

High Income In Turbulent Times

Marvin Appel, M.D., Ph.D.

Signalert Asset Management LLC

Great Neck, NY

Mappel@signalert.com

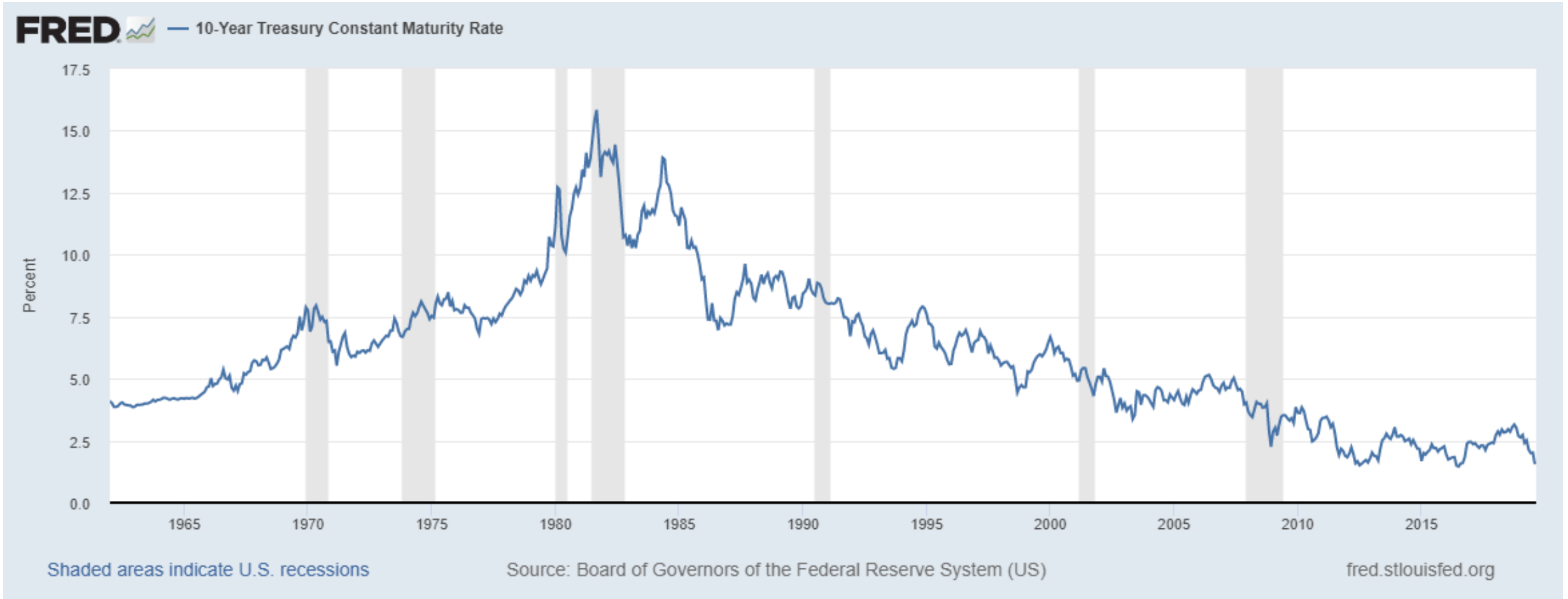
516-829-6444

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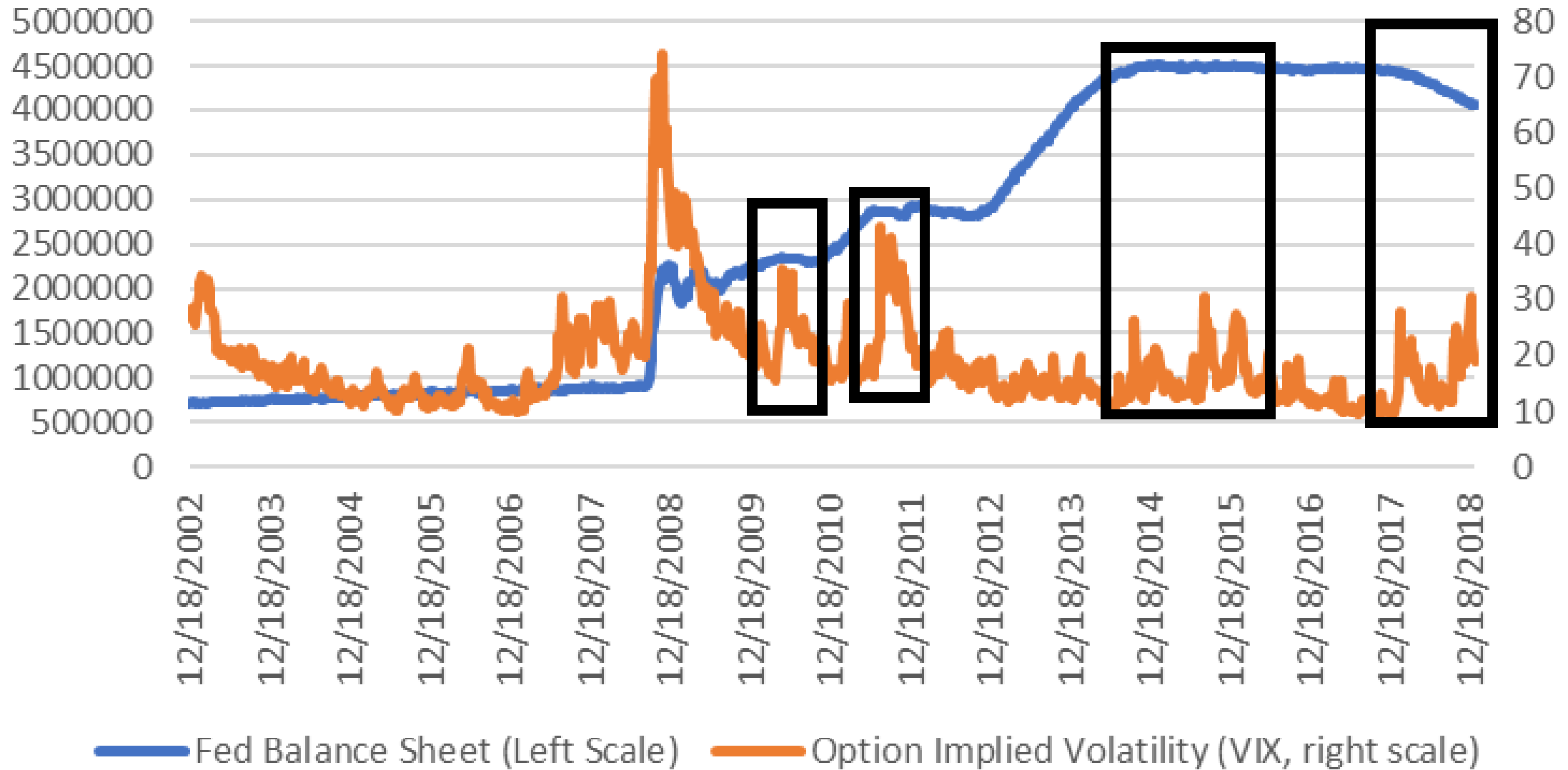
Outline

- Investment landscape: low interest rates, high volatility
- Fixed income investing to take advantage of higher yields
 - High yield bond fund trading
 - Floating rate funds
 - Floating rate preferred stocks (AGNCN, CIM-B)
- Covered call writing and cash-secured put writing
- Equity market outlook--Gains will be hard to achieve given valuations.
- Emerging markets are becoming attractive relative to the U.S.

Interest Rates Remain Near Multi-Decade Lows



Fed Tightening Raises Volatility 2002-2019



High yield (junk) bond fund trading



High yield bonds have been competitive with equities 1999-2019

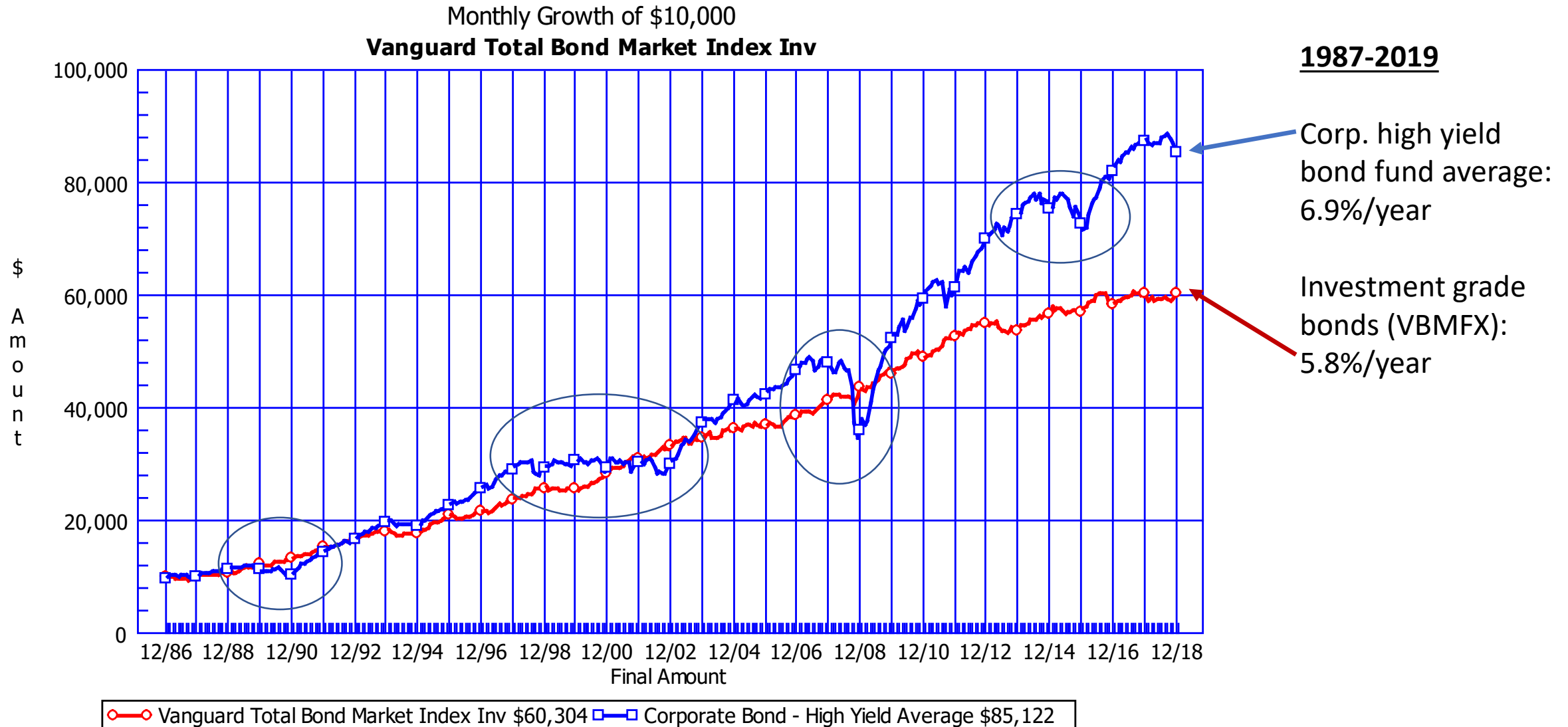


Merrill Lynch U.S. High Yield Master II 6.6%/year, 35% max drawdown

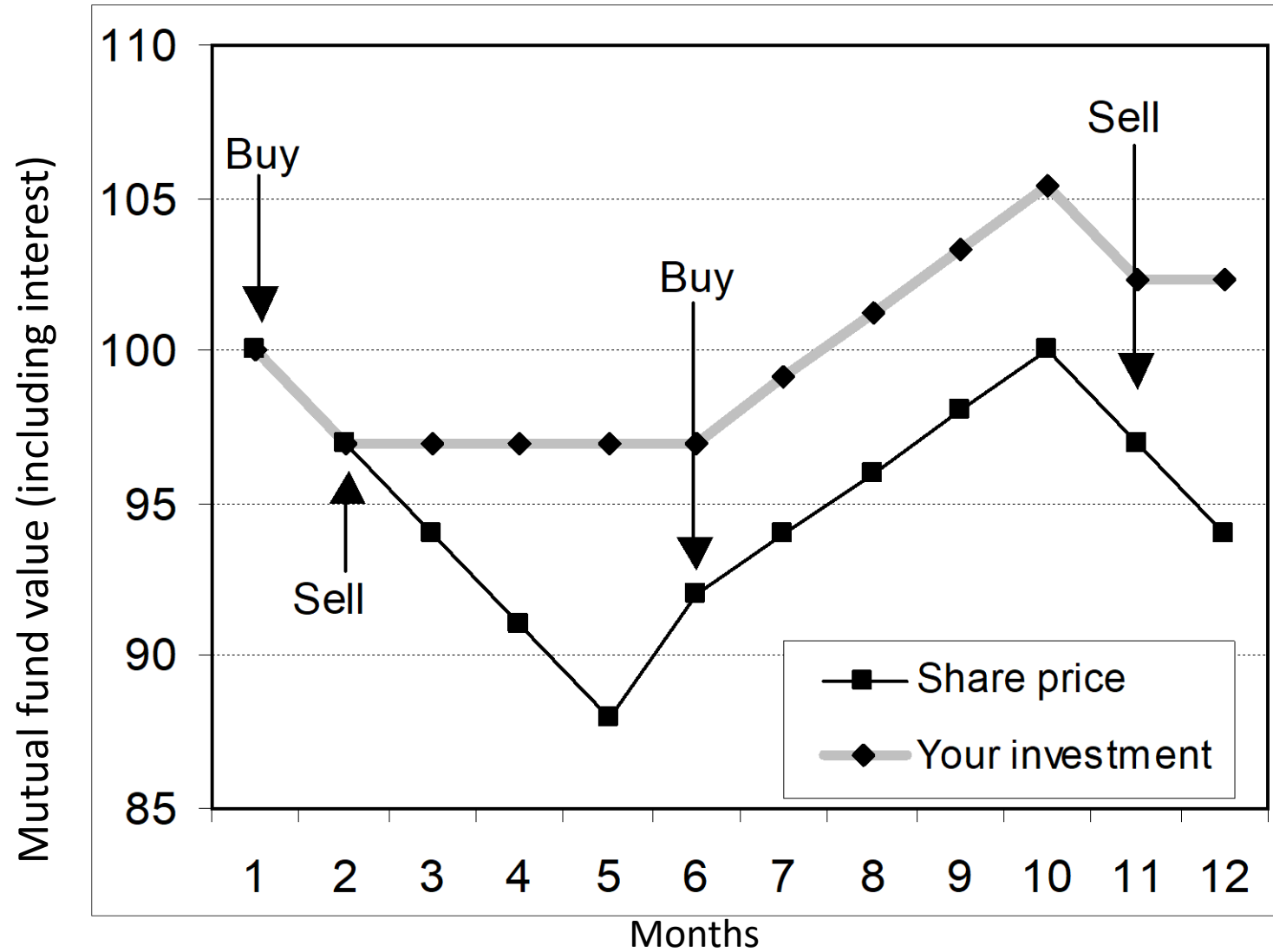
Consumer Staples Sector SPDR (XLP) 5.8%/year, 36% max drawdown

