LORING WARD
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Three Investment Income Strategies

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With interest rates at all-time lows in the U.S. and negative in other parts of the world, investors are desperately searching for ways to create sustainable income from their investment portfolios. Below are three strategies that can potentially be used for creating income.

Higher-Yielding Bonds

The first place investors usually turn is bonds with longer maturities, lower credit ratings or some combination of both.

Here are the risks you need to understand. First, as interest rates increase, the prices on longer-maturity bonds decline more than shorter-maturity bonds, holding all else equal. The price decline due to small interest rate increases can erase the yield advantages of longer-maturity bonds.

With lower-credit rating bonds comes greater risk that the issuer will suspend payment or even default on the bond entirely. And if the credit rating declines for whatever reason, the price decline in the bond may offset any yield advantages of higher-yielding bonds.

Remember, bonds rated lower than BBB are referred to as “junk” bonds for a reason.

Dividend-Paying Stocks

Historically, the top quartile of dividend-paying stocks earned a dividend yield almost double the market, 3.9% vs. 2.0% per annum.[1] This increase in yield is not without risk. The number of companies paying dividends has declined over the years, with only 61% of the global market paying dividends. The result is that a portfolio constructed to provide a high dividend yield may also become highly concentrated.

There is no guarantee that a company will continue to pay a dividend. In 2009, a total of 57% of dividend-paying firms either decreased or eliminated their dividends.[2] General Electric is a good example, cutting its quarterly dividend from $0.31 per share during 2008 to $0.10 per share in the second quarter of 2009.[2] You have no control over your income with this strategy. You put your income at the mercy of a handful of dividend-paying companies.

Total-Return Portfolio

A third way to create income from a portfolio is to harvest income (bond interest and stock

[1] Black, Stanley, Global Dividend-Paying Stocks: A Recent History, Dimensional, March 2013.
[2] Ibid.

dividends) and price appreciation. We call this a total return approach to income creation.

Total return is similar to the first two approaches in that an investor spends the income generated by the portfolio. It is only when an investor needs additional income beyond what was generated from the portfolio that the methods diverge.

Instead of taking more risk in bonds or concentrating in dividend-paying stocks, the investor harvests capital gains within the portfolio. For example, assume you invested $10 in a portfolio that is now worth $10.50 and had earned income of $0.50 during the year. If you want $1 of income for the year you could sell $0.50 of gains to add to the $0.50 of income already earned. The result, a portfolio worth $10 and $1 of income to meet spending needs. Assuming the portfolio continues to grow, you could repeat this process throughout your retirement.

Investors can do this without affecting the risk or diversification of their portfolios. It can be more tax efficient because long-term capital gains are taxed at a lower tax rate than ordinary income. It also gives the investor the option of deciding when to generate income and pay taxes, a valuable option lost with the first two methods.

Conclusion

We believe in using the total return approach to creating income. This approach doesn't require a shift in risk or concentration and can potentially lower tax expense, putting more money in your pocket.

	Higher-Yielding Bonds	Dividend-Paying Stocks	Total-Return Portfolio
Portfolio Risk Shift	Increases portfolio's exposure to changes in interest rates or bond defaults; may increase overall portfolio volatility	Decreases diversification of equity portfolio, increases concentration in certain sectors, decreases reliability of income due to cyclicality of stock dividend payments, may increase overall portfolio volatility	No change to portfolio risk
Taxes Impact	Income from higher-yielding bonds taxed as ordinary income	Non-qualified dividends taxed at ordinary income rates and qualified dividends taxed at long-term capital gains rates	Income from stocks and bonds taxed as ordinary income, income from sale of appreciated assets taxed at long-term capital gains rates*
Income Control	Income controlled by bond issuers and their ability to make coupon and principal payments	Income controlled by stock issuers and their ability/willingness to pay dividends	Income controlled by investor; can sell more/less shares to create more/less income

*Assumes assets were held for one year before sale. The information herein is general in nature and should not be considered tax advice. Please consult with a tax professional for additional information.