Higher Returns from Safe Investments

Using Bonds, Stocks, and Options to Generate Lifetime Income

Marvin Appel

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To my father Gerald Appel, with gratitude for his guidance and love all these years.

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About the Author

Marvin Appel originally trained as an anesthesiologist at Harvard Medical School and Johns Hopkins Hospital. He concurrently earned a PhD in Biomedical Engineering from Harvard University. However, in 1996 he changed careers and joined his father in the field of investment management, where he has been able to put his engineering and computer training to work in analyzing the stock market. He is now CEO of Appel Asset Management in Great Neck, NY, which manages more than $45 million in client assets in mutual funds, exchange-traded funds, and individual stocks and bonds using active asset allocation strategies.

Dr. Appel's book *Investing with Exchange-Traded Funds Made Easy*, now in its second edition, was published by FT Press and was featured on CNBC's *Closing Bell* show. Dr. Appel and his father have also written *Beating the Market, Three Months at a Time*, published by FT Press and released in January 2008.

Dr. Appel is the editor of *Systems and Forecasts*, a highly regarded newsletter on technical analysis that his father, Gerald Appel, started in 1973. He is also a regular contributor to *Investment News*. Dr. Appel has been a regular contributor to *Dental Economics* and to *Physician's Money Digest*. His market insights have been featured on CNBC, CNNfn, CBS Marketwatch.com, and Forbes.com. He has been invited to testify to the New York State Legislature regarding his market forecasts and has presented his investment strategies to numerous conferences, including several chapters of the American Association of Individual Investors and, most recently, at the Canadian Society of Technical Analysts at their annual meeting in Toronto.

chapter 1

Introduction

> *"Give a person a fish and you have fed him for a day. Teach him to fish and you have fed him for life."*
>
> *—Chinese proverb (Lao Tzu)*

In the wake of the worst financial crisis since the Great Depression, many investors are wondering how they can get attractive returns while still being able to sleep at night. This book shows you how, using investments that generate income.

You might ask what this means. Isn't the goal of all investments to generate income? Actually, there are two ways you can profit in the financial markets. One way is to buy low and sell higher (hopefully), thereby generating *capital gains*. The allure of investing in search of capital gains is that when you are successful, the profits can be very large. The main disadvantage of investing for capital gains is the significant risk that you will lose money. Even if your investment is ultimately profitable, you do not know in advance how much you will make or when your profits will materialize.

The other way to profit, which is the subject of this book, is to own investments that pay you a stream of income in return for just holding them in your account, regardless of which direction the markets are moving. You can profit even during periods when the financial markets are flat. Bonds are a prime example of an income-generating investment: You buy a bond and collect the income every six months.

Dividend-paying stocks are another. Stocks generally pay quarterly dividends. Even if the stock goes up and down while you hold it, you will continue to receive the quarterly dividend check as long as the company continues to pay.

Let's take a minute to discuss why income investing could be good for you. The major advantage of income-producing investment strategies is their greater potential safety than those strategies that entail buying and selling in pursuit of profit. Another advantage of making an income-generating investment, especially in bonds, is that once you invest, you have a very good idea how much cash you will receive and when you will receive the payments.

So far, so good—as an income investor, you could possibly earn dependable income at reduced risk. What's not to like? The answer in today's markets is that many income-producing investments, including bank certificates of deposit, money market funds, and many bond investments, are simply not paying you as much as you need. One of the fundamental principles in investing is that you have to bear greater risk to earn higher returns. (Unfortunately, many investors have learned the hard way that simply bearing risk does not guarantee returns.) The implication would seem to be that if you invest for safety, you could be condemning yourself to modest, perhaps even inadequate, earnings. The goal of this book is to show you that this is not necessarily true. The pursuit of greater safety than you might find in the stock market or in real estate, for example, need not limit your returns to the meager rates now available from the average bond or bank CD.

Fortunately for the investor concerned about safety, as an income investor, you might not need to give up much, relative to what you might earn from riskier approaches. This book shows you that not all bonds are created equal, and that there are several areas of the bond market with above-average profit potential. Promising areas in 2010 include high-yield corporate bond funds and long-term individual municipal bonds. Because these types of bonds pay more than average, they also expose you to potential risks. You will learn how to mitigate those risks when we discuss each type of bond in more detail. Down the road, conventional bonds might again pay attractive levels of interest income. This book tells you what you need to know to become an informed investor in such bonds, whether through mutual funds or with a brokerage account in which you buy bonds from individual borrowers.

You will also learn about two types of stock market investments that have been less risky than the overall stock market and which can be good sources of ongoing income: stocks with above-average dividends and a strategy using exchange-traded funds and stock options known as **covered call writing**. Moreover, in the right amounts, these stock market strategies can improve your returns (compared with holding only bonds) with very modest amounts of added risk.

The income-generating strategies you will learn from this book are those that have been safer than the typical investment in the stock market and have the potential to return more than the average investment in the bond market. Although the future performance of any investment strategy cannot be predicted or guaranteed, you will see how much risk has been associated with different income investments and you will learn how to manage that risk in the future. Even without a guarantee, you should be able to sleep at night.

How Much Money Do You Need to Retire?

Yogi Berra once said, "If you don't know where you are going, you might end up someplace else."[1] In the context of retirement planning, you should interpret Berra's wisdom to mean that you should not retire until you have established and achieved a prudent set of financial goals.