S&P 500 SPDR (SPY) 5.9%/year, 55% max drawdown

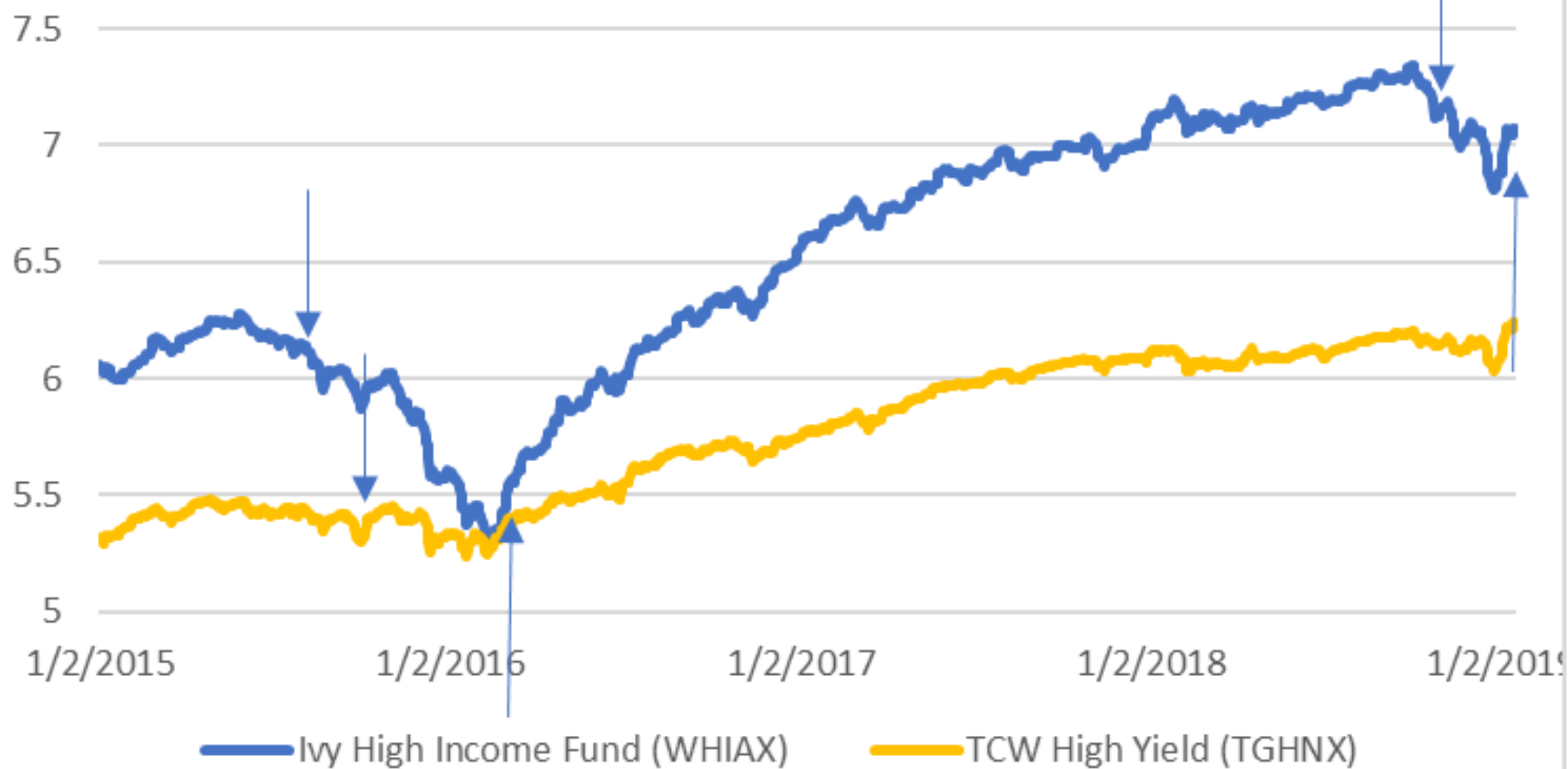
Opportunity in Corporate High Yield Bond Funds



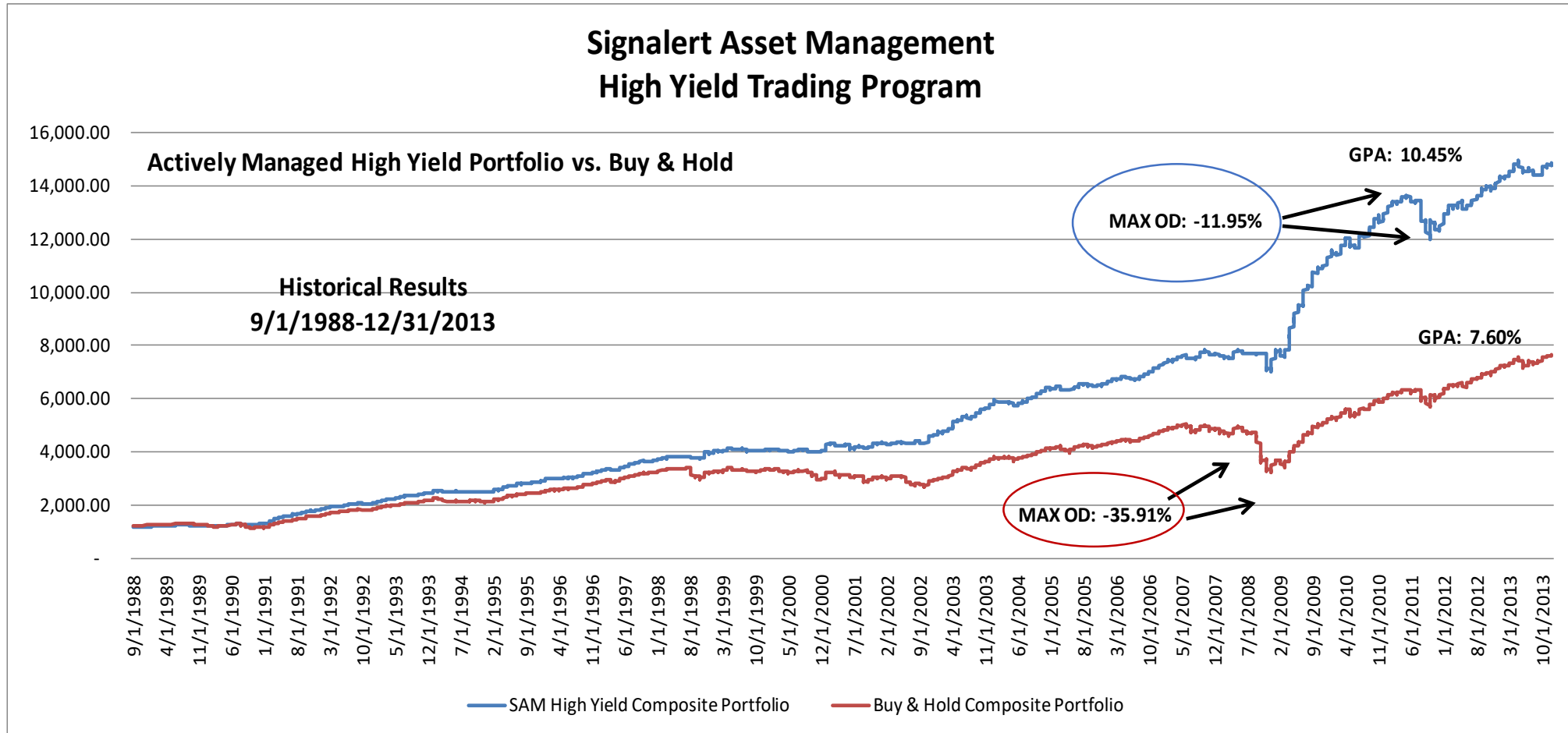
3% Buy and sell stops



Examples of High Yield Trading 2015-2019

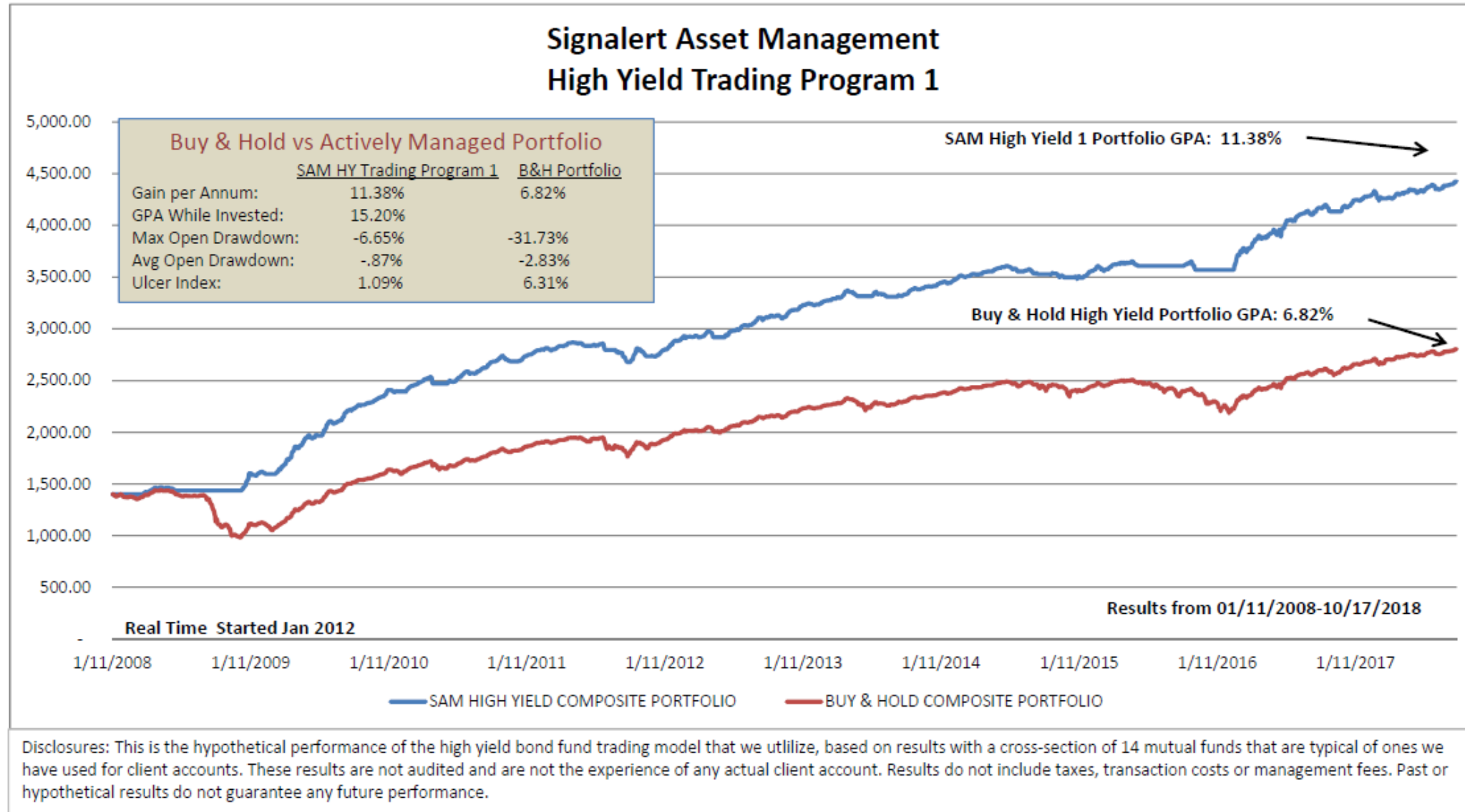


Trading High Yield Bond Funds



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.

High yield bond fund trading 2008-2018



High yield bond spreads are still attractive

FRED — ICE BofAML US High Yield Master II Option-Adjusted Spread



Shaded areas indicate U.S. recessions

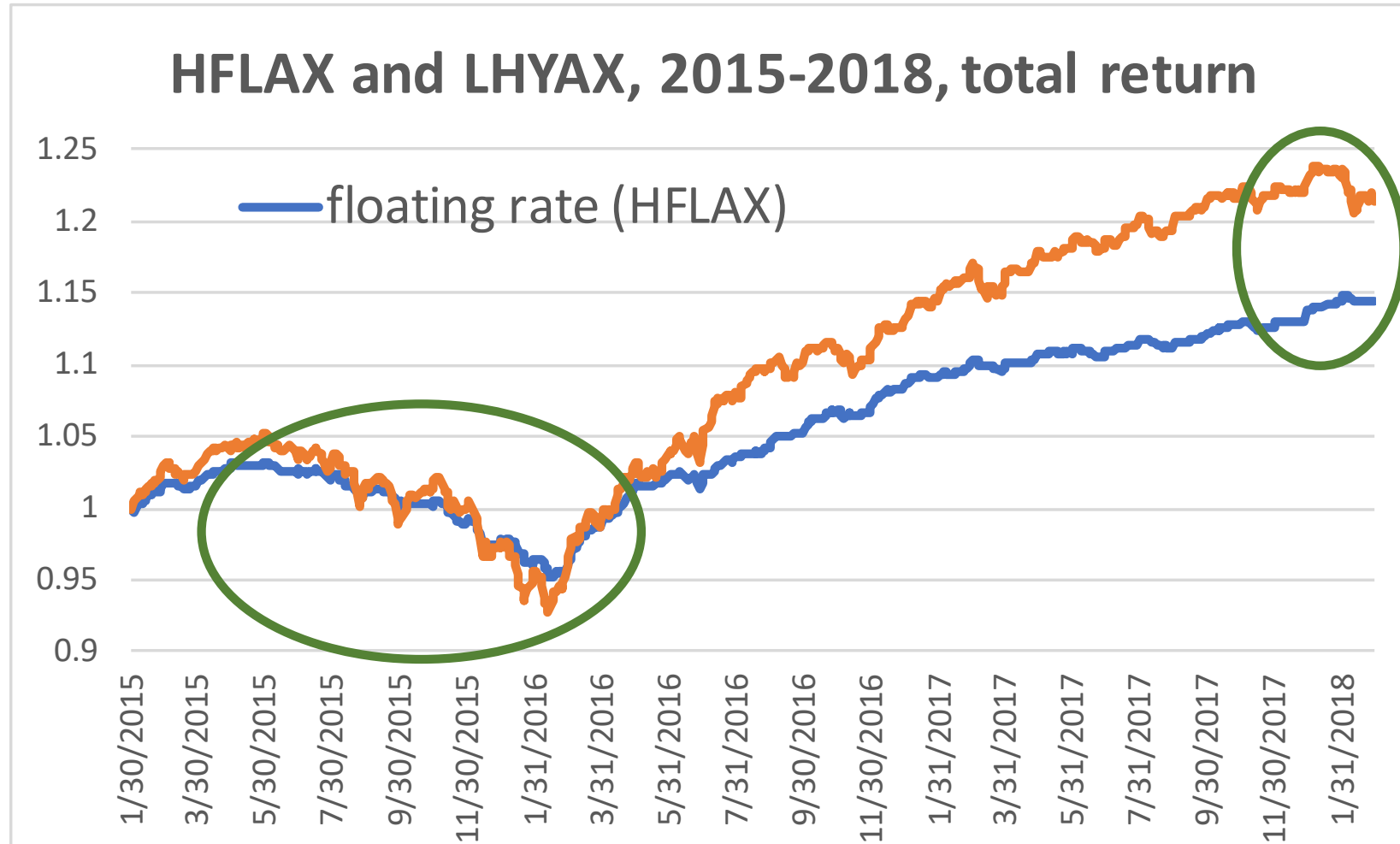
Source: ICE Benchmark Administration Limited (IBA)

fred.stlouisfed.org

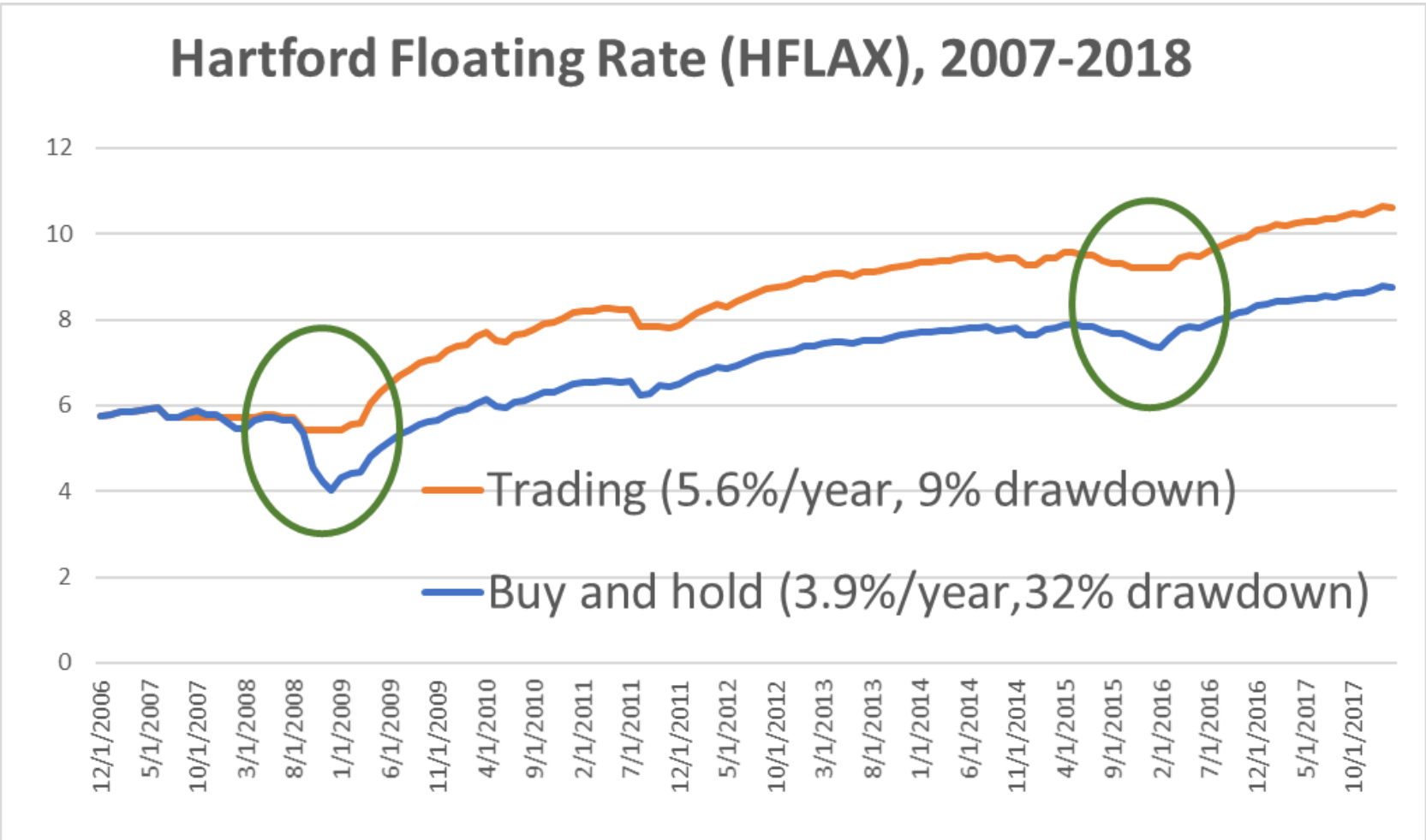
Floating rate bond funds

- Hold adjustable rate bank loans made to below-investment grade borrowers
- Better collateralized than high yield bonds, so better recovery (>80%) in cases of default
- Interest income tracks the prime rate, currently 5%, which rises and falls parallel to the Fed Funds Rate
- 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.

