
Higher Returns from Safe Investments

USING BONDS, STOCKS, AND OPTIONS TO
GENERATE LIFETIME INCOME

MARVIN APPEL

Vice President, Publisher: Tim Moore
Associate Publisher and Director of Marketing: Amy Neidlinger
Executive Editor: Jim Boyd
Editorial Assistant: Pamela Boland
Development Editor: Russ Hall
Operations Manager: Gina Kanouse
Senior Marketing Manager: Julie Phifer
Publicity Manager: Laura Czaja
Assistant Marketing Manager: Megan Colvin
Cover Designer: Chuti Prasertsith
Managing Editor: Kristy Hart
Project Editor: Betsy Harris
Copy Editor: Karen Annett
Proofreader: Williams Woods Publishing
Senior Indexer: Cheryl Lenser
Senior Compositor: Gloria Schurick
Manufacturing Buyer: Dan Uhrig
© 2010 by Pearson Education, Inc.
Publishing as FT Press
Upper Saddle River, New Jersey 07458

This book is sold with the understanding that neither the author nor the publisher is engaged in rendering legal, accounting, or other professional services or advice by publishing this book. Each individual situation is unique. Thus, if legal or financial advice or other expert assistance is required in a specific situation, the services of a competent professional should be sought to ensure that the situation has been evaluated carefully and appropriately. The author and the publisher disclaim any liability, loss, or risk resulting directly or indirectly, from the use or application of any of the contents of this book.

FT Press offers excellent discounts on this book when ordered in quantity for bulk purchases or special sales. For more information, please contact U.S. Corporate and Government Sales, 1-800-382-3419, corpsales@pearsontechgroup.com. For sales outside the U.S., please contact International Sales at international@pearson.com.

Company and product names mentioned herein are the trademarks or registered trademarks of their respective owners.

All rights reserved. No part of this book may be reproduced, in any form or by any means, without permission in writing from the publisher.

Printed in the United States of America

First Printing March 2010

ISBN-10: 0-13-700335-8

ISBN-13: 978-0-13-700335-8

Pearson Education LTD.

Pearson Education Australia PTY, Limited.

Pearson Education Singapore, Pte. Ltd.

Pearson Education North Asia, Ltd.

Pearson Education Canada, Ltd.

Pearson Educación de México, S.A. de C.V.

Pearson Education—Japan

Pearson Education Malaysia, Pte. Ltd.

Library of Congress Cataloging-in-Publication Data

Appel, Marvin.

Higher returns from safe investments : using bonds, stocks and options to generate lifetime income / Marvin Appel.

p. cm.

Includes bibliographical references and index.

ISBN 978-0-13-700335-8 (hbk. : alk. paper) 1. Investments. 2. Bonds. 3. Financial risk. 4.

Retirement income—Planning. I. Title.

HG4521.A657 2010

332.63'2—dc22

2009048198

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

This page intentionally left blank

Contents at a Glance

Chapter 1	Introduction	1
Chapter 2	Basics of Bond Investments	7
Chapter 3	Risks of Bond Investing	29
Chapter 4	Bond Ladders—Higher Interest Income with Less Risk	45
Chapter 5	Bond Mutual Funds—Where the Best Places Are for Your One-Stop Shopping	51
Chapter 6	The Safest Investment There Is—Treasury Inflation-Protected Securities (TIPS)	67
Chapter 7	High-Yield Bond Funds—Earn the Best Yields Available while Managing the Risks	81
Chapter 8	Municipal Bonds—Keep the Taxman at Bay . . .	93
Chapter 9	Preferred Stocks—Obtain Higher Yields Than You Can with Corporate Bonds	115
Chapter 10	Why Even Conservative Investors Need Some Exposure to Other Markets	133
Chapter 11	Equity ETFs for Dividend Income	139
Chapter 12	Using Options to Earn Income	153
Chapter 13	Conclusion—Assembling the Program for Lifetime Investment Income	167
	Endnotes	177
	Index	183

