Want More Income? Consider These Strategies!

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Call it what you will, a distribution, paycheck replacement, cash flow, dividends, interest, distribution, but the goal of all investing is ultimately to create a regular payout from your nest egg, either now or at some future time, typically retirement.

Creating that payout has never been more challenging. The current yield on the ten-year US Government bond is less than 1.5%. Not only is that a small payout, given that expected inflation is 2.4%, the "real," meaning after inflation, payout is nearly a negative 1%.

If you go overseas, the situation is even worse. Ten-year German sovereign debt is yielding ***negative*** 0.17%!

The hunt for income is critical. Ideally, you'd like a real payout from your portfolio, namely a return higher than inflation. That way you have something to enjoy yet you can still preserve the inflation-adjusted value of your portfolio.

Hunt for Income or Focus on Total Return?

A myopic focus on income is no longer best practice. First, there is very little income, as evidenced by the current yield on US Government debt. Greater income payout will rarely come without increasing your risk.

The days when dusty legal documents governed distributions from portfolios, limiting payouts to the "income from the corpus," are mostly gone, giving investment managers more leeway to invest for total return. Total return is the combination of capital appreciation and income.

We believe the best practice is to focus on total return, constructing a portfolio with a strategic mix of both risk assets as well as less risky assets. To satisfy distribution needs, simply create a cash flow by carefully trimming from various assets so that, when coupled with traditional income generated, the desired payout is available. The advent of commission free trading has facilitated this process.

Tips and Traps When Looking For Income

Even when focusing on total return, the income portion is important. Typically, a security that generates income will be less volatile, as investors will gravitate to the regular distributions in periods of uncertainty. Capital appreciation, while profitable, is less predictable; income producing securities reduce uncertainty.

More income would seem to be better than less income, but assume that if there's more reward, there's more risk. There are two key types of risk, credit, and interest rate.

Credit risk is straightforward. A higher yield is of not much use if you're not paid. Check the credit ratings and the finances of anyone you lend money to.

Interest rate risk is more subtle. Generally, the longer dated the debt instrument, the greater the yield. That's why if you lend money to the US Government for two years your yield is just 0.15% but for ten years it will be 1.5%.

The higher rate compensates you for the longer wait before your money is returned. The longer the wait, the greater the risk of factors like inflation.

Inflation risk is a third risk, close kin to interest rate risk. Yields normally reflect the expected erosion of purchasing power from the time you make the loan or invest in the bond until the time you are repaid.

Be on the lookout for other risks, too. Cross border transactions can create exchange risk, meaning the value of the currency returned to you is not what you expected. Some credit instruments allow for prepayment, which is almost always exercised when interest rates drop below what the security is yielding. Liquidity risk can crop up during periods of market volatility, making it difficult and or expensive to sell your bond.

Why High-Quality Bonds Belong in Every Portfolio

Diversification 101 calls for every investor having some bonds in their portfolio. We believe high quality bonds best offset risk assets and their volatility. These are bonds that investors will flock to during periods of stock market turmoil. Credit quality should not be an issue.

Low quality bonds, while they may yield more, typically move with risk assets like stocks when markets are down. For example, in 2008, high yield (a/k/a junk bonds) declined 26%, while the S&P 500 tumbled 37%. Yet, high quality bonds, as reflected in the Barclay's Aggregate, gained, including income, over 5%. To hedge the risk of stocks, diversify over high quality fixed income.

Some investors object because the yields are so low now. True, but view it as a type of insurance for your portfolio. Just as you hope you don't have to make a claim on your auto insurance policy, you hope that those bonds are not where you are going to outperform. You're not going to go without that insurance even though yields are low, any more than you'll drive without insurance because you view the premium as too expensive.

It's Not the Yield, But the Yield After Tax

Most fixed income, like Government bonds, CDs, and corporate bonds, are taxed as ordinary income, at an investor's highest marginal rate.

As a result, we advise most clients to hold their fixed income in their tax-sheltered accounts, like their IRAs and 401Ks, and hold equities in taxable accounts. The fixed income payout in an IRA is tax deferred. The long-term gains of most equities and their dividends are taxed at preferential rates, nearly half of what an investor pays on ordinary income, but only if held in a taxable account.

If fixed income must be held in a taxable account, begin by examining tax exempt municipals. Their payouts are free from Federal tax and if issued by a jurisdiction in the state where the investor lives, state taxes, also.

State and local coffers are flush post pandemic due to revenues received from Washington, coupled with higher than expected tax receipts. As a result, investors are clamoring for municipals, bringing their yields down to less than 1%. Do the math, because currently in many situations the yields on taxable debt leave an investor with more, even after paying taxes.

Are Dividend Paying Stocks the New Bonds?