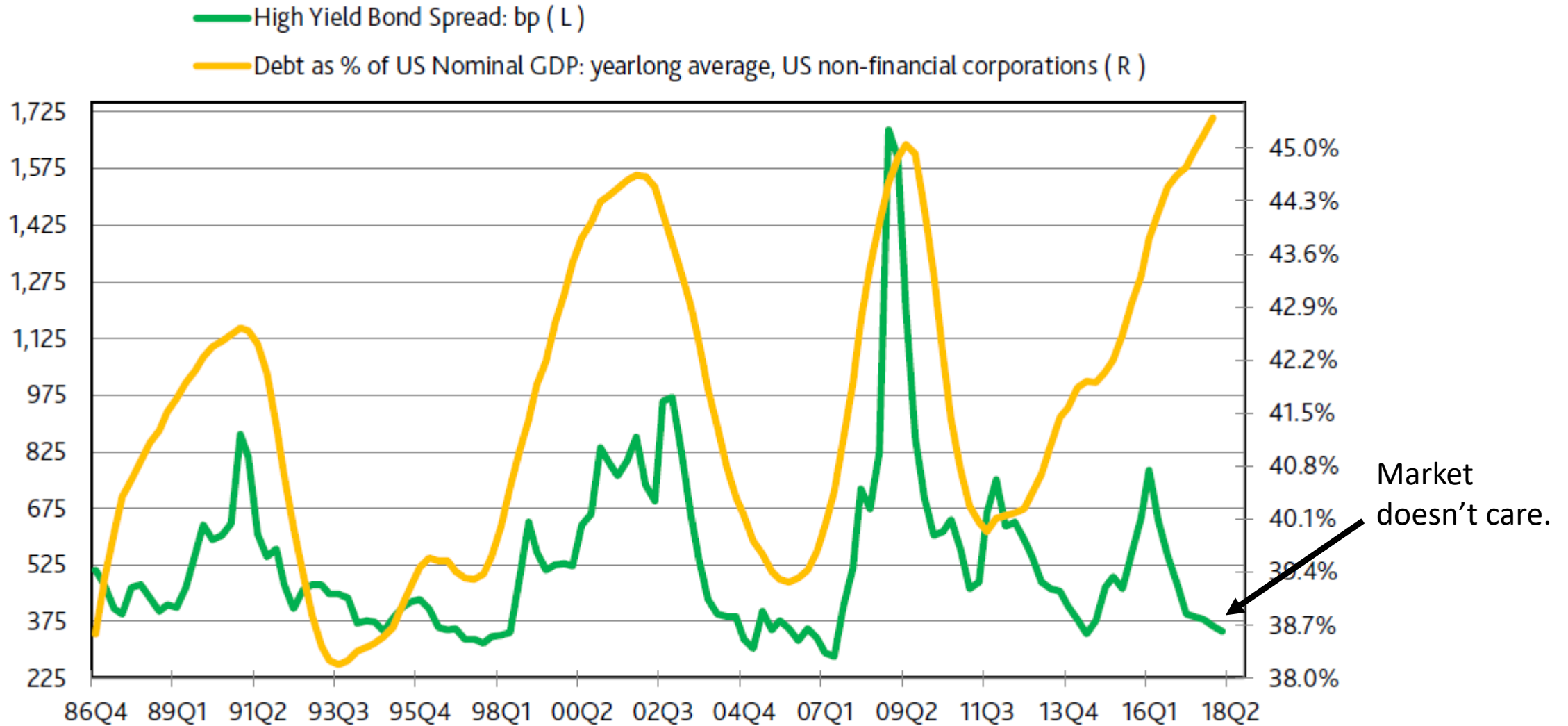
Floating rate funds are less volatile than corporate high yield bond funds



Example of Trading Floating Rate Funds

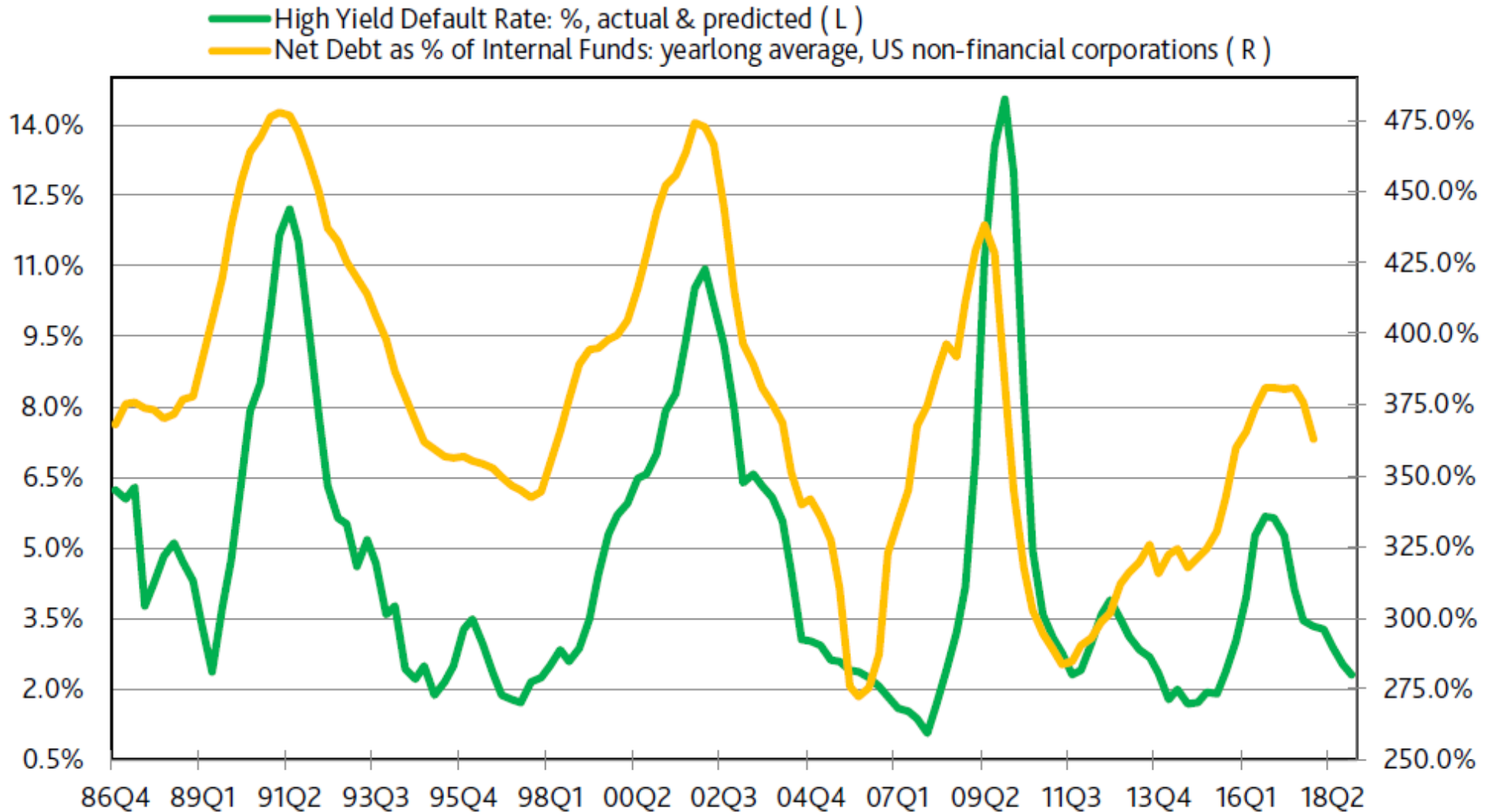


Corporate Debt is at a Record High vs. GDP



Source: Moody's Capital Markets Research, "Default Rate Defies Record Ratio of Corp. Debt to GDP"

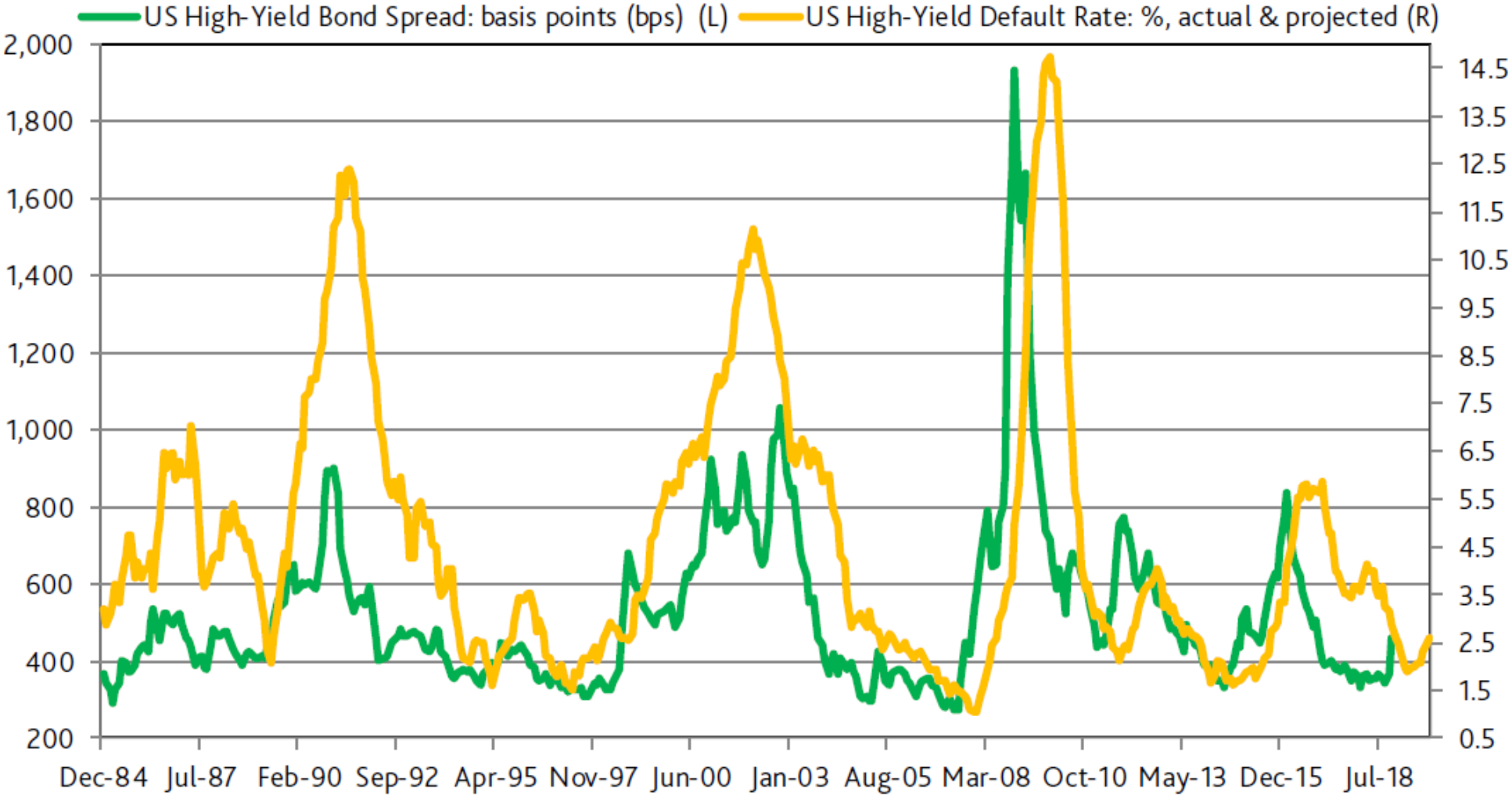
Good news: debt burdens are manageable.



Source: Moody's Capital Markets Research, "Default Rate Defies Record Ratio of Corp. Debt to GDP"

High Yield Bond Default Risk Remains Low

sources: Moody's Investors Service, Moody's Analytics



Source: Moody's Analytics Weekly Market Outlook 12/13/18

Treasury markets are signaling slowdown fears

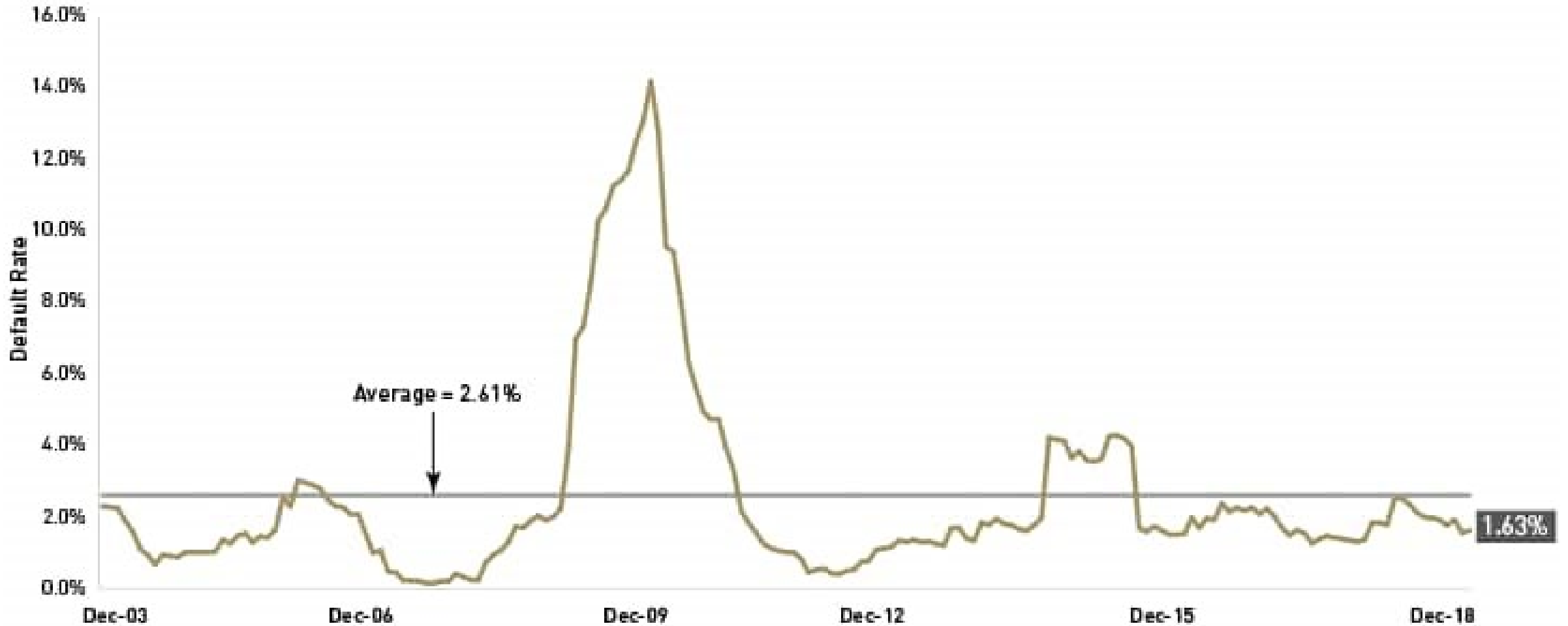


Yields on floating rate loans are at multi-year highs



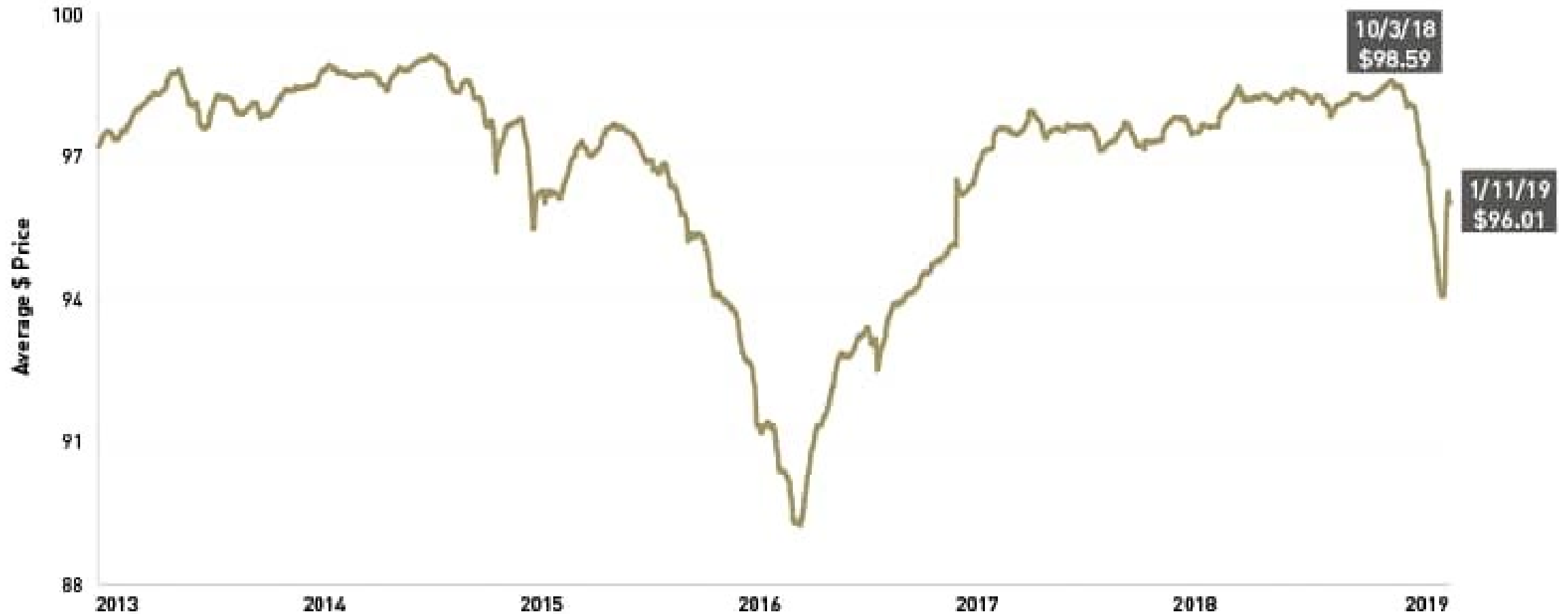
Source: <https://www.lordabbett.com/en/perspectives/marketview/bank-loans-whats-state-floating-rate.html>, accessed 1/17/19

