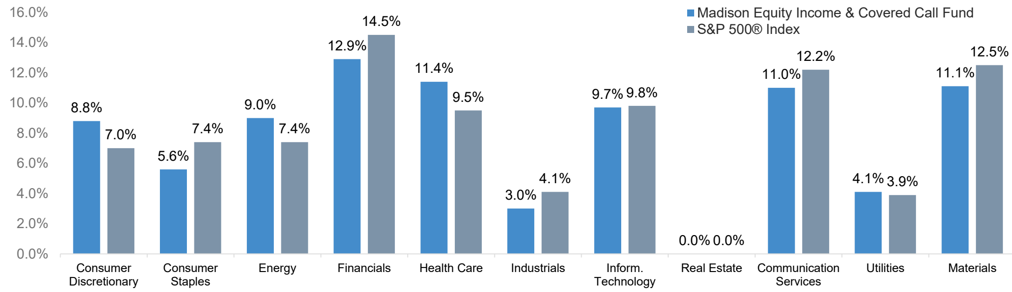
## Sector Allocation (%)




ETFs (5.1%), short-term investments, cash (7.5%) 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.

## Characteristics

| | |
|---|---|
| P/B | 1.8x |
| TTM P/E | 16.5x |
| ROE | 18.4% |
| Dividend Yield | 2.23% |
| Active Share (vs. S&P) | 85.8% |
| Equities covered by call options | 77.1% |
| Average days to expiration | 24.7 |
| Number of Equity Holdings | 47 |
| Wtd. Average Market Cap, billions | $146.1 |

## Top Ten Holdings (%)

| | |
|---|---|
| NEWMONT GOLDCORP CORP | 3.8 |
| ALPHABET INC CL C | 3.8 |
| JPMORGAN CHASE + CO | 3.0 |
| BAXTER INTERNATIONAL INC | 2.9 |
| BANK OF AMERICA CORP | 2.9 |
| T MOBILE US INC | 2.9 |
| ZIMMER BIOMET HOLDINGS INC | 2.9 |
| BERKSHIRE HATHAWAY INC CL B | 2.8 |
| INVESCO DB GOLD FUND | 2.6 |
| MICROSOFT CORP | 2.5 |

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**Standard Deviation** measures dispersion from an average, which, for a mutual fund, depicts how widely the returns varied over a certain period of time. Higher deviation represents higher volatility. **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 (as of 12/31/2018) 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 12/31/18 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.

An investment in the fund is subject to risk and there can be no assurance that the fund will achieve its investment objective. The risks associated with an investment in the fund can increase during times of significant market volatility. The principal risks of investing in the fund include: equity risk, mid-cap company risk, option risk, tax risk, concentration risk and foreign security and emerging market risk. More detailed information regarding these risks can be found in the fund's prospectus.

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.

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