

## An Alternative Investment Strategy<sup>©</sup>

Jonathan Davey, CPA MBA  
Registered Investment Advisor  
President  
Trustar Financial Group, Inc.  
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If you are like most stock mutual fund investors, 2000 was a disappointing year. To add insult to injury, while investments went south, taxes on those investments went north. Subsequently, investors pulled their money out of mutual funds last month at a record rate. Many have realized that one of the main drawbacks of mutual funds is that they limit the investor's ability to manage his tax exposure. A mutual fund manager's primary goal is achieving the highest possible return. To do this, he may turn the entire portfolio over during the year, which in turn, can result in significant tax liability for the fund owners. Unfortunately, the mutual fund owner has no control over his taxable income even if he sells the mutual fund at a loss. This does not mean that mutual funds are all bad. They are suitable investments, primarily in tax deferred retirement accounts.

What Stock mutual funds rely on is income and capital appreciation to generate returns for investors. What most people do not realize is that there are actually three different sources for generating returns on stocks: 1) Dividend income, 2) Capital appreciation, and 3) Option premiums. By investing directly in stocks (bypassing mutual funds), one can earn a respectable return by using all three sources, and can rebalance their portfolio to minimize taxes.

I would like to promulgate an investment strategy that is conservative yet can produce high returns in either a bull or bear market. This strategy employs all three of the above sources. Before we review an example, we need to make sure we understand what an option is. An option is simply a contract to either buy or sell a stock at a predetermined price by a predetermined date. There are two different options. A "Put" is a contract to buy a stock, and a "Call" is a contract to sell a stock. Since Puts entail higher risk, the conservative approach deals only in Calls.

Now let's review an actual example of how this strategy would work in the real world. On May 8<sup>th</sup> RPM, Inc. (NYSE: RPM), a chemical manufacturer, was trading at \$9.16. The dividend yield was at 5.45% and they have had consistent dividend growth for the past 12 years (a good indicator of future dividend payouts). November Call options were trading for \$.55 at a strike price of \$10. Now let's say you buy 1,000 shares on May 8<sup>th</sup> and immediately sell November Calls at \$10. Excluding trading fees, your stock cost would be \$9,160 (1,000 x \$9.16) and you would receive option premiums of \$550 (\$.55 x 1,000) for a net cost of \$8,610 (\$9,160 - \$550). By selling a call option, you have agreed to sell your stock for \$10. If by November the stock hasn't risen above \$10, then the option expires, you are still ahead \$550, still have the stock, and you can sell another Call option. We all know the stock market is always changing, so let's review the actual return potential.

Since we all want the market to go up, let's say that by November the stock is trading at \$20. Although you had to sell your stock at \$10, you still realized a capital gain of 9.2% ( $\$10 \div \$9.16$ ). You also received a return of 6.0% on your option premium ( $\$.55 \div \$9.16$ ). Therefore, in a matter of 6 months, you realized a return on your investment of 15.2% (approximately 14.1%

after fees). Since this option date covered a 6 month period, the effective annual rate of return on this investment has a potential of 30.4% ( $15.2\% \times 2$ ) because you could have made this transaction at least twice during one year. Some investors might get upset because they couldn't sell their stock at \$20. However, in the long run, consistent growth of 10% – 30% is always better than the occasional burst of 100% growth.

What happens if there is a bear market? Let's say that by November the stock has drifted down to \$8. Your options will expire meaning that you still own the stock. You still realized 6% from those option premiums and will also receive dividends of \$.50 per share. This dividend yield of 5.45% ( $\$.50 \div \$9.16$ ) coupled with the option premium of 6% produces a return of 10.45% even though the stock price is dropping. The effective annual return on this investment in a bear market has a potential of 17.45% ( $5.45\% + (6\% \times 2)$ ). Adjusted for fees, the annual return would be about 15.3%. If the stock is still depressed at year end, you can sell the stock for a capital loss that could be used to offset gains in other equities.

As you can see, by investing directly in stocks and utilizing all three sources of income from those stocks, you increase your potential returns on investment. Additionally, the opportunity for tax planning increases your realized after-tax return. Of course, there is still the requirement upon the investor to evaluate each company and compute the potential returns before investing.

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