Generating income from a portfolio of dividend paying stocks is a tried and true method of developing regular cash flow and beating the market. Over a recent near 50-year period, dividend paying S&P 500 companies outperformed the equal weighted S&P 500 by nearly 1.5% per year. Nonpayers lagged by nearly 5% annually.

Unlike the fixed income from bonds, dividends historically keep rising, potentially allowing your income to keep up with or even outpace inflation.

What's not to like? Can dividend paying stocks replace your high-quality fixed income you have as a hedge? No.

The risk level with stocks, even dividend payors, is much greater. Dividends are not contractually required, can be cut or eliminated at will, and can only be paid after a company's more senior stakeholders, like its bond owners, have been paid in full.

Even among your stocks, you shouldn't just own dividend payors. Dividends are just one use of company profits; companies may be better off using excess cash flow to pay down debt, buy back stock, buy other companies, or simply invest in their businesses. A dividend payment merely moves money from one of your pockets, your stock portfolio, to your other pocket, holding your cash.

While most dividends are treated lightly under our tax law, an investor can come out even better taxwise by focusing on companies generating superior capital gains. Strategically trim those gains when cash flow is needed.

Selectively selling stocks can create "home grown" dividends, an approach we advocate for flexibility and tax efficiency.

Preferred Stocks – A Hybrid

Yield seekers often clamor for preferreds. Are they right?

Certainly, preferreds yield more than bonds, and they should. Their payouts are not contractually guaranteed and can only be paid if more senior creditors have been paid in full.

One pitfall with preferreds is that they can be called. Just like a homeowner can pay off a mortgage early, a preferred issuer can redeem those shares at a set price. If the preferred investor has paid more than that set price, prepayment can trigger a loss. Since, in a crisis preferreds can become worthless, the risks are asymmetric, meaning gains are capped due to those call provisions but losses are not.

Preferreds typically have no maturity so, like long dated bonds, have significant interest rate risk. Preferred portfolios may not be well diversified as they are typically issued by banks and utilities.

We believe an occasional preferred can be a valuable holding but should always be classified as part of the "risk on" portion of your portfolio.

High Yield Bonds – Do They Still Exist?

High yield bonds are issued by credit challenged companies. The debt yields more to offset risk of default.

Whether the additional yield is sufficient to offset that risk is sheer speculation. The average high yield bond now pays relatively little, about 4.4%, representing a margin of 3% over comparable maturity Treasuries. During the height of the pandemic the yield approached 12%.

Will an investor lose only 3% of his high yield portfolio due to defaults? Certainly, an improving economy will lower the default risk, and vice versa. There is typically some recovery even despite default.

Is the economy improving now? All signs point that way, but arguably that's now reflected in the low rates.

We advise our clients to steer clear of junk bonds in the fixed income portion of their portfolios. As witnessed last year in the pandemic, they are unlikely to provide ballast if the equity portion of the portfolio sags. Particularly attractive high yield offerings could be included in a portfolio but should be categorized among your equities.

Closed End Funds

Closed end funds can offer attractive yields. For example, the Nuveen NJ Quality Muni Income Fund (NXJ) yields 4.56%. Most of that payout is free from both Federal and, for NJ residents, state tax. That's superior to the average muni payout, 0.737% per the Muni Master published in the Wall Street Journal, or a typical muni bond fund, like Fidelity's Tax-Free Bond Fund (FTABX), yielding 1.05%

So, what's the catch? Three items: Leverage, the big difference between short term interest rates and longer-term ones, and the volatility associated with closed end funds.

Most closed end funds borrow against their portfolio to add to their holdings. In NXJ's case, for every dollar of holdings they've borrowed nearly 40 cents. The profit comes from the margin between what they pay out for the debt versus the payout on the bonds they buy. Right now, that's a big margin but that can dissipate if short term yields rise faster than longer term ones.

Closed ends are more volatile than high quality fixed income. Unlike conventional mutual funds or ETFs, no fund sponsor tries to keep the net asset value of the holdings in line with the share price. The good news is that NXJ now trades at a 9% discount to net asset value; a current buyer gets a discount. However, NXJ can and has traded at a discount more than 20% during periods of market stress.

Closed end funds can constitute a part of a well-diversified fixed income investor's portfolio, provided the extra volatility is acceptable.

Bottom Line

There are many ways to increase your fixed income yields. However, a focus on yield may not be as profitable as investing for total return, including both capital appreciation and regular payout.

Don't just focus on gross income paid out, but income paid out after taxes. Inflation, rising interest rates, and weak credits can be the enemy of the fixed income investor; portfolios tilted to stocks will want high quality fixed income to serve as ballast for the inevitable equity volatility. Always be sure you understand the liquidity of any fixed income investment.

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