This page intentionally left blank

Contents

Chapter 1	Introduction.....	1
	How Much Money Do You Need to Retire?..	3
	Let's Get Started.....	5
Chapter 2	Basics of Bond Investments.....	7
	What Is a Bond?.....	7
	Why Bonds Are Safe.....	8
	How Much Money Have Bond Investors Made in the Past?.....	9
	For Bonds, Past Is Not Prologue.....	11
	Which Type of Bond Is Right for You?.....	13
	<i>Taxable Versus Tax-Exempt</i>	13
	<i>Investment Grade Versus High Yield</i>	15
	Interest Rate Risk.....	16
	How Much Is Your Bond Really Paying You?.....	19
	Why Long-Term Bonds Are Riskier Than Short-Term Bonds.....	21
	How to Buy Individual Bonds.....	24
	Understanding Bond Listings.....	26

	Buying Bonds Far from Coupon Payment	
	Dates	27
	Conclusion	28
Chapter 3	Risks of Bond Investing	29
	How to Measure Risk—Drawdown	29
	Interest Rate Risk	32
	Default Risk	33
	Credit Ratings	34
	<i>Credit Downgrade Risk</i>	38
	Inflation	39
	Liquidity Risk	41
	Market Catastrophes—The Example of Asset-Backed Bonds	41
	Conclusion	43
Chapter 4	Bond Ladders—Higher Interest Income with Less Risk	45
	How a Bond Ladder Works	45
	Conclusion	49
Chapter 5	Bond Mutual Funds—Where the Best Places Are for Your One-Stop Shopping	51
	Bond Mutual Funds Can Reduce Your Transaction Costs	51

Bond Mutual Funds Reduce Your Risk through Diversification.	52
Expenses in Bond Funds	53
Sales Charges (Loads) in Bond Funds.	54
Other Expenses.	55
The Biggest Drawback to Bond Mutual Funds—No Maturity Date.	56
It Can Be Difficult to Know How Much Interest Your Bond Fund Is Paying.	56
<i>Pitfall #1—Current Yield or Distribution Yield</i>	<i>57</i>
<i>Pitfall #2—Yield to Maturity</i>	<i>58</i>
The Gold Standard—SEC Yield.	58
The Hurdle Bond Funds Have to Clear: Barclays Capital U.S. Aggregate Bond Index	59
Swing for the Fences: Pimco Total Return Fund	61
The Safest of the Safe: FPA New Income and SIT U.S. Government Securities	62
Conclusion.	63
Appendix: A Word of Caution about Bond ETFs	64

Chapter 6	The Safest Investment There Is—Treasury Inflation-Protected Securities (TIPS)	67
	How TIPS Work	67
	<i>TIPS Prices Fluctuate when Interest Rates Change, Similar to Regular Bonds.</i>	72
	Market Prices for Previously Issued TIPS: Trickier Than You Might Expect	73
	How to Buy TIPS	75
	What Is a Good Yield for TIPS?	75
	Should You Invest in TIPS or Invest in Corporates?	77
	Conclusion	79
Chapter 7	High-Yield Bond Funds—Earn the Best Yields Available while Managing the Risks.	81
	The Challenge of High-Yield Bond Funds	81
	Who Should Avoid High-Yield Bond Funds	83
	Risk Management: The Stop Loss	84
	<i>What to Do after Your Stop Loss Triggers a Sale</i>	85
	<i>Results with Some Actual High-Yield Bond Funds</i>	87

	<i>Why Not Evaluate More Frequently Than Once a Month?</i>	90
	<i>Why Not Just Avoid High-Yield Bonds during Recessions?</i>	90
	<i>Individual High-Yield Bonds Are Likely to Be Unsuitable for You</i>	91
	Conclusion	92
Chapter 8	Municipal Bonds—Keep the Taxman at Bay	93
	Comparing Apples with Oranges	94
	Tax-Exempt Mutual Funds Have a Big Hurdle to Clear	95
	Recommended Tax-Exempt Bond Mutual Funds	96
	The Alpine Ultra Short Tax Optimized Income Fund	98
	Earn 7% per Year, Free of Federal Income Tax	100
	Long-Term Municipal Bonds: You Are Paid to Take the Risk	102
	Buying Individual Municipal Bonds—Some Municipal Bond Borrowers Are Safer Than Others	104
	Call Provisions	105
	Bond Insurance	107