Defaults on floating rates remain low



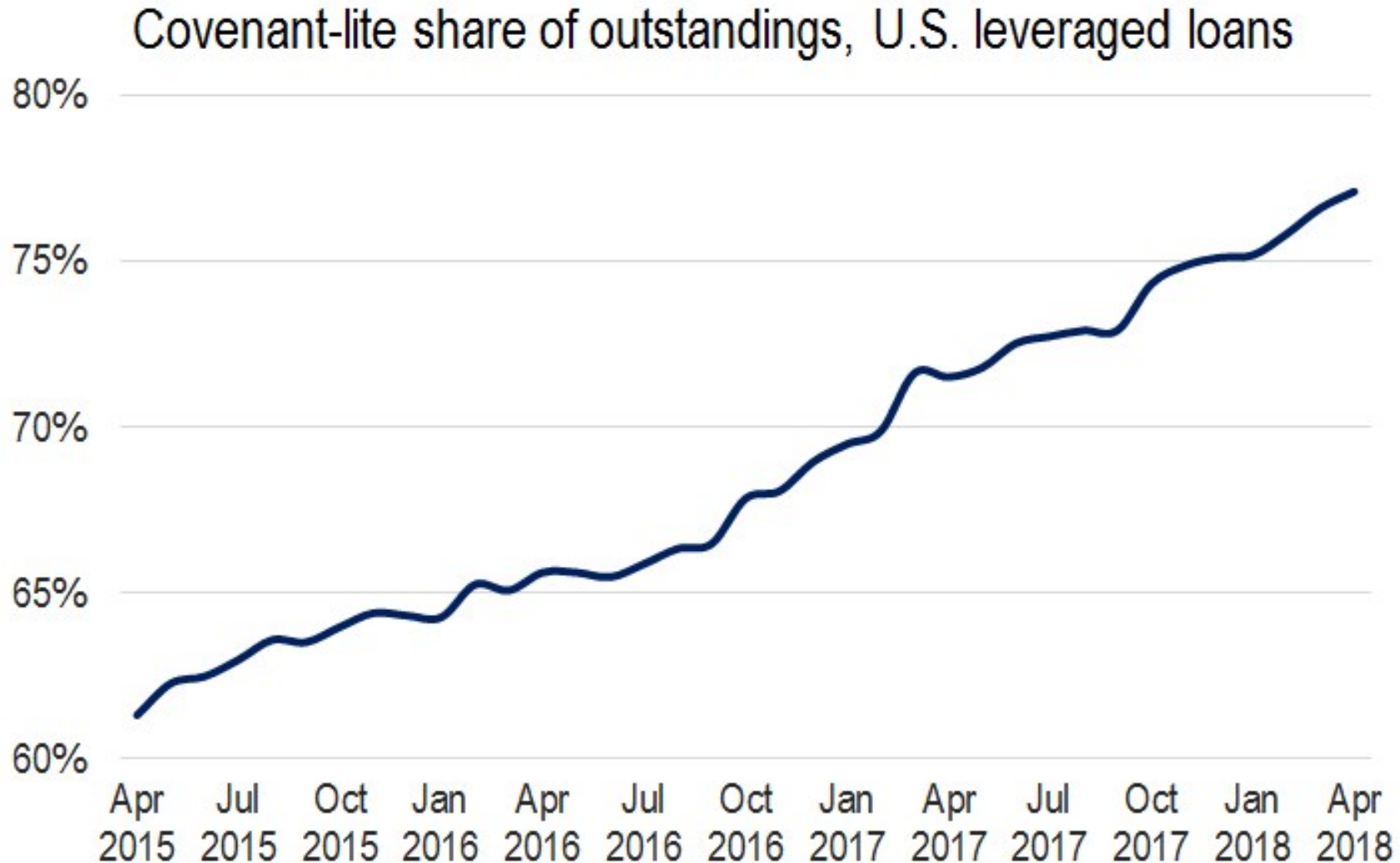
Source: <https://www.lordabbett.com/en/perspectives/marketview/bank-loans-whats-state-floating-rate.html>, accessed 1/17/19

Prices remain off their recent peaks



Source: <https://www.lordabbett.com/en/perspectives/marketview/bank-loans-whats-state-floating-rate.html>, accessed 1/17/19

The next decline will be dangerous



Source: LCD, an offering of S&P Global Market Intelligence

Recommended preferred stock: AGNCN

- Mortgage REIT—All agency mortgages
- 7% coupon until 10/15/2022
- Then floating coupon LIBOR + 5.111%
- Callable starting 10/15/2022
- Cumulative
- Earnings would have to fall by more than 90% before threatening the preferred dividend (AGNC, the common share, yields 11% which appears sustainable under current interest rate conditions).
- Recommended below \$26/share

Floating rate preferred stock for aggressive investors: CIM-B

- Chimera Investments: mostly private-label mortgages (credit risk)
- 8% coupon until 3/30/2024
- Then LIBOR + 5.791%
- Callable starting 3/30/2024
- Cumulative
- Earnings would have to fall by more than 90% before threatening the preferred dividend. (The common dividend is 11.8% and appears sustainable under current interest rate conditions.)
- CIM-A with a fixed 8% coupon is also recommended (callable 10/30/2021)
- Both CIM-A and CIM-B recommended below \$26/share for aggressive income investors

Options strategies for Quantitative Tightening

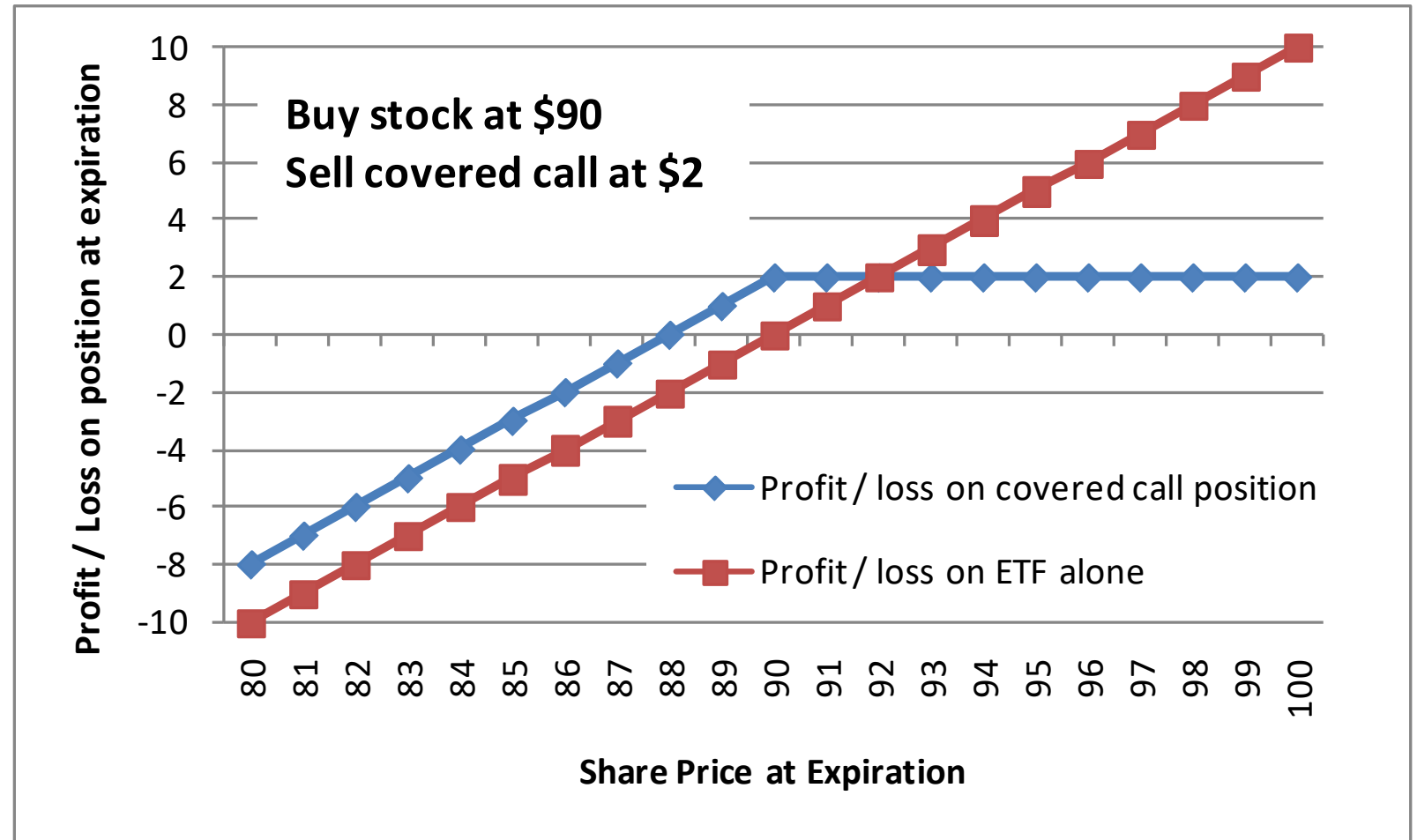


Introduction to options

- 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

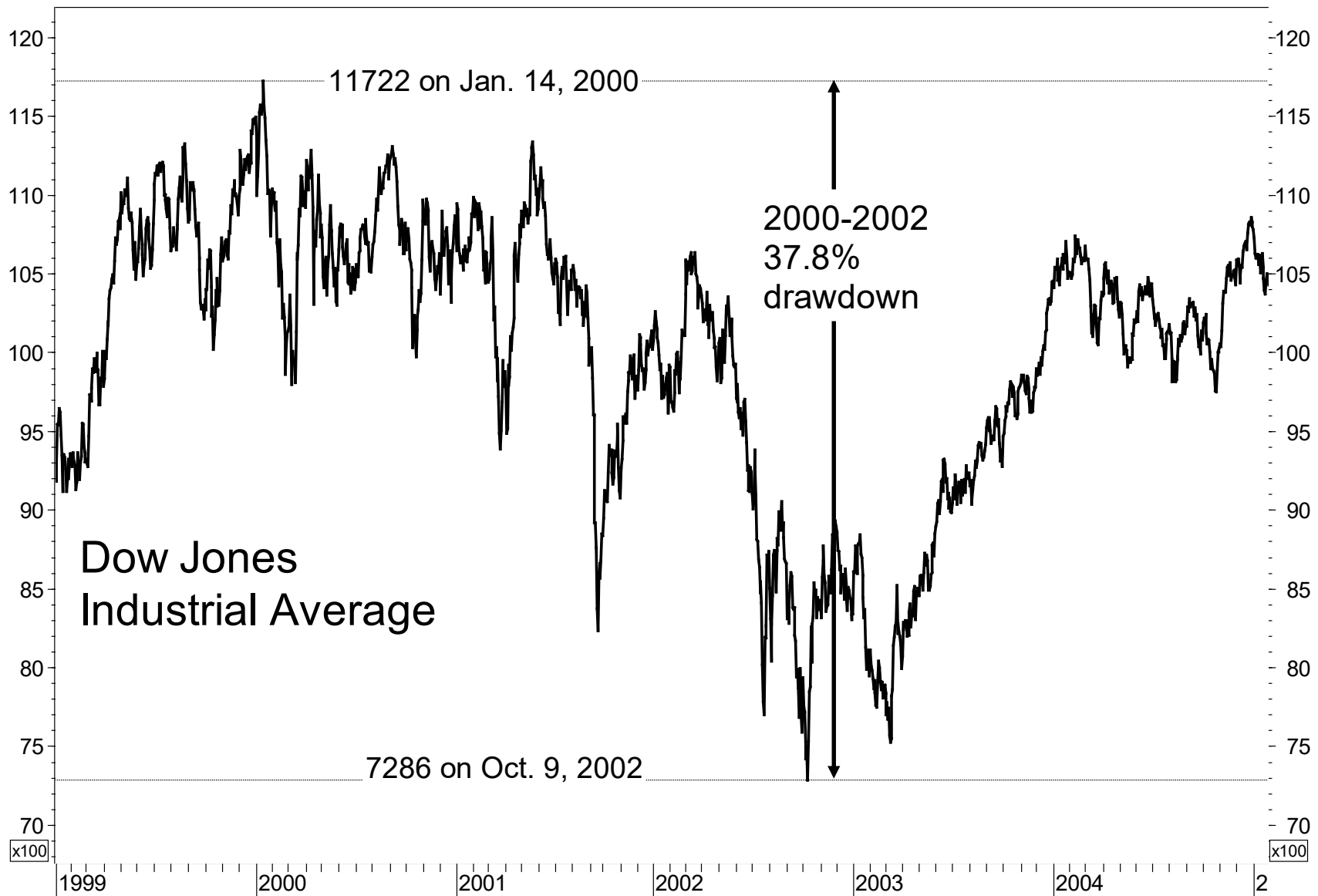
(cash earns risk-free interest)

