## High Income In Dangerous Times

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### For my presentation today I'll be reading the PowerPoint slides word for word



### Outline

- Investment landscape: low interest rates, high volatility, economic uncertainty.
- Fixed income investing to take advantage of higher yields
  - High yield bond fund trading
  - Floating rate funds
- Covered call writing and cash-secured put writing

### Treasury Yields Are at All-time Lows





60% S&P 500, 40% Barclays US Aggregate Bond, Withdraw 0.333% of initial principal per month, adjusted for inflation (but not for taxes or expenses)



60% S&P 500, 40% Barclays US Aggregate Bond, Withdraw 0.333% of initial principal per month, adjusted for inflation (but not for taxes or expenses)

### High yield (junk) bond fund trading



## High yield bonds have been competitive with equities 1999-2019



### **Opportunity in Corporate High Yield Bond Funds**



□----□ Vanguard Total Bond Market Index Inv \$60,304 □----□ Corporate Bond - High Yield Average \$85,122

### Risk measure: worst drawdown



### 3% Buy and sell stops











NCINX buy and hold: 5.4%/year, 30% drawdown. Trading: 6.3%/year, 12% drawdown

### Trading High Yield Bond Funds 1988-2013



**Disclosures**: This is the hypothetical performance of the high yield bond fund trading model that we utilize, based on results with a cross-section of 12 mutual funds that are typical of ones we have used for client accounts. These results are not audited and are not the experience of any actual client account. Results do not include taxes, transaction costs or management fees. Past or hypothetical results do not guarantee any future performance.

### Trading High Yield Bond Funds 2008-2020



Disclosures: This is the hypothetical performance of the high yield bond fund trading model that we utilize, based on results with a cross-section of 14 mutual funds that are typical of ones we have used for client accounts. These results are not audited and are not the experience of any actual client account. Results include a .75% management fee but do not include taxes and transaction costs. Past or hypothetical results do not guarantee any future performance.

### Floating rate bond funds

- Hold adjustable rate bank loans made to below-investment grade borrowers
- Better collateralized than high yield bonds, so better recovery (>65%) in cases of default
- Interest income tracks the prime rate, currently 3.25%, which rises and falls parallel to the Fed Funds Rate. But these loans usually have a minimum interest rate of 4% even when prime is below that.
- No interest rate risk, but potentially significant credit-spread risk
- Beware of potential liquidity problems (as in 2008). Read your fund's prospectus regarding trading restrictions.

# Floating rate funds are less volatile than corporate high yield bond funds (2013-2020)



### **Example of Trading Floating Rate Funds**



### **Outlook for Below-Investment Grade Bonds**





### High yield bond spreads have widened recently



### Floating Rate Yields Are High

**Yield to Maturity** 



Source: S&P Global Market Intelligence, leveraged loan trends, accessed 4/24/2020 <a href="https://www.spglobal.com/marketintelligence/en/campaigns/leveraged-loan">https://www.spglobal.com/marketintelligence/en/campaigns/leveraged-loan</a>

Yield to Maturity

### This climate remains dangerous for floating rate funds



### High Yield Bond Defaults Started Picking Up in 2019



### Floating Rate Default Rates Have Started to Pick Up

Leveraged loan default rates - US (principal amount)



Leveraged loan default rates - US (principal amount)

Source: S&P Global Market Intelligence, leveraged loan trends, accessed 4/28/2020 <a href="https://www.spglobal.com/marketintelligence/en/campaigns/leveraged-loan">https://www.spglobal.com/marketintelligence/en/campaigns/leveraged-loan</a>

### Treasury markets are signaling caution



### Debt burdens have been climbing faster than profits



Yields are too low to protect against a surge in defaults

#### **RECOVERY RATES: HIGH YIELD BONDS**





Source: Lord Abbett, "An Update on Floating Rate Bank Loans Amid Recent Market Volatility" by Stephen Hillebrecht, 4/17/2020

