The Investor's Yield Dilemma

"More money has been lost reaching for yield than at the point of a gun." – Ray Devoe, Investment Writer

Since the financial crisis, historically low interest rates have created a serious challenge for investors who depend on their portfolio for steady income in retirement. With the 10-year Treasury bond yielding 2.2% and the S&P 500 yielding 2.1%, gone are the days when a portfolio could conservatively generate 4-5% from dividends and interest alone. Unfortunately, while yields from traditional investments have declined, income needs are the same or higher for most retirees. Left unchecked, the tendency for investors who depend on a certain level of annual income is to "stretch" their portfolio to the areas of the market that provide the highest yields. In doing so, however, we believe investors run the risk of misallocating their portfolios to the detriment of their long-term goals. In this edition of MAInsights, we will review the most common pitfalls of chasing yield and offer our views on better solutions for investors with income needs.

Reaching for Yield in Fixed Income

The fixed income asset class has long been considered the primary vehicle for generating steady income at low levels of principal risk. Over the past several years, however, the unprecedented actions of global central banks to stimulate their economies have driven the interest rates on "safe" bonds (i.e. investment grade government, municipal, and corporate bonds) to low absolute levels on a historical basis. Compared to its 25-year average, the Barclays U.S. Aggregate Bond index now yields 2.2% less and averages 1.2 years more in duration (higher duration = higher sensitivity to interest rates). To combat a more challenging fixed income environment, investors may be inclined to reach for lower quality bonds that have higher yields and/or extend duration to capture more yield further out on the curve; both of which introduce new risks to the portfolio that may not be obvious until we face a downturn in the economy (credit risk) or a sharp rise in interest rates (interest rate risk).

At MAI, we believe a better strategy is to maintain the same quality and duration standards that have earned fixed income its low risk reputation and tactically identify relative yield advantages in certain sectors, securities or structures. One example of a tactical theme we continue to find attractive is in Callable Municipal Bonds where investors are being nicely compensated with approximately 50 basis points of extra yield, on average, compared to non-callable bonds for the duration uncertainty created by the call feature. Another compelling allocation we favor is to Fixed-to-Float Preferred Securities, which often carry investment grade credit ratings, feature limited interest rate risk due to a back-end floating rate component, and offer 3-5% tax-advantaged yields. Since our tactical bets are only at the margin, we don't expect to achieve the yields that have historically been available from fixed income, but we believe investors should be willing to sacrifice some yield in order to preserve the low risk character of the asset class within their portfolio.

Reaching for Yield in Equities

A byproduct of the lack of available yield in bonds has been an elevated investor focus on stock dividends as an additional source of income. When faced with the hypothetical question, "Would you rather own the S&P 500 paying 2.1% dividend or a 10-year Treasury bond paying 2.2% interest over the next 10 years," it is hard to argue against owning more stocks for a similar yield and at least some upside potential. One potential pitfall from this thinking, however, is that an investor who is otherwise risk averse could overestimate their ability to stomach the extra volatility of equities relative to bonds. Again, this wouldn't be tested until there was a sharp downturn in the economy and stock prices, but investors should be careful that meeting an income goal doesn't compromise their overall risk allocation.

Another pitfall for investors looking to equities as a source of income is the risk of concentration in certain parts of the market that boast high dividend yields but have little potential to provide the growth they need from their equity portfolio over the long-term. For example, investors with a heightened focus on dividend yield are more likely develop high concentrations in defensive sectors like Utilities (3.6% yield) and Telecom (4.9% yield), and overlook higher growth areas like Technology, Healthcare, and small cap stocks simply because they do not pay high dividends. In doing so, an investor may achieve their income goal, but would likely sacrifice significant market appreciation potential in the process.

In our view, focusing not only on the yield but also the future *growth* of the dividend and diversifying across sectors, market caps, and geographies can help provide the best of both worlds from a yield and growth potential standpoint. Interestingly, both developed and emerging international markets offer dividend yields (3.2% and 2.4%, respectively) that are competitive with the U.S. and are trading at much cheaper relative valuations from a long-term perspective. In addition, pipeline MLPs are one of the few U.S. equity market segments providing distribution yields above their historic norm (Alerian MLP index currently yielding 7.4%) with visible growth ahead. At the margin, we believe both of these areas can be attractive total return plays while also supporting the income needs of investors.

An Alternative Source of Income

Outside of the traditional asset classes, income-producing real estate is an asset class that we believe is deserving of consideration for investors. Particularly when it is backed by investment grade tenants, this type of real estate can possess the credit characteristics of fixed income and a total return opportunity similar to equities. Of course, given the lack of liquidity associated with private real estate investing, investors must have the ability to commit their funds for an extended period of time; but we believe monthly cash flows in the 8% area backed by high-quality real estate support an allocation in the current environment.

An Alternative Withdrawal Strategy

Even with allocations to the most attractive income plays we see today, a well diversified portfolio in today's market will still struggle to obtain levels of income consistent with history. For retired investors who depend on their portfolio to fund their living expenses, this may require a shift in mindset from planning to withdraw only dividends and interest to including some principal withdrawal from the portfolio as well. Assuming the investor's total withdrawal rate is consistent with achieving long-term portfolio longevity, we would much prefer this strategy versus overextending the portfolio simply to support income-only withdrawals. As discussed above, the pitfalls associated with reaching for yield can be costly for investors; thus, we would advocate not just for a total return *investment* approach, but a total return *withdrawal* approach as well.

Closing Thoughts

While the yield environment is out of our control, we can control how we adapt to it to further increase the likelihood of meeting your long-term goals. To this end, we are working hard every day to identify and implement solutions that are right for you and avoid the traps that can so easily disrupt a long-term plan.

As always, we are honored that you have chosen MAI as your trusted advisor and are always available to discuss the markets, your portfolio, and any changes to your financial situation or investment objectives.

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