As a result,

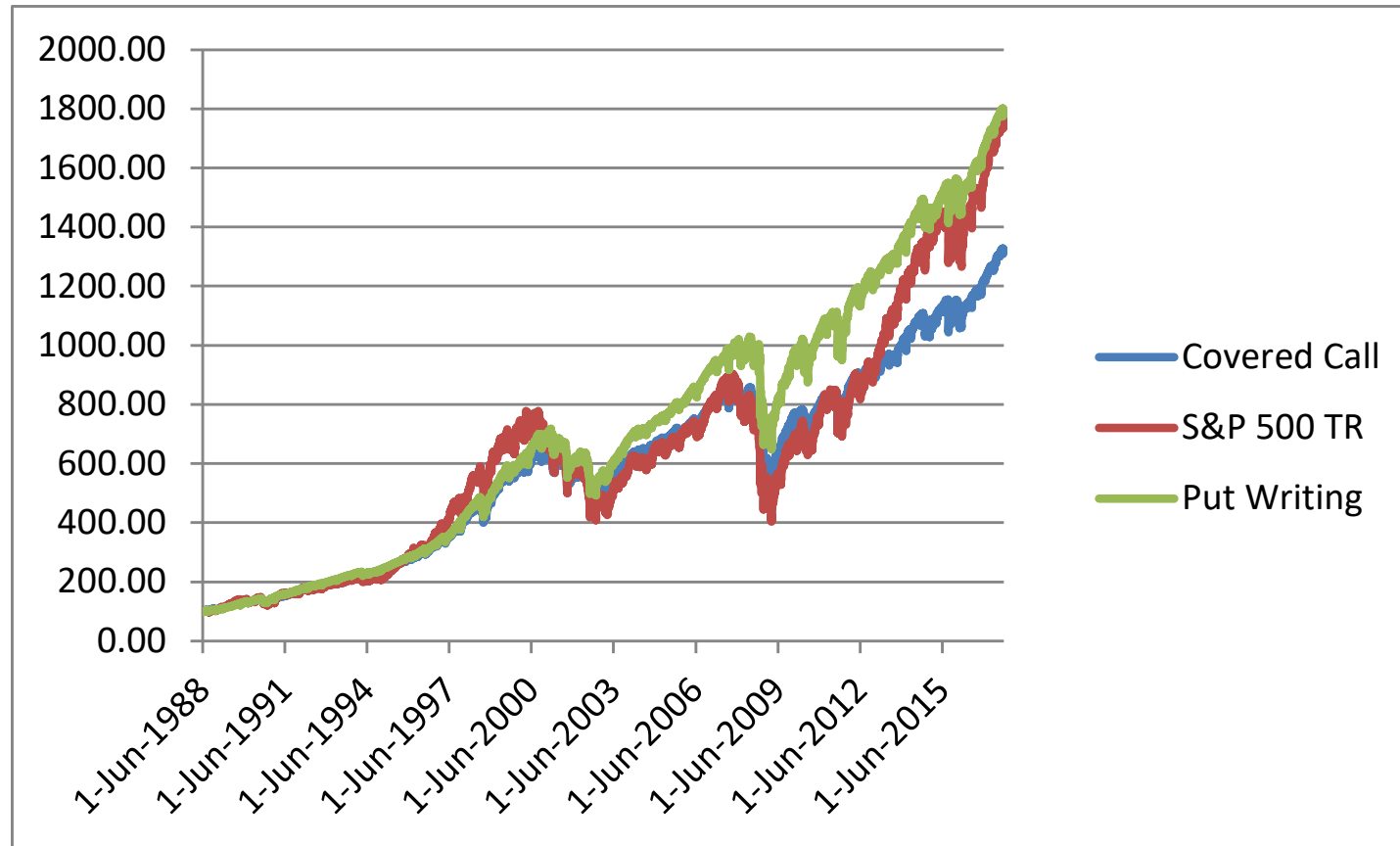
Stock – call = cash – put

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

Risk measure: worst drawdown



Total Returns 1988-2017

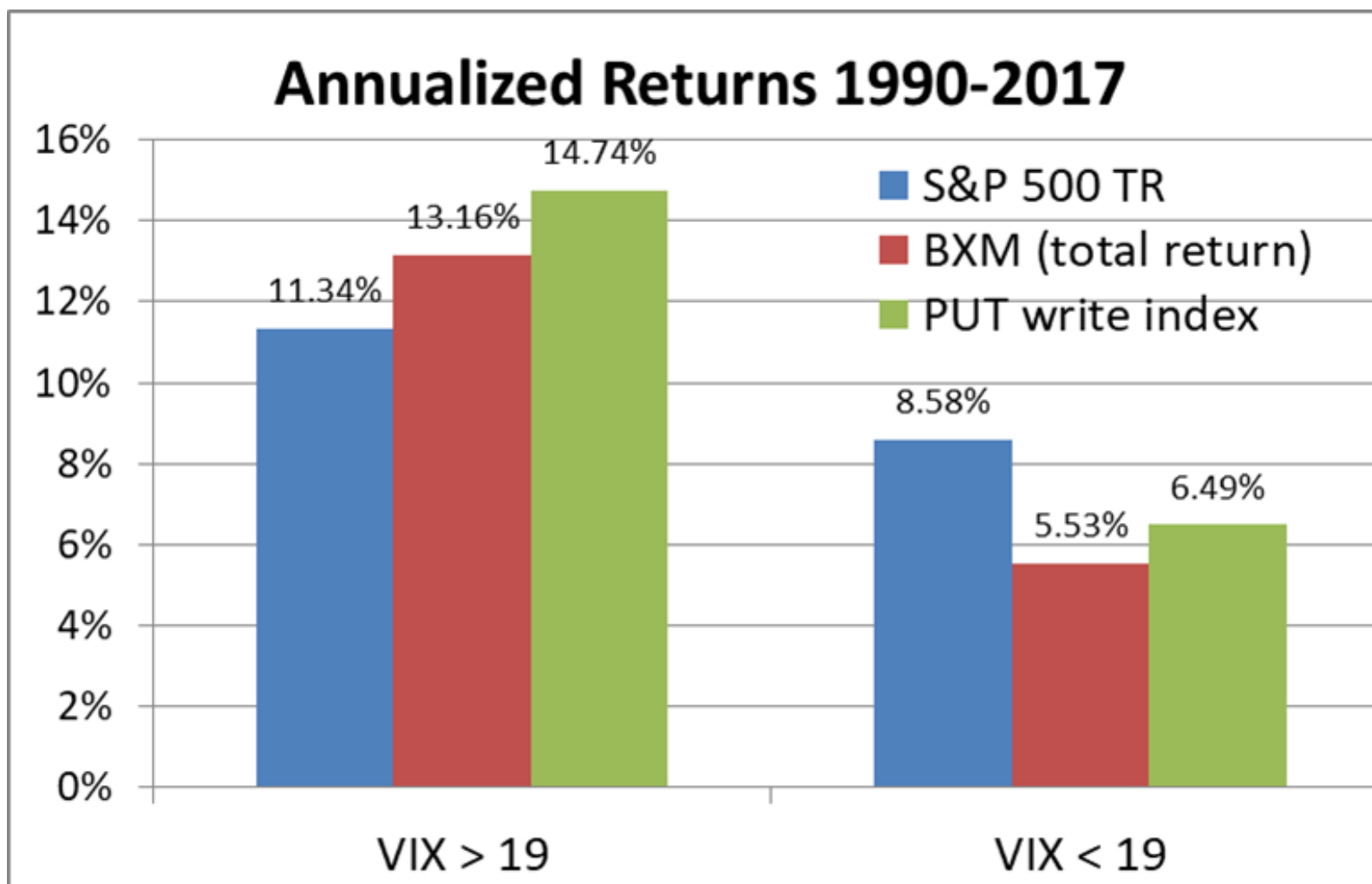


Index	Annual return	Worst Drawdown
Covered call (BXM)	9.2%	-40%
S&P 500 total return	10.3%	-55%
Put writing (PUT)	10.4%	-37%

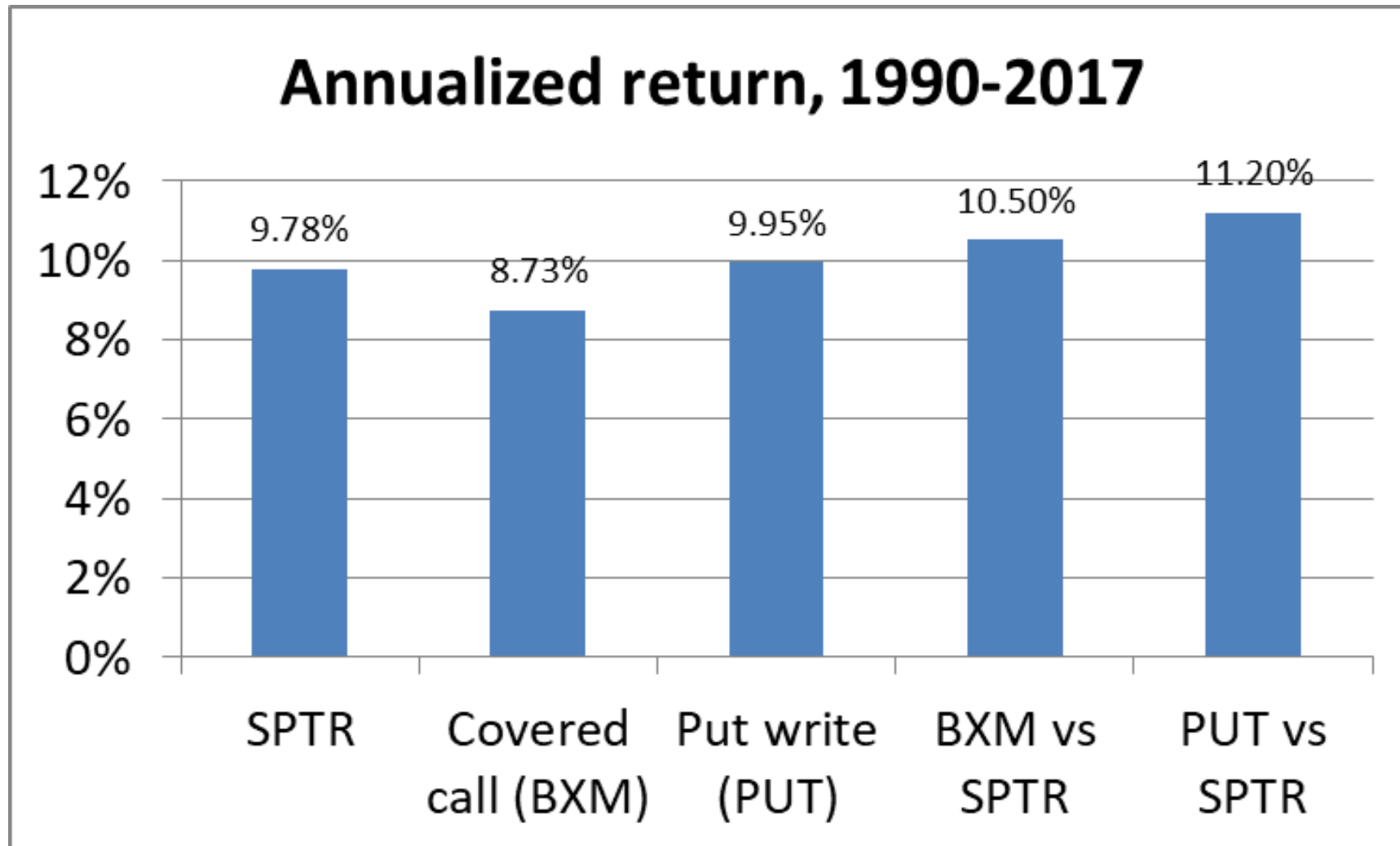
Implied volatility and VIX

- “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.**

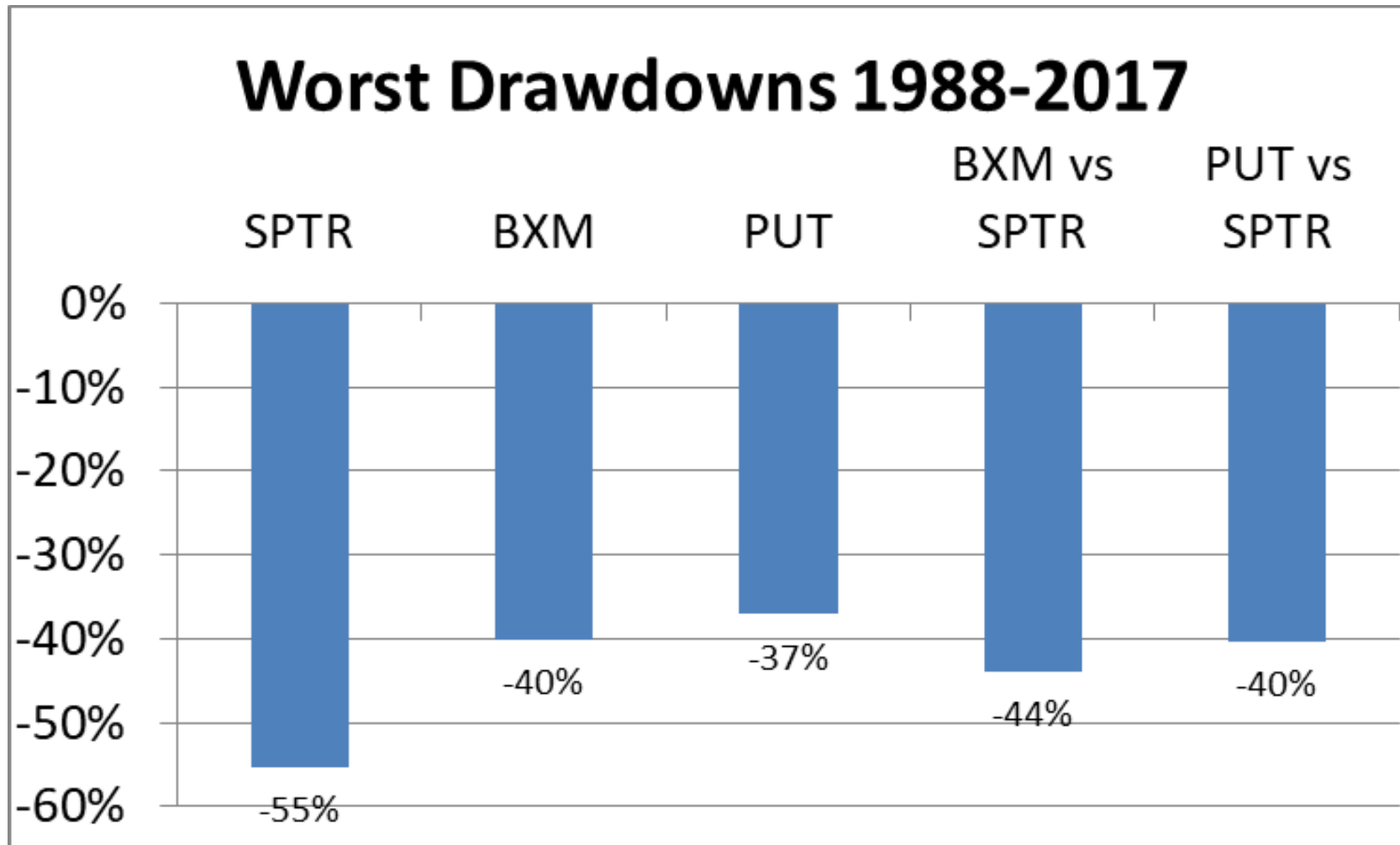
Market returns under high versus low volatility



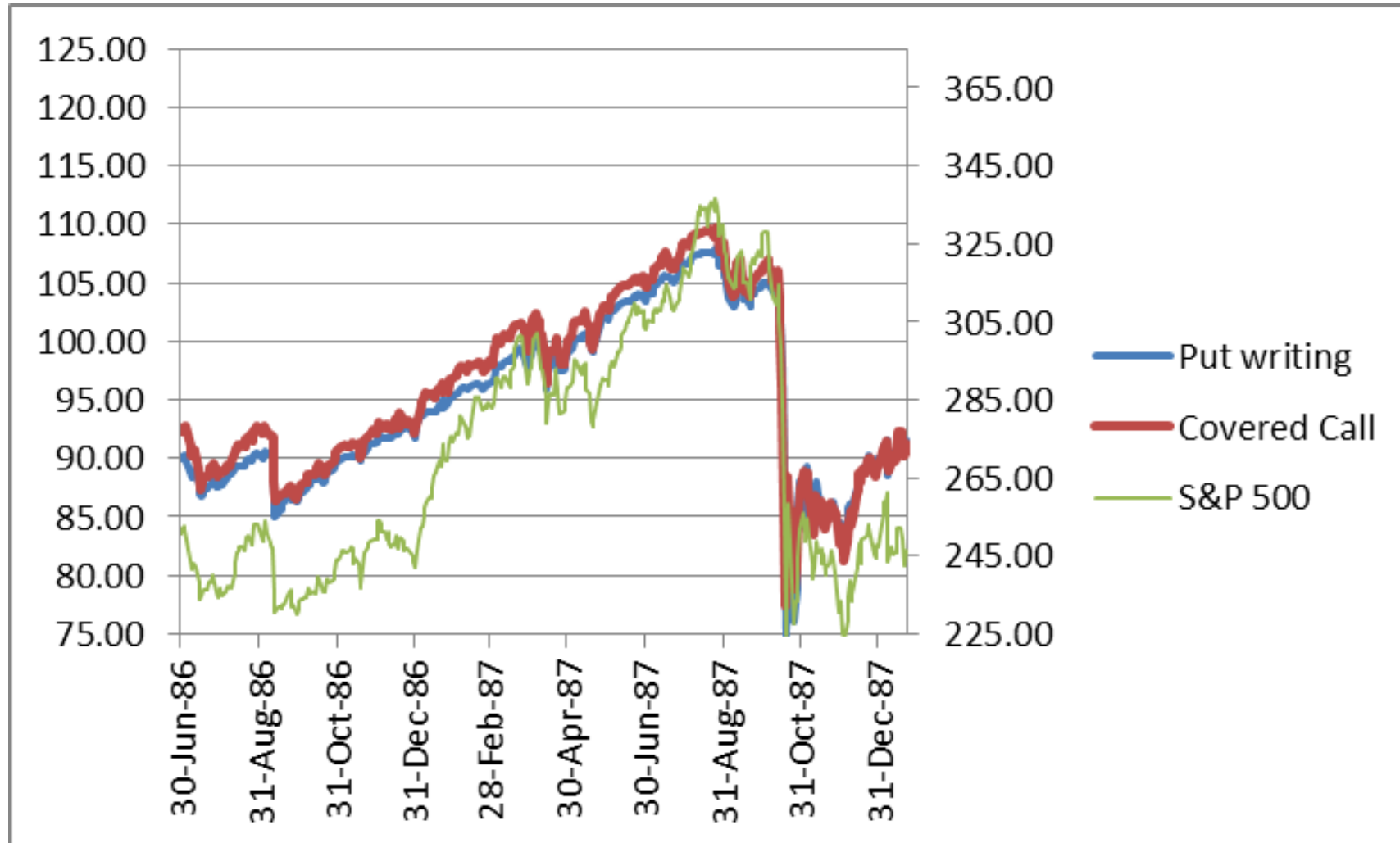
Take advantage of VIX to guide your strategy: write options when VIX > 19