	Excellent Source of Municipal Bond Information Online	110
	Conclusion	112
Chapter 9	Preferred Stocks—Obtain Higher Yields Than You Can with Corporate Bonds	115
	Features of Preferred Stocks	115
	Taxes on Preferred Stock Dividends	116
	Price Risk with Preferred Stocks	117
	Credit Risk with Preferred Stocks	119
	Watching Your Sector Exposure	120
	How to Find Information about Preferred Stocks	126
	Trading Preferred Stocks	127
	Where Do Preferred Stocks Fit into Your Portfolio?	128
	Other Types of Preferred Stocks	129
	Conclusion	131
Chapter 10	Why Even Conservative Investors Need Some Exposure to Other Markets	133
	The Bond Market Likes Recessions and Hates Expansions	133

The Stock Market Likes Expansions and Hates Recessions	134
Conclusion	137
Chapter 11 Equity ETFs for Dividend Income	139
The Importance of Dividends	139
Recommended Foreign Equity ETF: Wisdom Tree Emerging Markets Equity Income ETF (DEM)	148
Recommended Dividend Portfolio	150
Conclusion	152
Chapter 12 Using Options to Earn Income	153
What Are Stock Options?	153
Covered Call Writing	156
Getting Income from Writing Covered Calls	158
Let's Look at the Record	159
How to Implement a Covered Call Writing Strategy	161
Covered Call Writing against Indexes besides the S&P 500	164
Conclusion	166

Chapter 13 Conclusion—Assembling the Program for
Lifetime Investment Income 167

 For the Most Conservative Investor—
 A Program of Predictable Returns with
 Individual Bonds. 169

 For the Investor Who Needs to Spend a
 Little More and Is Willing to Take Some
 Risk to Do So—Allocate 25% of Your
 Portfolio to Stocks. 171

 For the Investor Willing to Assume Some
 Risk and to Monitor His Portfolio—
 Allocate 25% of Your Capital to
 High-Yield Bond Fund Trading 172

 Preferred Stocks—Boost Your Interest
 Income with Less Effort 174

 Conclusion. 175

Endnotes 177

Index 183

Acknowledgments

I extend my heartfelt thanks to Audrey Deifik, Joanne Quan Stein, Bonnie Gortler, and Lucas Janson for reading the drafts of this manuscript along the way. Their insightful feedback helped me stay on-message. I shudder to think how difficult it would have been to earn the editors' approval at FT Press without the benefit of their input in advance. I would also like to thank the staff at FT Press for bringing this book from my word processor into print so smoothly.

Lastly, I am grateful for the resources that were available on the Internet at no cost and which enabled me to do the research necessary to write this book. I have referenced all specific sources of information within the book, but I am particularly grateful to QuantumOnline.com, Moody's, Fitch Ratings, and the Chicago Board Options Exchange (CBOE).

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.

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.

This page intentionally left blank

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

sample content of Higher Returns from Safe Investments: Using Bonds, Stocks, and Options to Generate Lifetime Income

- [download online Essentials of Organizational Behavior pdf, azw \(kindle\), epub, doc, mobi](#)
- **read [Santiago: A Myth of the Far Future](#)**
- [download Rhetorical Darwinism: Religion, Evolution, and the Scientific Identity \(Studies in Rhetoric & Religion\) pdf, azw \(kindle\)](#)
- [download The Sake Handbook online](#)
- [La pena mÁxima book](#)

- <http://pittiger.com/lib/Spitfire-Mark-V-Aces-1941---45.pdf>
- <http://jaythebody.com/freebooks/Santiago--A-Myth-of-the-Far-Future.pdf>
- <http://flog.co.id/library/Photoshop-LAB-Color--The-Canyon-Conundrum-and-Other-Adventures-in-the-Most-Powerful-Colorspace.pdf>
- <http://betsy.wesleychapelcomputerrepair.com/library/Colditz--The-Full-Story.pdf>
- <http://cavalldecartro.highlandagency.es/library/The-Fly-Trap.pdf>