### An Option Strategy When Investors are Fearful



### Introduction to options

### • Call option

- Gives the owner the *right* but not the obligation to buy 100 shares at a pre-agreed price (*strike price*) on or before an *expiration date*.
- Value of a call option rises when the underlying stock or ETF rises.
- Put option
  - Gives the owner the *right* but not the obligation to *sell* 100 shares at a pre-agreed price (*strike price*) on or before an *expiration date*.
  - Value of a put option rises when the underlying stock or ETF falls.
- For every option bought there must be someone writing options on the other side of the trade who must pay up if the buyer exercises the option.
- All else being equal, options are more expensive the longer until the expiration date and the more volatile traders expect the underlying stock or ETF to be.

### **Covered call position**

- Buy 100 shares of stock and sell one option on the stock.
- Gain is likely to occur, but is limited.
- Losses are relatively unlimited, but in a losing month writing a covered call always reduces losses compared to owning the shares alone.



## Put-Call parity

### Stock + dividends = call – put + cash

(cash earns risk-free interest)

As a result,

Stock – call = cash – put

In theory, covered call writing should return the same as cash-secured put writing.

### Total Returns 1990-2020



Index	Annual return	Worst Drawdown
Covered call (BXM)	7.5%	-40%
S&P 500 total return	9.3%	-55%
Put writing (PUT)	8.6%	-37%

### Implied volatility and VIX

- "Implied volatility" is the level of volatility that a stock must demonstrate between now and expiration to make its stock options fairly priced.
- VIX is an index that measures the average level of implied volatility (annualized) over the next 30 days built into S&P 500 Index options (puts and calls) expiring between 23 and 37 days from now. Its average value has been 19.5%.
- The higher the level of implied volatility, the more expensive the same level of option protection.
- Just because options are cheap (low VIX) doesn't mean that they are a bargain.

### Market returns under high versus low volatility

#### Annualized Returns 1990-2020 16.00% 13.70% 14.00% 12.20% BXM 11.60% 12.00% PUT 10.00% 7.80% S&P 500 8.00% 5.20% 6.00% 4.30% 4.00% 2.00% 0.00%

VIX >= 19

VIX < 19

# Take advantage of VIX to guide your strategy: write options when VIX > 19

### **Total Returns 1990-2020**



### These are not conservative strategies

#### Worst Drawdowns 1990-2020



### Poor risk management during market crashes



### Poor Risk Management in 2020



# There are other covered call indexes available from CBOE

- Dow Jones Industrial Average (BXD, 1997-2017)
- Russell 2000 Index (BXR, 2001-2017)
- Nasdaq 100 Index (BXN, 1995-2017)

Beware: Not all ETF covered call strategies are created equal.

### Volatility Ebbs and Flows







### Strategy for low volatility conditions

- Buy an S&P 500 Index Option (SPX, XSP or SPY)
  - Shoot for 5%-10% in the money, a year to expiration
- Use remaining capital to trade high yield bond funds
- Result: Approximately match gain of S&P 500 Index with less risk
- Example (based on close on 1/14/2020)—Instead of investing \$328,3000 in an S&P 500 Index fund or SPY (S&P 500 Index at 3283):
  - Buy 3100 call at 320 (183 points in the money, time value 137 points or 4.2% of notional value. Maximum risk of call option is 10.3% of notional value)
  - Use remaining capital (\$296,300) to trade high yield bond funds
  - Need to make 6.6% to match S&P 500 Index total return. (S&P 500 dividend yield of 1.8%)

### Summary—Strategies for Volatile, Low-Yield Markets

- Corporate high yield bond fund trading
- Floating rate bond fund trading
- Covered call or cash-secured put writing on S&P 500 index ETFs when options are expensive
- Market timing
- Next: Market outlook

### Election years are good on average



### **Re-election of incumbent party is important**



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#### The S&P 500's Price Return July 31 thru Oct. 31 Has Typically Been a Reliable Indicator of Presidential Party Reelection or Replacement