These are not conservative strategies



Poor risk management during market crashes

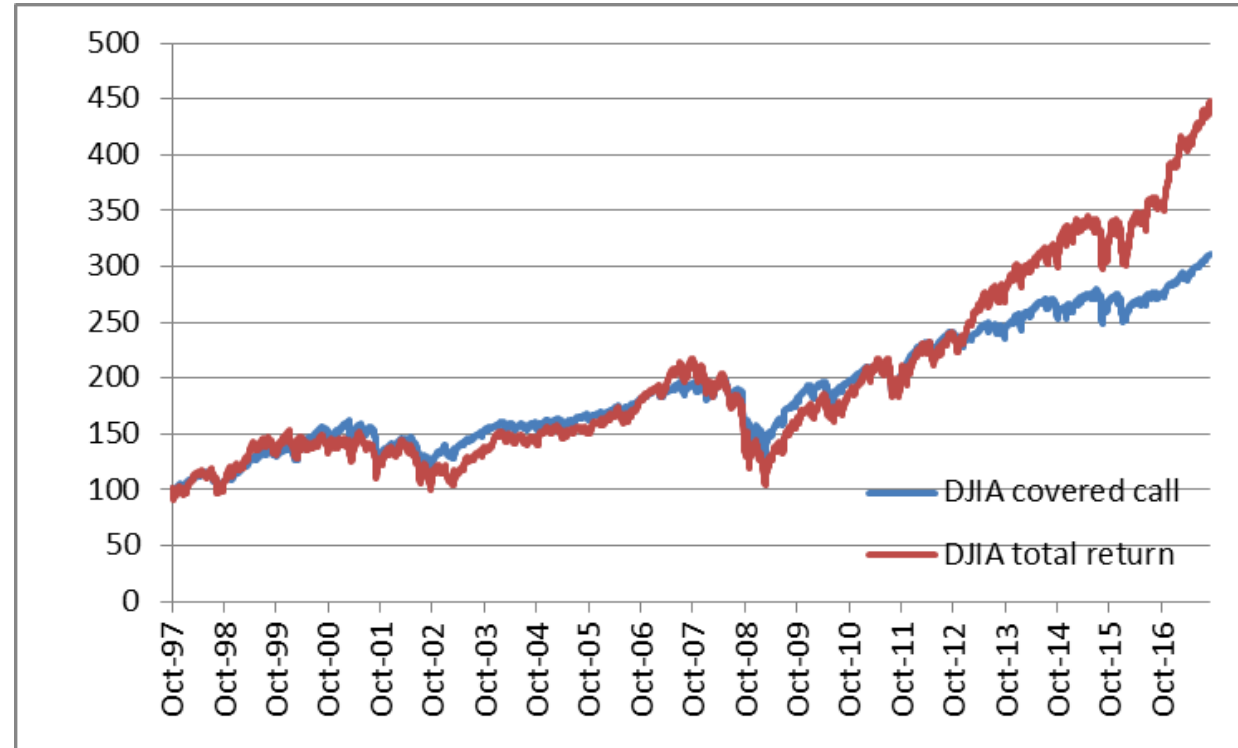


There are other covered call indexes available from CBOE

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

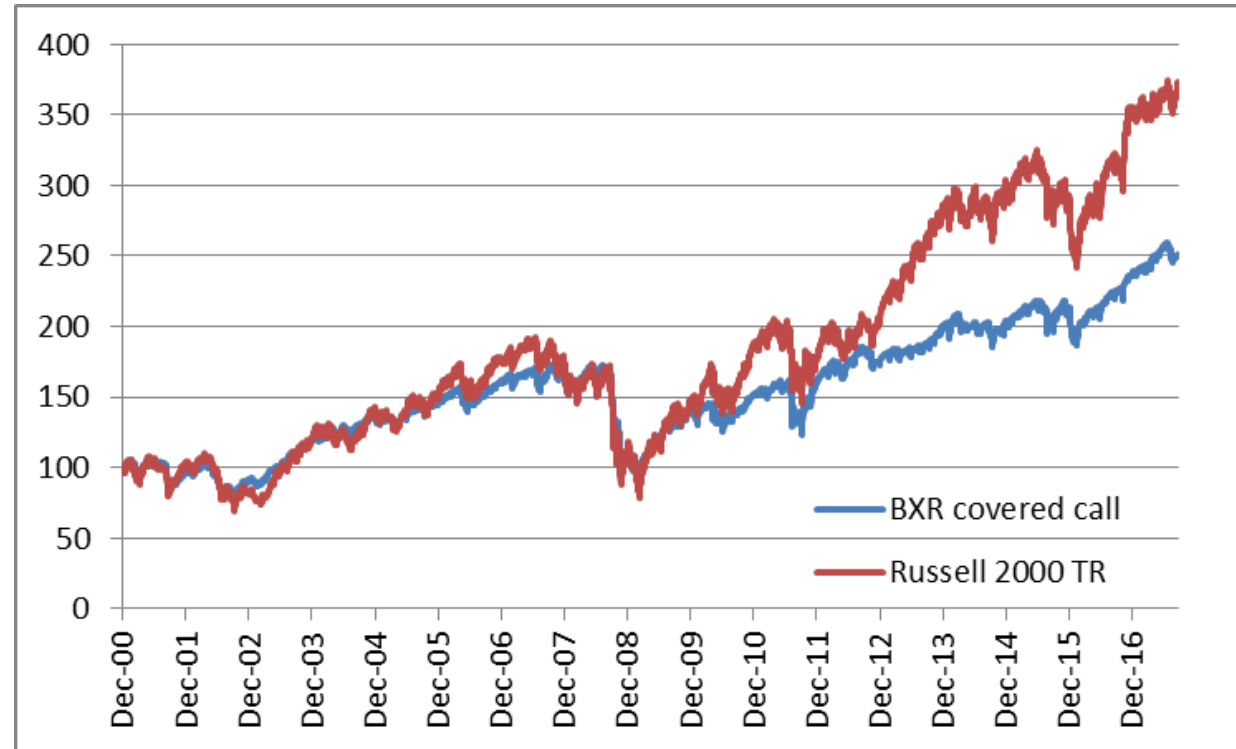
Beware: Not all ETF covered call strategies are created equal.

Covered calls and DJIA, 1997-2017



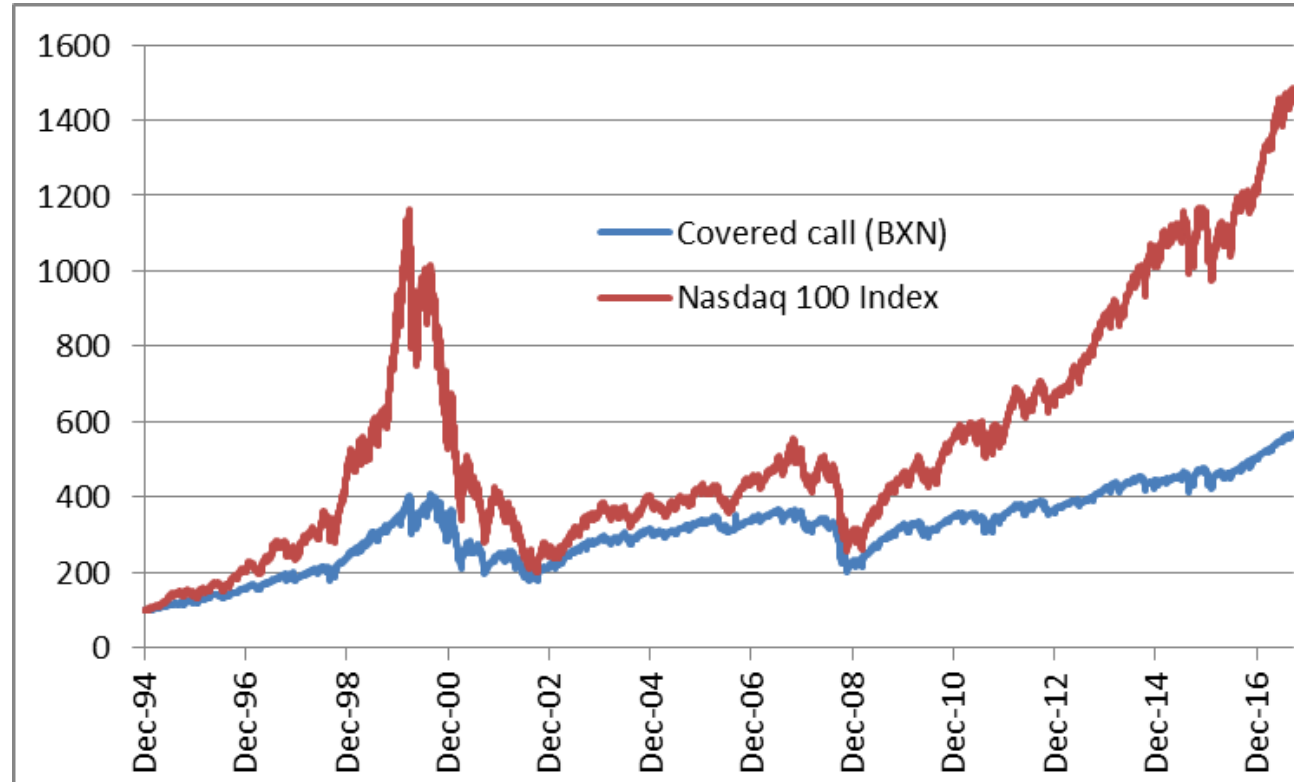
Index (total return)	Annual Return	Worst Drawdown
DJIA	7.8%	-52%
BXD	5.9%	-36%
S&P 500	6.9%	-55%
BXM	6.3%	-40%

Covered calls and Russell 2000



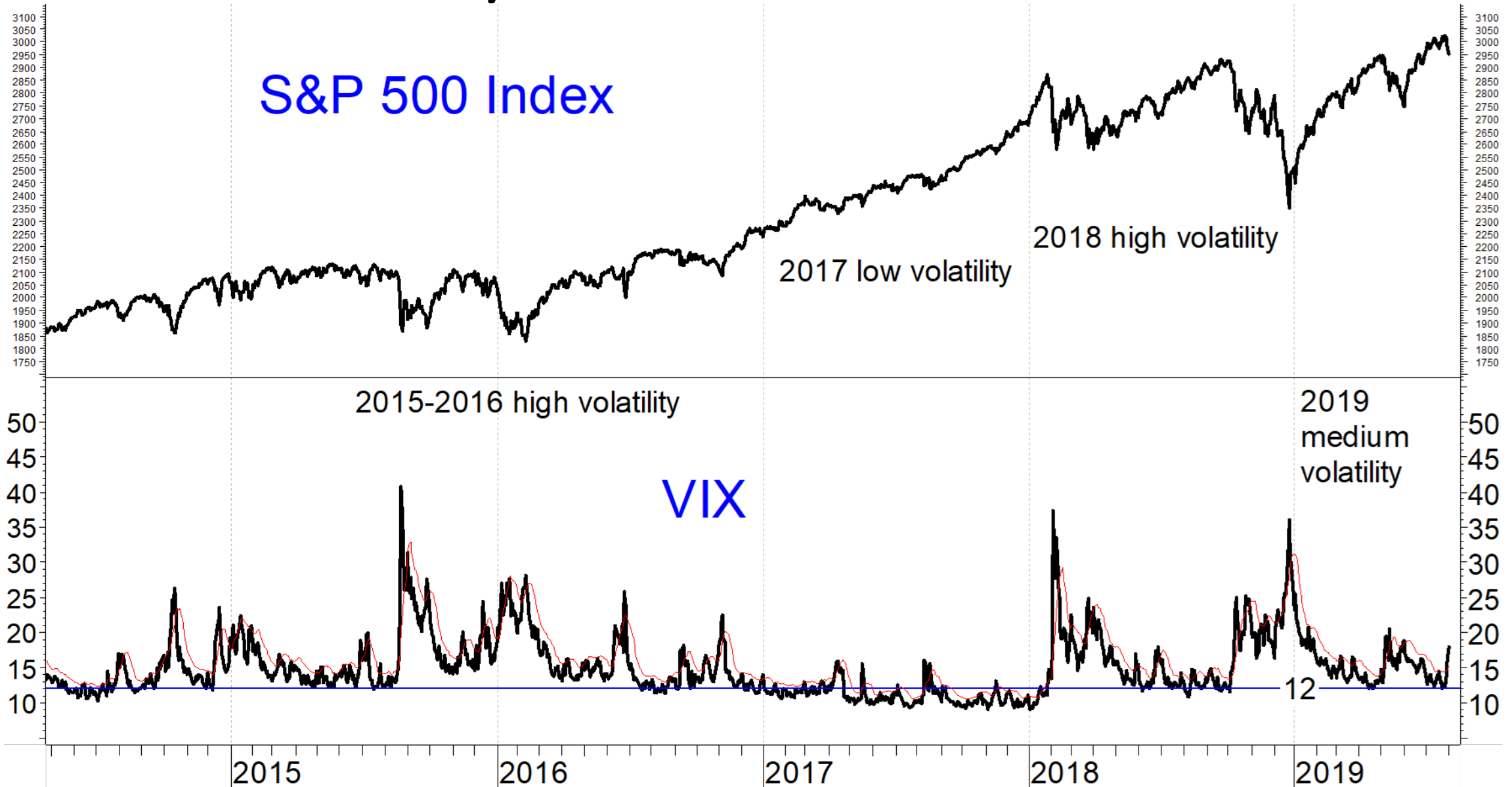
Index (total return)	Annual Return	Worst Drawdown
Russell 2000 Index	8.2%	-59%
BXR	5.7%	-51%
S&P 500	5.9%	-55%
BXM	4.5%	-40%

Covered calls and Nasdaq 100

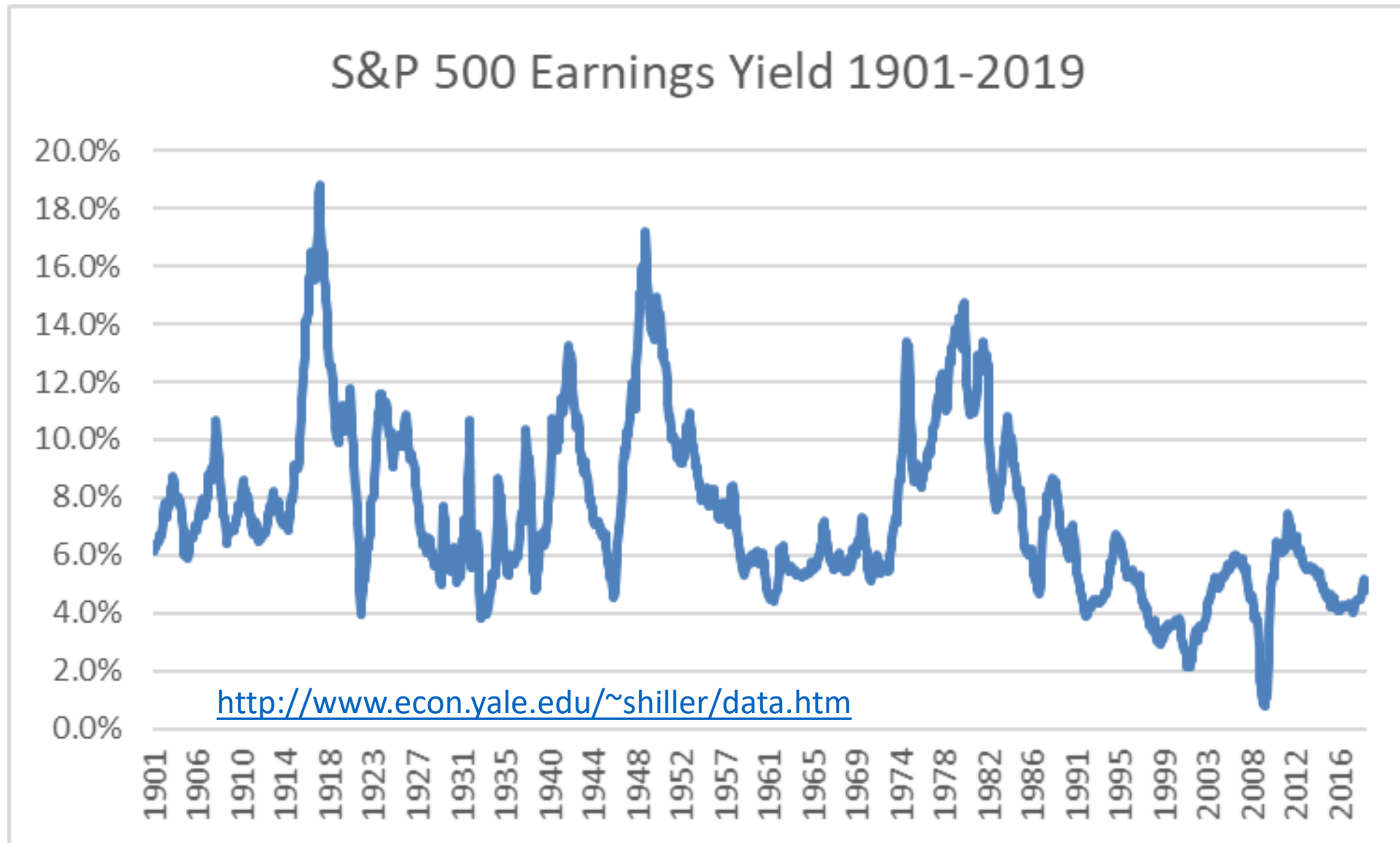


Index (total return)	Annual Return	Worst Drawdown
Nasdaq 100 Index	12.6%	-83%
BXN	8.0%	-57%
S&P 500 Index	9.8%	-55%
BXM	8.0%	-40%