As a general rule, I counsel clients to *plan on spending up to 5% of their retirement savings each year if they don't want to deplete their savings over time*. Although no future results can be guaranteed for any investment program, the assumption behind this advice is that it should be possible to earn an average of 5% per year on your investments without taking unacceptable levels of risk. To the extent you earn more than 5%, you should save any surplus to help keep up with inflation and to provide a cushion for those years when your earnings fail to meet your expenses. If you can limit your expenses to 5% or less of your savings each year, your savings might last you indefinitely. On the other hand, the greater the amount you withdraw from your savings to spend each year, the greater the chances that you will deplete your investments and possibly run out of money.

Let's see how this works with an example. Suppose you have saved $250,000 in your 401(k) plan; 5% of that amount is $12,500, which is the amount you should be able to safely withdraw from your 401(k) plan each year to spend. Now, I realize that very few retirees are living on $12,500/year. Fortunately, you will also receive Social Security and, if you are lucky, perhaps a pension from your job. Your retirement budget should be within the sum of all these sources of income: 5% of your retirement savings plus Social Security plus any other pensions.

Another example in reverse: Suppose you decide that after taking Social Security and other pension income into account, you still want to be able to withdraw $50,000/year from your investments. How much do you need before you retire? You would divide $50,000 by 5% (which is 0.05) to get the answer, in this case $1 million. If you want to be able to spend $50,000/year from your investments without taking on too much investment risk, you need to have saved $1 million.

According to the longevity tables that the IRS uses to calculate required minimum IRA distributions (IRS Publication 590 at www.irs.gov), a couple that retires when both spouses are 65 will, on average, need to support one or both spouses for another 26 years. A lot of crazy things can happen in 26 years: inflation, recession, economic dislocations, and more. You don't want to find yourself short of money in your seventies if events take an unexpected turn. Rather, you need to be confident that the money you had when you retired will still be there in 10 or 15 years. Achieving that confidence requires investing with both safety and returns in mind, and limiting the rate at which you spend your money to a sustainable level of 5% or less of principal each year.

Let's Get Started...

The next two chapters describe what you need to know about bonds, including how they work, how you can invest in them, and what their risks are. Following that, the book shows you various strategies for investing in the safest types of bonds. To increase your potential returns, I recommend including some less-conservative income strategies in your portfolio: high-yield bond mutual funds, preferred stocks, and stock market strategies (high-dividend exchange-traded funds and covered call writing). Such strategies are the subject of Chapters 7, 9, 10, 11, and 12. The final chapter shows you how much of your capital to allocate to the different strategies described in the book. There is no single correct answer—the best investment program for you depends on how much income you need, how long you expect to need it, and how much risk you are willing to accept. Chapter 13 presents some choices for your consideration. Ultimately, the goal of this book is to show you how to invest safely for attractive returns that could potentially sustain you for years to come.

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chapter 2

Basics of Bond Investments

If you are planning for retirement, you want to be able to sleep well at night without having to worry about whether your investments will pay you enough to live on. A thoughtful program of investing in bonds can help you achieve this peace of mind. This chapter explains what bonds are, how they work, and why they are usually (but not always) safe. This chapter covers several different types of bonds. Some offer absolute safety but relatively low returns, whereas others offer very high-potential returns but with significant risk. Some or all of these bonds have a role in your investment program.

What Is a Bond?

A bond is a loan that an investor makes to a business or government. Bond investors make loans, and in return receive regular interest payments. You might be familiar with loans from your own borrowing. For example, if you have a mortgage, you make an interest payment each month and, in addition, pay down a bit of the principal so that by the time the mortgage ends, everything is paid off. Bonds are a little different—they resemble interest-only mortgages. A company borrows $1,000 from you and during the life of the loan pays you only the interest due. When the bond (loan) matures, you get the principal back as a lump sum.

If you were deciding to borrow money, you would naturally evaluate whether the amount of interest charged is reasonable and whether you will be able to pay back the loan on the date it is due. As a lender, you also have to evaluate both of these factors, this time from the other side of the table.

The bond market uses a special name to describe the interest rate on the loan that you, the investor, are extending: the **coupon rate** (also called **coupon yield**). This originated because in the past, bonds were physical pieces of paper that included attached coupons that specified the amount and date of each interest payment due during the life of the bond. Bond investors would turn in the coupons for each scheduled payment and collect the cash due. In the United States, bond interest payments generally occur every six months.

Bonds are usually sold in units of $1,000. (That is, whoever owns bonds at maturity will receive $1,000 for each bond.) So, a bond that pays $50/year in interest is said to have a coupon rate of 5% because $50 represents 5% of the original and final principal of $1,000 per bond. The amount for which a bond will be redeemed when it matures (usually $1,000) is called its **par value**.

Short-term bonds are those that mature in three years or less. Long-term bonds mature in more than ten years. Bonds that mature in three to ten years are intermediate-term bonds. Most of the time, short- and intermediate-term bonds will be the suitable maturities for you because they offer the best balance between the level of investment risk and return, as you will see later in this chapter. I generally do not recommend long-term bonds to individual investors except in special situations.

Why Bonds Are Safe

From the moment you buy a bond, you know when you will receive scheduled interest payments and how much they will be. You also know the date at which you will get your principal back. In contrast, when you buy a risky investment like a stock, you do not know what

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