Election	Candidates		S&P 500	Correct Prediction?	
Year	Democrat	Republican	AugOct.	Reelection	Replacement
1944	FDR	Dewey	0.6	1	
1948	Truman	Dewey	4.4	1	
1952	Stevenson	Eisenhower	(3.5)		1
1956	Stevenson	Eisenhower	(7.7)		0
1960	Kennedy	Nixon	(3.8)		1
1964	Johnson	Goldwater	2.0	1	
1968	Humphrey	Nixon	5.8	0	
1972	McGovern	Nixon	3.9	1	
1976	Carter	Ford	(0.5)		1
1980	Carter	Reagan	4.8	0	
1984	Mondale	Reagan	10.2	1	
1988	Dukakis	Bush	2.6	1	
1992	Clinton	Bush	(1.3)		1
1996	Clinton	Dole	10.2	1	
2000	Gore	Bush	(0.1)		1
2004	Kerry	Bush	2.6	1	
2008	Obama	McCain	(23.6)		1
2012	Obama	Romney	2.4	1	
			Success Rate	82%	86%

Source: S&P Global Market Intelligence, S&P Dow Jones Indices. Past performance is no guarantee of future results. Data: 12/31/45-10/31/12.

http://www.bloomberg.com/news/articles/2016-09-30/this-chart-predictstrump-will-win-unless-the-s-p-rallies-in-october

### Stocks are priced for perfection



#### - Corporate Profits After Tax (without IVA and CCAdj)/Gross Domestic Product

### **Business** still has it good.



### Epidemics and the stock market 1981-2019



		6-Month	12-Month
Epidemic	Date	% Change	% Change
HIV/AIDS	June 1981	-6.6%	-16.5%
Pneumonic Plague	Sept 1994	8.2%	26.3%
SARS	April 2003	14.6%	20.8%
Avian (Bird) Flu	June 2006	11.7%	18.4%
Dengue Fever	Sept 2006	6.4%	14.3%
H1N1 (Swine Flu)	April 2009	18.7%	36.0%
Cholera	Nov 2010	13.9%	5.6%
MERS	May 2013	10.7%	18.0%
Ebola	March 2014	5.3%	10.4%
Measles	Dec 2014	0.2%	-0.7%
Zika	Jan 2016	12.0%	17.5%
Measles	June 2019	9.8%	N/A*
Average Price	e Return	8.8%	13.6%

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CO.D.C.00

#### Observations

- 6-month change of the S&P 500 Index following the start of the epidemic was positive in 11 of the 12 cases, with an average price return of 8.8%.
- 12-month change of the S&P 500 Index following the start of the epidemic was positive in 9 of the 11 cases\*, with an average price return of 13.6%.

#### Source: First Trust

### Sharp Corrections Usually Retest the Lows: 2011





### Sharp Corrections Usually Retest the Lows: 2018



### Books by Marvin Appel

### (published by Prentice-Hall)





"The authors have created a simple, systematic plan that gives investors a long-term edge with minimal effort and reduced risk. They've done all the work for you, and it's rewarding and easy to follow."

-Bob Kargenian, President, TABR Capital Management

### Beating the Market, 3 Months at a Time



A Quarterly Asset Allocation Strategy for Foreign-Equity ETFs

#### FT Press 2008

### For more information

- Money management by Signalert Asset Management: www.signalert.com
- Investment newsletter: Systems and Forecasts
  - High yield bond timing signals
  - US equity timing signal
  - Relative strength between US and foreign equity timing signals
- Free newsletter trial (Sign up at www.systemsandforecasts.com)
- Copy of these slides:

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### Disclaimers

- Past results do not guarantee any future performance.
- Results are based on data and calculations believed reliable, but are not audited or guaranteed.
- Results are hypothetical. They are not the experience of any actual client.
- Transaction costs, trading delays, taxes and other expenses are not accounted for.
- The strategies presented here may not be suitable for every investor.
- Index data from <u>www.msci.com</u>, <u>www.cboe.com</u> and from Steele Mutual Fund Expert.