Volatility ebbs and flows in waves



Stocks are priced for perfection



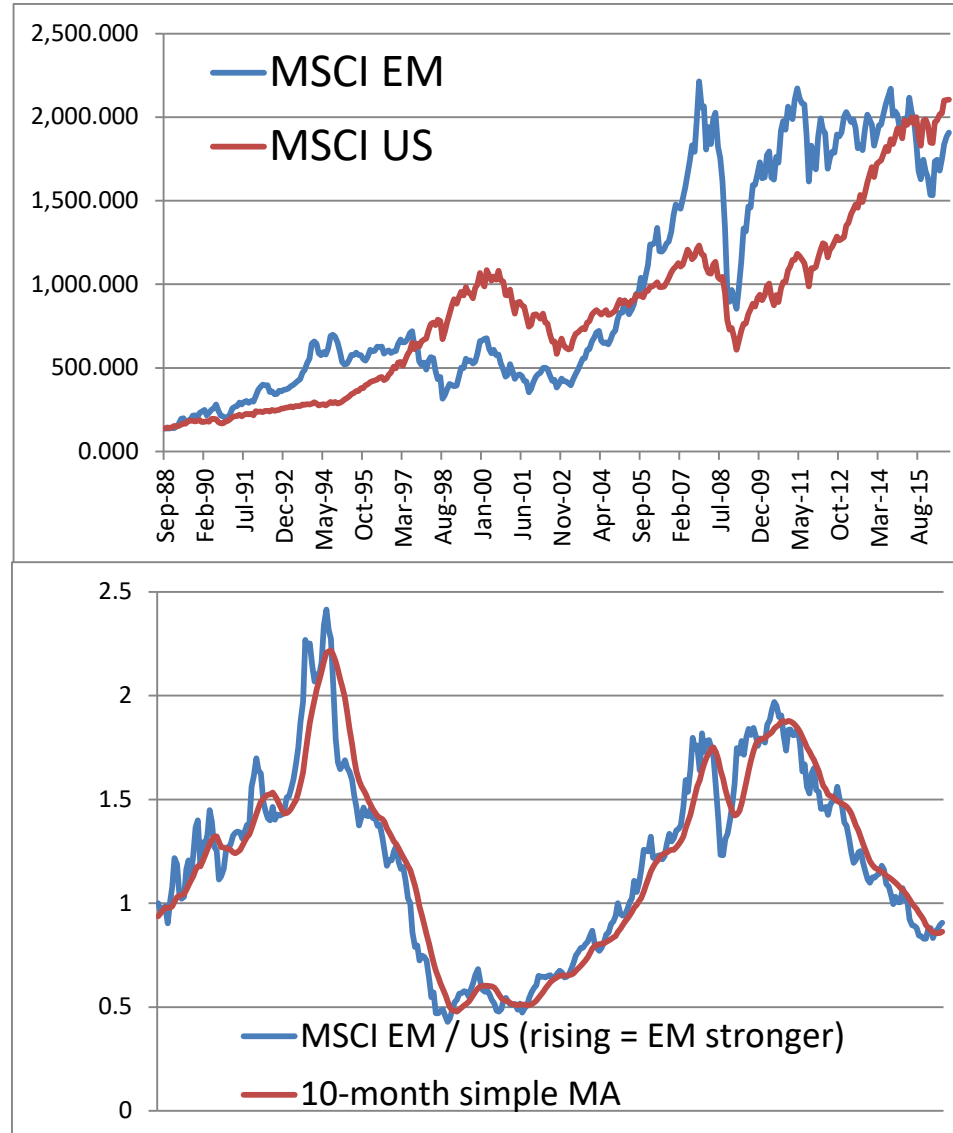
Business
still has it
good.



Monthly switching model: Emerging markets vs. U.S.

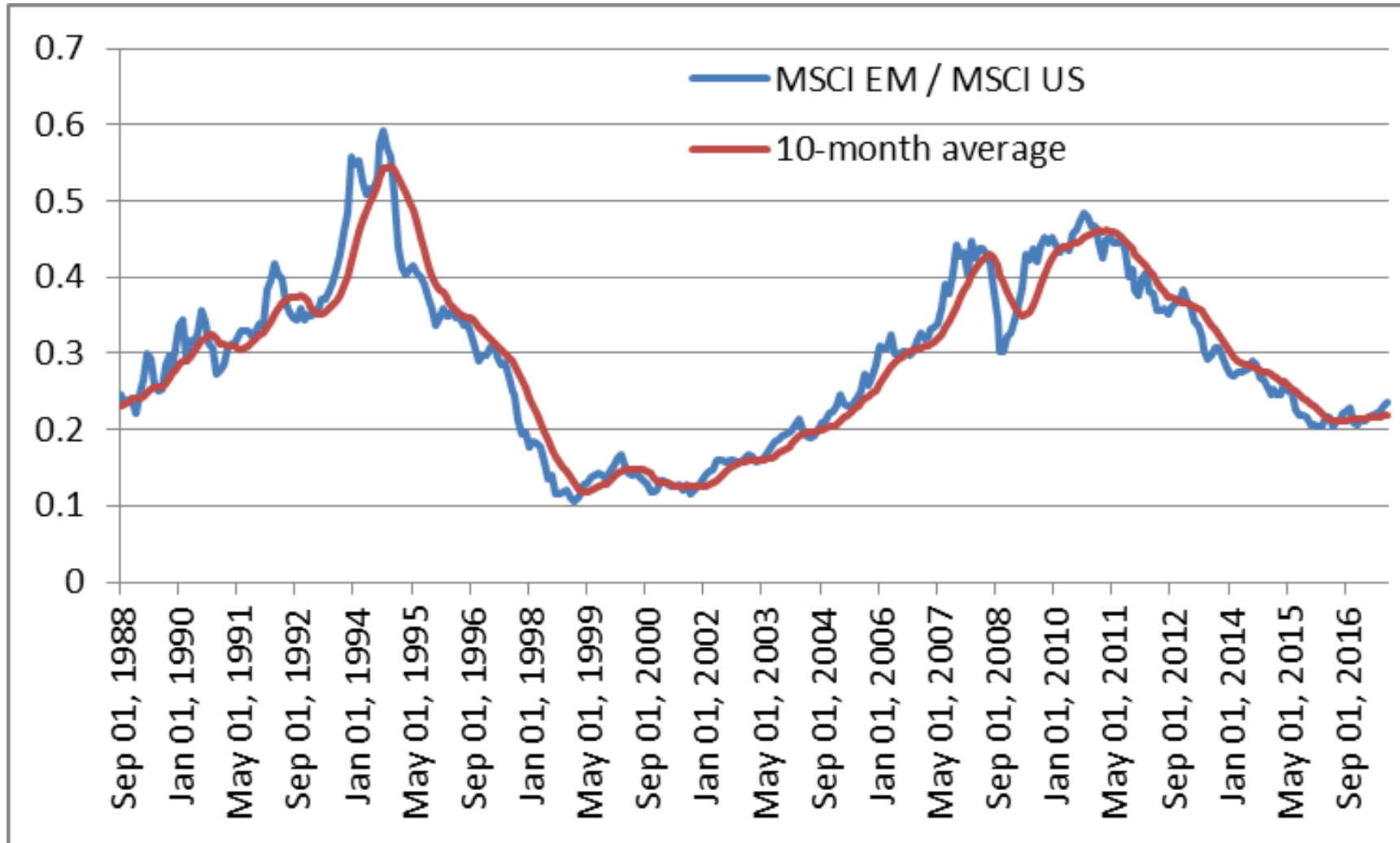
- On the last trading day of each month update total return indexes for MSCI EM and for U.S.
- Calculate the ratio (emerging markets divided by U.S.) and update its 10-month simple moving average.
- If the ratio is above its moving average, be in emerging markets for the coming month. Otherwise, be in U.S. equities. (Model is in U.S. as of 4/30/2018).
- Can use ETFs: EEM or VWO, and SPY.

MSCI Emerging Markets and U.S. Indexes (total return, \$), 1988-2016

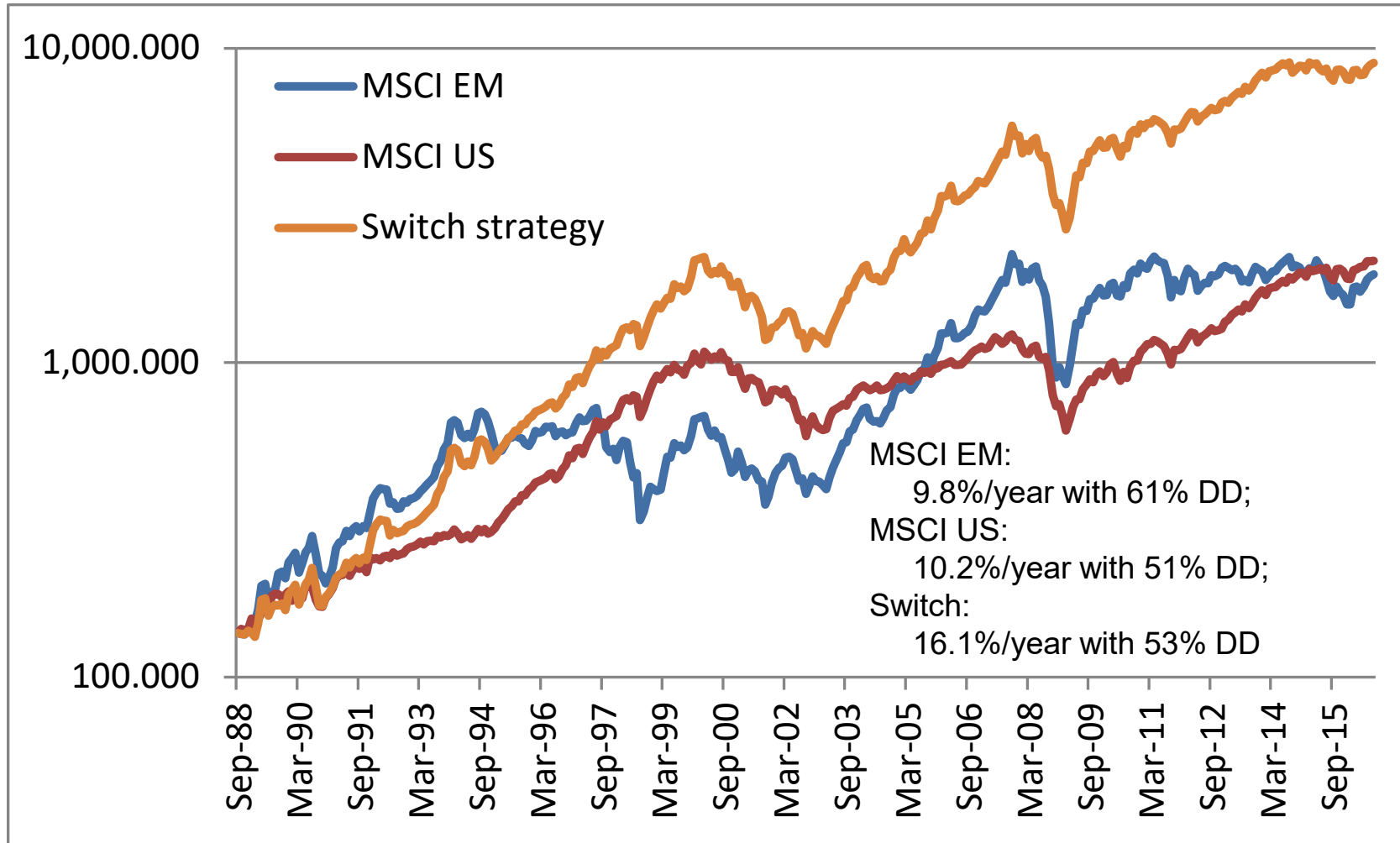


Source: www.msci.com

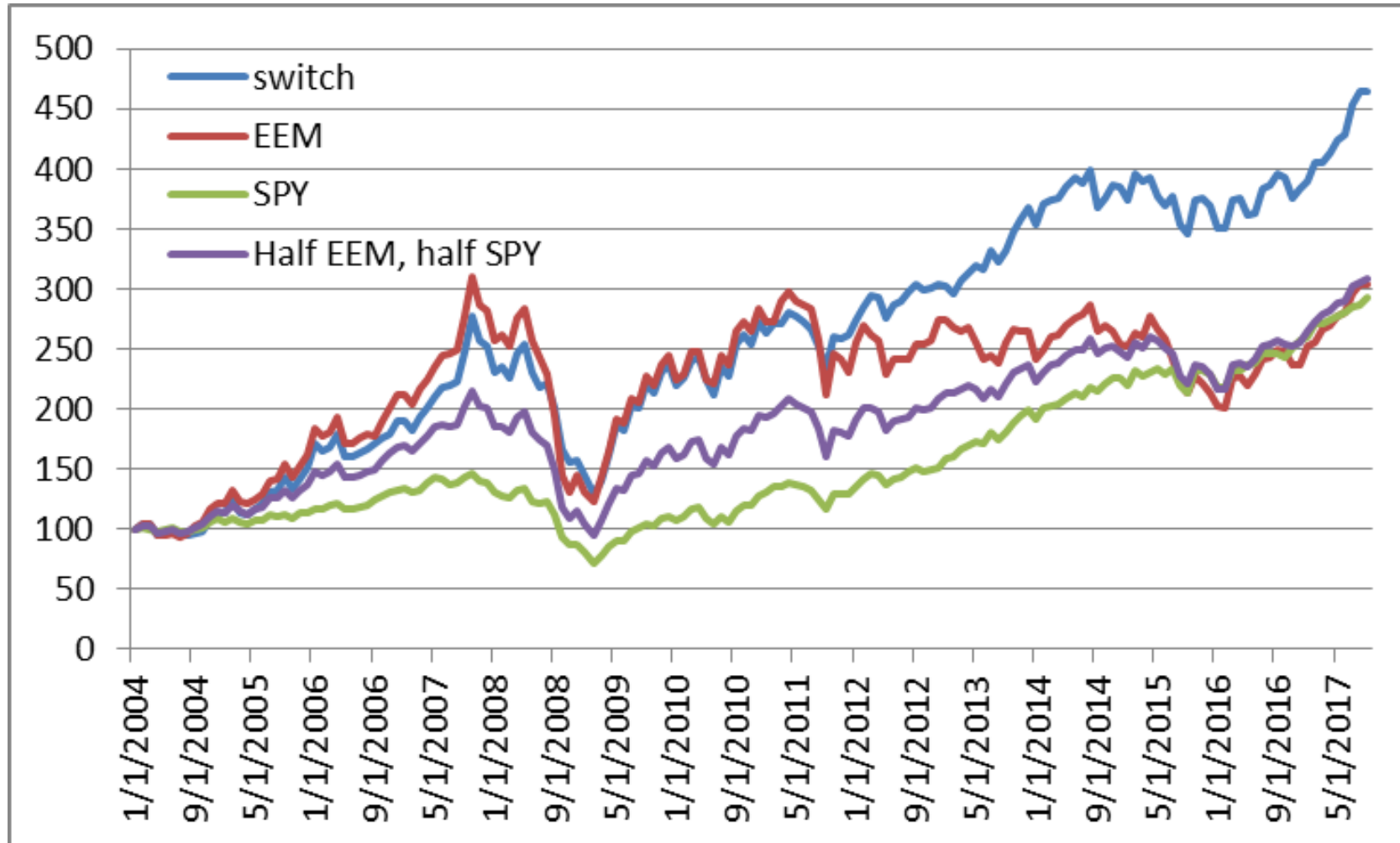
History of Emerging Markets vs U.S.



