How to be a better investor

If money is the object, you should approach investment with a total outlook

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While places in which to invest capital are many and varied, many individuals and corporations think only in terms of actual risk to principal. While this is an important fundamental consideration (as well as the equivalent potential for reward), many overlook the devastating effects of annual taxes and inflation. Married taxpayers with taxable incomes, after deductions, in excess of $60,000 ($41,500 for single taxpayers) are subject to a 50% federal tax rate on all “earned” income (salary, fees, etc) and up to and including a 70% tax rate on any “unearned” income (interest dividends, etc) that is realized above these levels. Inflation, like taxes, is here to stay. Even though the inflation rate fluctuates, the general consensus is that it will average out to 8% to 10% annually. Thus, investment planning must include these two elements as well. A taxable investment return when coupled with loss of purchasing power through annual inflation can produce a net rate of return that could be somewhat less than satisfactory.

Funds suitable for these type investments are those that may be needed for near term contingencies, those that are being accumulated for a longer term investment, and those idle funds that are between longer term investments.

Money Market Interests

This area includes such instruments as U.S. Treasury Bills, Bank Certificates of Deposit, U.S. Government Agency Notes, Commercial Paper and Money Market Funds all with maturities usually ranging from 30 days to twelve months.

All of these instruments are virtually free of risk to principal and come with relatively high yields which makes them ideal short term investments. Current yields are between 10% and 12%. However, since these yields are taxable as “unearned” income (income which is not subject to the federal 50% “maximum tax” on earned income) their value as longer term investments is questionable. In addition, if interest rates should decline, one would be forced to purchase less yield upon maturity of the original instrument. For example, a 10.25% six-month Treasury Bill bought today may only be able to be renewed in an 8.50% bill upon maturity next February. This is known as “income” risk.

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dollars) of this $11,657 net accumula-
tion would be approximately $9,186.
This is not to say that long term
certificates are not a good or sound
investment. For the right individual
under the proper circumstances they
can be most appropriate. Individuals
in lower income tax brackets and/or
those that require absolute safety of
principle at all times should consider
certificates or similar type situations.
Additionally, these are appropriate
for non-taxable or tax-deferred situa-
tions such as qualified retirement
plans which require continuous safety
of principal.

Fixed Income Investments

Fixed income refers primarily to
municipal, corporate, U.S. Govern-
ment and Government agency bonds.
These instruments are issued with a
fixed interest rate (called a coupon)
and a fixed maturity date. Interest is
paid semi-annually and maturities can
range anywhere from one to forty
years. Municipal bonds are federally
(and in some cases state) income tax
free, U.S. Government bonds (which
guarantee interest and, at maturity,
principal) are federally taxable but
free from state and local income taxa-
tion, and corporation bonds are fully
taxable.

The purchasing power risk that ap-
plies to Certificates of Deposit most
certainly apply to bonds. Since, as
previously mentioned, long term in-
terest rates historically have increased
over time, and since the coupons (in-
terest rates) on existing bonds will
never change, the risk becomes cor-
respondingly higher as maturities
lengthen. As in the Certificate of De-
posit example, a 50% taxpayer plac-
ing $10,000 in a 30 year, 10% ($1,000
interest per year) tax free municipal
bond will have approximately $10,294
in net purchasing power (in today’s
dollars) at maturity.

Moreover, all of these bonds entail
market risk. While original principal
is returned at maturity, interim in-
terest rate cycles will affect the current
market value of a bond. The longer
the maturity, the more pronounced
the market value risk. As an example,
an A. T. & T. 8.875% bond maturing
in 2007 that was issued in 1977 for
$1,000 per bond is now worth approx-
imately $670 per bond. This in no way
reflects on the quality of A. T. & T., it
merely reflects the fact that the cur-
rent level of interest rates for a similar
quality bond is above that of 1977.
Should interest rates drop to a point
below those that existed in 1977, then
the same bond might be selling above
the $1,000 purchase price. In any
event, the full $1,000 face value would
be returned upon maturity in 2007.

The proper strategy for purchasing
bonds is determined by the objectives
of that particular individual. One who
is retired may be concerned more
about a steady stream of income than
interim fluctuations in market value.
The high income taxpayer simply can
not or should not overlook the non-
taxable status tax free municipal
bonds. However, bonds, like most in-
vestments are a function of timing. In
a period of abnormally high interest
rates, such as those now in existence,
are excellent times in which to pur-
chase bonds. When the level of inter-
est rates recedes, these bonds pur-
chased across the peak of the cycle
will increase in market value. Addi-
tionally, for the individual desiring to
trade bonds for short term profits,
those previously issued bonds now
selling at a discount from face value
should be sought. In a period of de-
clining interest rates it is these bonds
that will undergo greater capital ap-
preciation. Finally, bonds selling at a
discount from face value due to ma-
ture at a preselected time are excellent
for funding future contingencies such
as retirement or education.

Common Stocks

Common stocks come in a variety
of different types ranging from the
high-grade “Blue Chip” growth
stocks through those involving rank
speculation. For the individual desir-
ing current income, electric utility
common stocks can be appropriate
since many of these type stocks have dividend yields that are on a par with that of corporate bonds. However, unlike the fixed income nature of bonds, many of the higher grade utilities have excellent histories of increasing dividends annually. Thus, some element of income protection can be provided. On the other hand, in a period of rising interest rates, the market value of utility stocks will tend to drop similar to that of bonds. The individual desiring growth has available a multitude of different common stocks representing a vast number of industries through various risk levels. Unlike the utility stocks which carry dividend yields of 9.0% to 14.0%, growth type stocks can have dividend yields ranging from zero through 7.0% or 8.0%.