Results of switching: Emerging markets vs. US equities



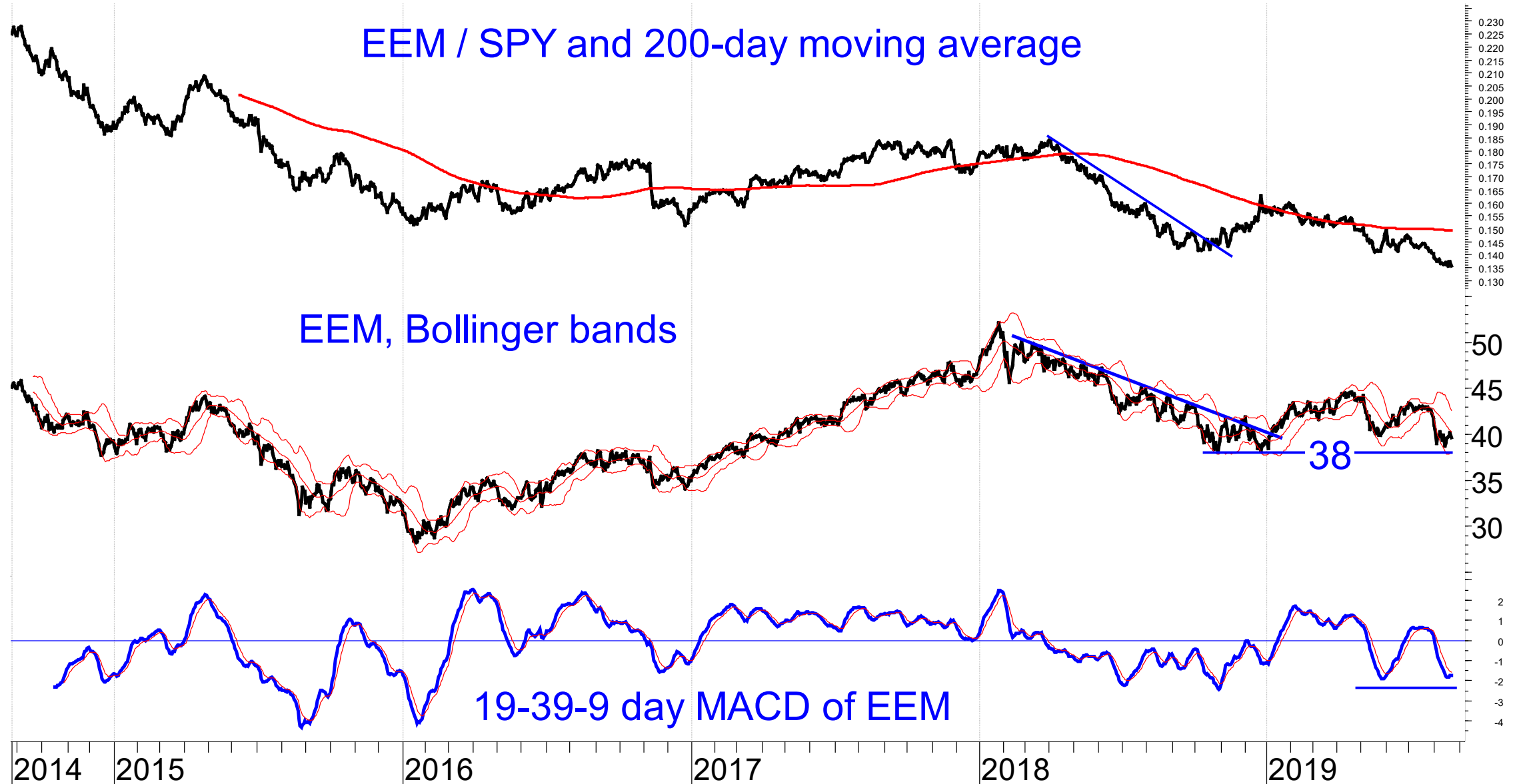
Update on emerging markets vs. U.S. equities



Latest trades of Emerging Markets vs U.S. model

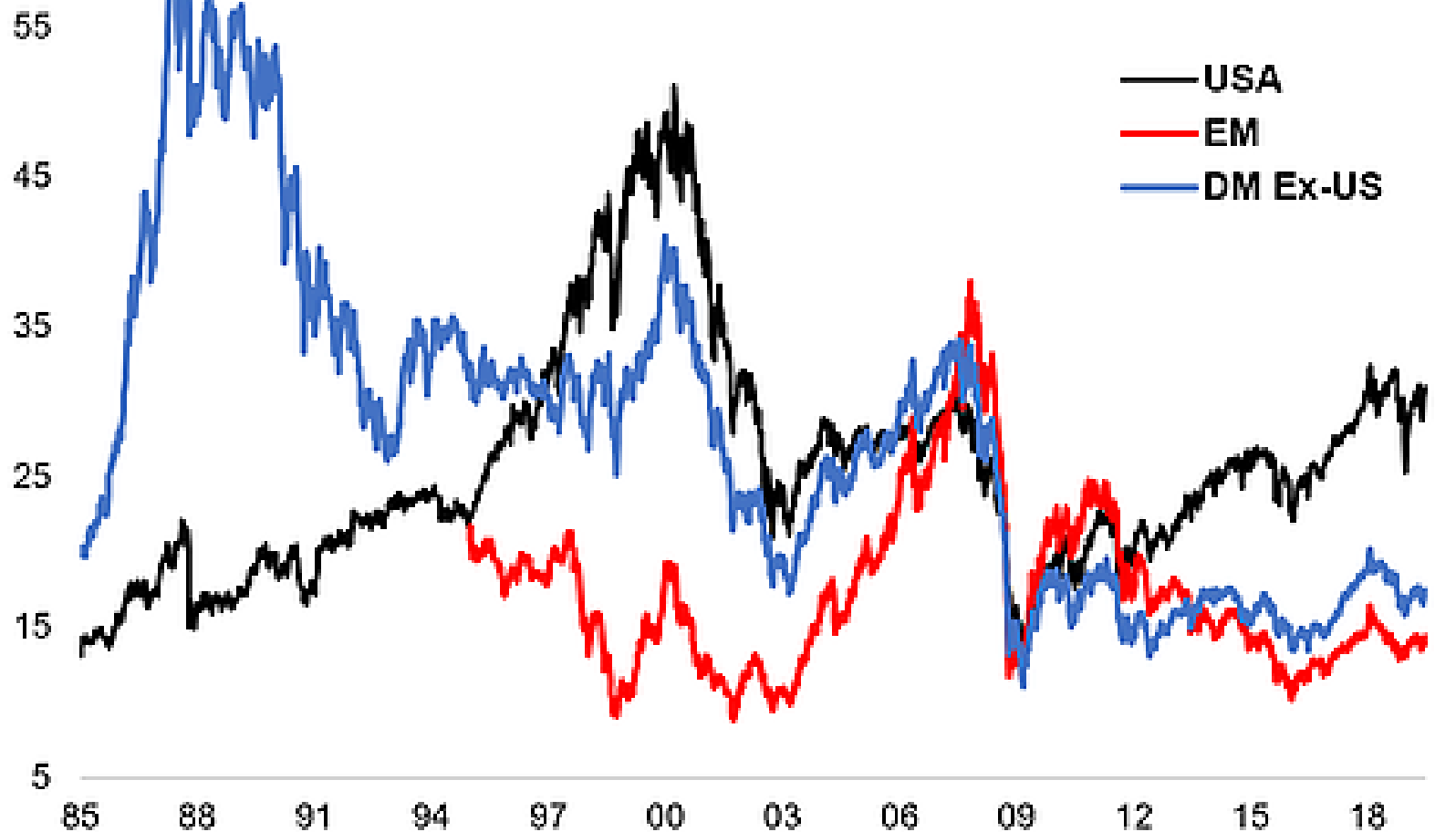
- Prior trade: 7/31/2016 to 4/30/2018 in emerging markets
- SPY gain 26%
- EEM gain 34%
- Model favored SPY over EEM from 4/30/2018 to 1/31/2019
 - SPY up 3.6%, EEM down 6.2% during that trade
- One month flip to EEM in February 2019
 - EEM down 1.5%, SPY up 3.2%
- Back to SPY as of 2/28/2019
 - Since then, EEM down 5.9%, SPY up 5.9% (as of 8/23/2019)

Technical prospects for E.M. not yet attractive



Relative Valuations for EM are Attractive

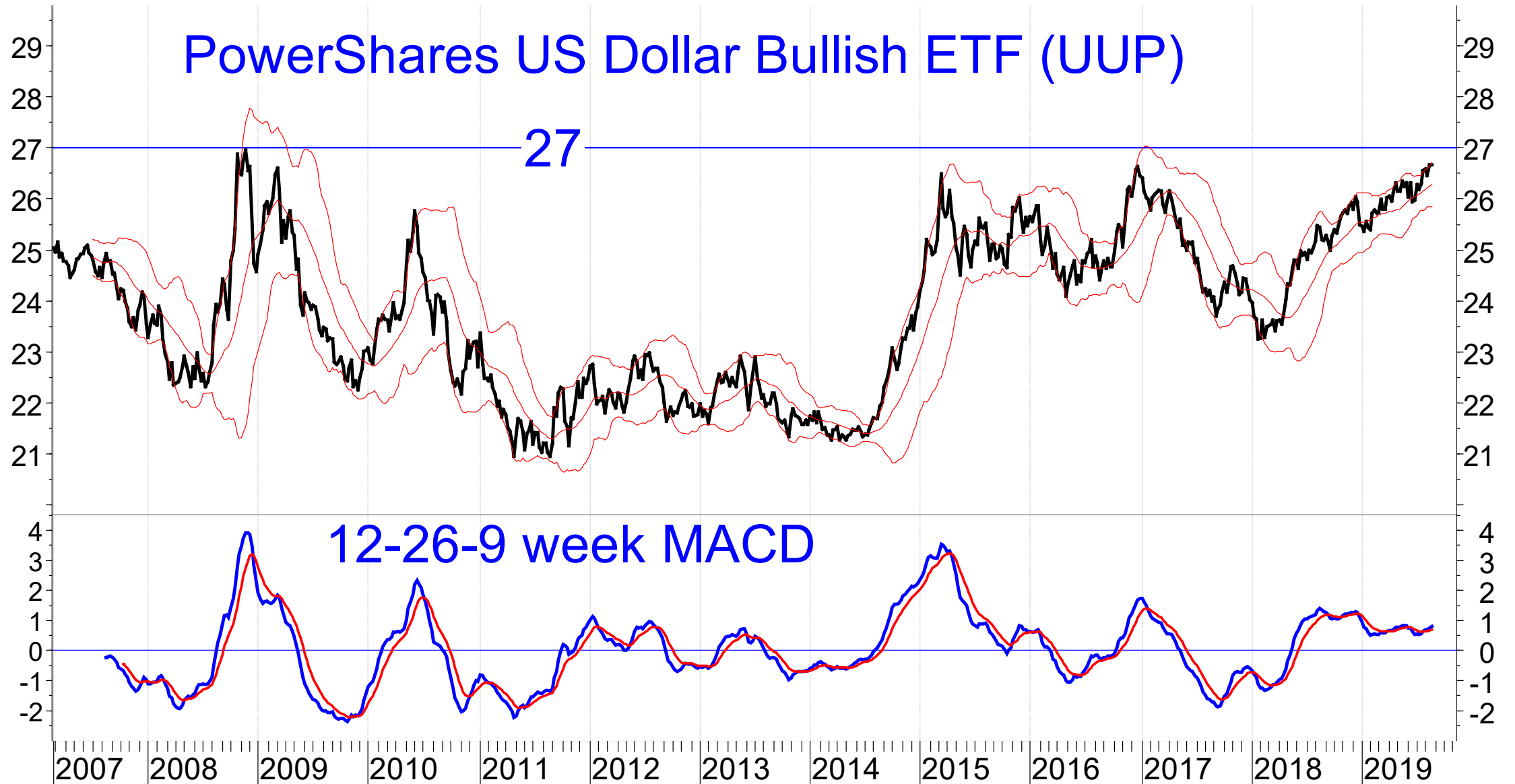
Global Equity Valuations - PE10
(Price vs 10-year average earnings)



Source: Topdown Charts, Thomson Reuters Datastream

topdowncharts.com

Dollar Has Little Upside

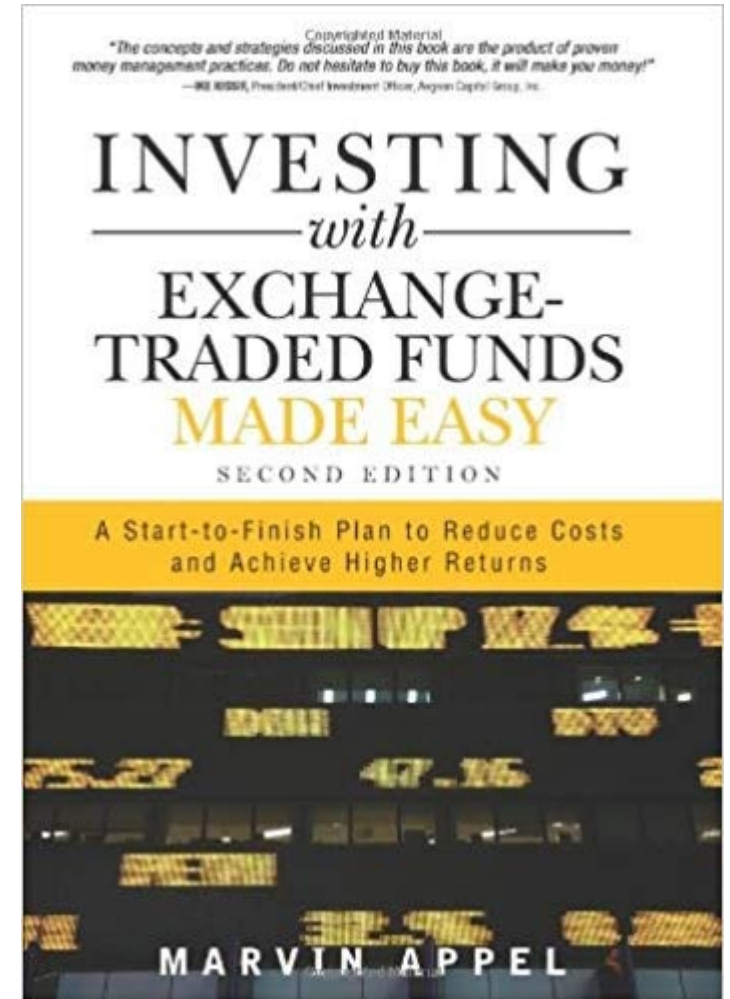
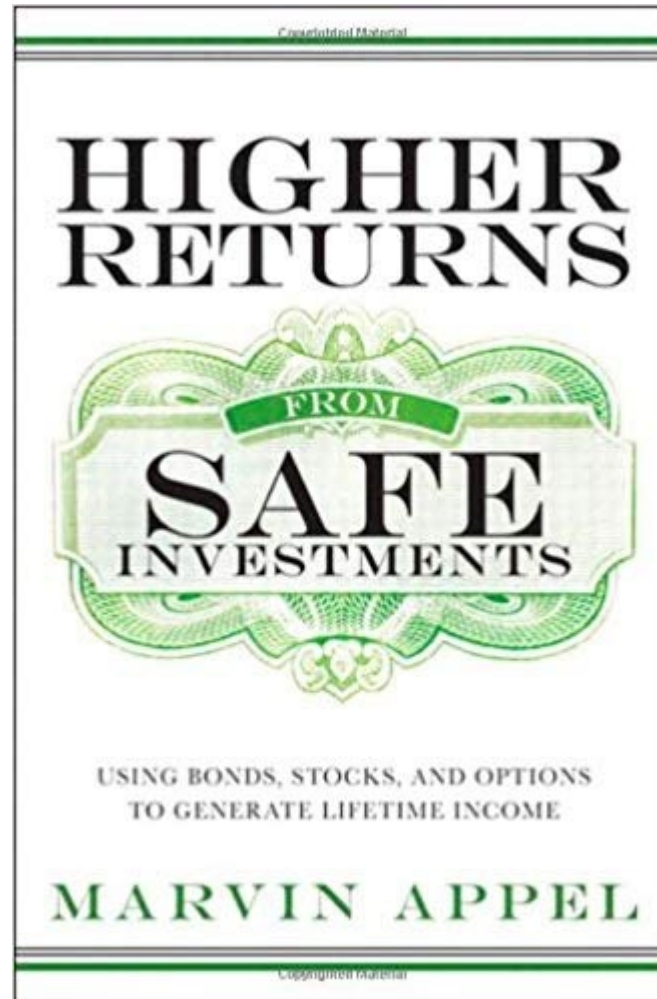


Summary—Strategies for Volatile, Low-Yield Markets

- Corporate high yield bond fund trading
- Floating rate bond fund trading
- Floating rate preferred stocks AGNCN and CIM-B (buy and hold)
- Covered call or cash-secured put writing on S&P 500 index ETFs
- Look for opportunities in emerging market stocks
- Market timing

Books by
Marvin Appel

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mappel@signalert.com
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