While time and space do not permit an in-depth review of the stock market, there are some broad outlines and basic strategies that apply to almost any common stock portfolio which will be outlined below. It must be kept in mind that the stock market in general responds almost as much to investor psychology (current events, political factors, etc.) as it will to fundamental financial changes relative to a particular industry or corporation.

Basically, any common stock portfolio should be well balanced and properly diversified. That is each stock should represent an equivalent portion of the total portfolio and different industry classifications or geographic location. As an example, a $100,000 common stock portfolio should contain eight to ten different stocks each with a market value of between $8,000 and $12,000. These eight to ten stocks should represent enough different industries as to provide proper diversification of risk.

Finally, the downfall of many stockholders is not knowing when to sell. It makes as little sense to buy a stock and ride it down 30% to 40% as it does to have a stock go up 30% to 40% in a reasonable period of time and then watch that gain evaporate. One common strategy is to sell when a stock hits 15% on the downside. This is based on simple mathematics. If a stock is down 15% it will have to increase by 17% to break even. If it goes down 25%, a 33% rise in market value will be required to break even. If a 50% drop occurs, then 100% is needed on the upside to break even. The further the drop, the larger the upside move required to just break even and the larger the odds grow against that happening. While one should let profits run, it is important not let an appreciated stock deteriorate without realizing the gain. Among other things, a basic strategy is to place “stop” orders (orders to sell) at some point below the current trading price of the stock. This will permit interim trading fluctuations in the price of the stock as well as allowing it to continue to appreciate in value if that is to be the case. If the stock should take a strong downturn, then a good portion of the profit would be realized.

A final point to realize is that an appreciated stock (or almost any asset for that matter) could approach a point of diminishing returns. To exemplify this, assume a stock has appreciated 30% in the past year, that is a 30% annual return which is indeed excellent. If that same stock is up 50% after three years, then the annualized return is reduced to approximately 17%. To best summarize the above points would be to say that investing in the stock market is reliant not only on well timed and informative decisions, but on a great deal of investor discipline as well.

Real Estate

Real estate by its very nature is a long term, non-liquid investment. However, as most people realize, real estate in general has an excellent track record as an inflation hedge. Additionally, due to the various forms of depreciation associated with structures and equipment, real estate investors can enjoy some significant tax advantages.

Basically, there are three ways in which individuals invest in real estate: on an individual basis, as a corporation, or via a limited partnership. The latter is the most popular method since it permits more investors to participate with smaller amounts of cash,
it limits their risk exposure to the amount of capital invested, and it permits any tax benefits to flow directly to the investor. There are public limited partnerships and private limited partnerships. The former is registered through the Securities and Exchange Commission and can take on any number of investors. The minimum investment in public partnerships is usually $5,000 which allows smaller investors to participate in real estate. The latter is a non-registered partnership which usually involves no more than 35 investors. The minimum investments in these are generally between $80,000 and $160,000. While the public partnerships will enter into five to ten different property transactions, the private partnerships usually involve only one property thus involving more risk than a public partnership might entail.

Described below are the basic types of investment real estate:

1) Raw Land: This is highly speculative with little or no tax benefits and no cash flow. The property may have to be carried for years and is subject to substantial political risk (zoning changes, etc). However, the profit potential when raw land becomes pre-developed is usually the highest among the various types of real estate investments.

2) Residential Construction: Conventionally financed construction programs can provide excellent tax savings and strong cash flow potential. Cash overruns and lease-up deficiencies are the two major risk factors. In a typical apartment project, the investor will be permitted to deduct from ordinary income their total investment through the use of accelerated depreciation. Cash flow should commence in the third or fourth year of the partnership formation ranging, initially at least from 6.0% to 7.0% and increase annually. A good portion of the cash flow should be sheltered from income taxation. A program of this nature has a life of usually 9 to 12 years.

3) Government Assisted Housing: This involves government financed, rent subsidized low-income or elderly housing projects. They may be new construction or rehabilitation projects and are very long term in nature. Since these projects employ unusual financing techniques, the investor will receive deductions from ordinary income that are usually two and one-half to three times the total investment. However, cash flow and profit potential are extremely limited while creating the potential for some very adverse tax ramifications. These programs are designed only for the very high taxpayer.

4) Commercial Net Leased Properties: This type of transaction involves the purchase of usually a retail type store and leasing it back to the parent corporation. Generally this involves a 20 year to 40 year lease with the lessee paying all expenses. Depending upon the financing utilized, leased properties can generate either strong cash flow with nominal tax benefits or excess tax deductions from ordinary income with little or no cash flow. Suitability for this type transaction is based on the financing structure of a particular program.

5) Income Producing Properties: This type program utilizes existing, leased-up commercial and residential properties for the purposes of annual cash flow and long term capital appreciation potential. Typical average annual cash flow may range from 7.0% to 10.0% which should be tax sheltered to a large extent. Little, if any, excess tax deductions should be generated. The average life of this type property is usually 4 years to 10 years.

It is important to point out that not all real estate is suitable for everyone. In particular, those properties involving large tax benefits should be entered only with great care and full awareness of any potential future adverse tax consequences.

This article encompassed only those basic investment areas to which one is exposed almost daily. Such other investment areas as commodities contracts, precious metals, art, coins, put and call options, oil and gas, and individual businesses, to name just a few, require a more specialized approach than can be summarized in an article of this nature. While it is impractical to try and learn all there is about a particular investment prior to entering it, it is well worthwhile to take the time needed to achieve a comfort level and be aware of the risk factors as well as the potential benefits.

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