High Income Investment Strategy

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This paper presents a solution to a problem facing millions of Americans who are either in retirement or are considering retiring in the near future – "How do I generate sufficient income from my portfolio to maintain my lifestyle." Our perspective is the typical two asset-class discussion of bonds and stocks is not helpful in solving this problem, and that a third major investment group called "high income" – which uses segments from both the stock and bond market – needs to be created to provide sufficient income for retirees while having sufficient diversification to maintain consistent cash flow and portfolio value. The high income portfolio uses six distinct groups of investments, and is diversified across several management companies, thereby providing the income and diversification needed to support a retiree's investment goals.

Nature of the problem

While a person might have many investment goals over the course of their lifetime, such as college savings, the purchase of a house, and charitable giving, the retirement savings goal is different from all of the rest. For most investors it is the largest and most vital. It also is the one goal that represents a dramatic change in lifestyle and requires a different outlook. Until retirement, investors tend to focus solely on wealth accumulation, with little or no focus on income yield. However, once an investor hits retirement, income yield becomes not only important, but necessary to meet living expenses. It is this shift from a wealth accumulation phase to an income generation phase that makes investing for retirement such a challenging process.

Most investment advisors recommend that investors put a majority of their funds in stocks until they retire, and then hold a much lower proportion of stocks in retirement. The reduction in equities at retirement is done for two reasons – to reduce the amount of portfolio risk and increase the yield for income purposes. However, the amount of risk and projected income yield is difficult to control.

To see this, consider a simple investment strategy in which beginning ten years before retirement, an investor holds 100% U.S. stocks until retirement, and then switches to 100% five-year Treasury bonds. Let's go back and look at recent history to see how this strategy would impact an investor who has a portfolio of $1 million ten years before retirement. Table 1 shows the results for three retirement dates: 1990, 2000 and today (2012). An investor starting in 1980, and retiring in 1990, would have earned a return of 17.5% throughout the 1980s, and would have accumulated $5.3 million of wealth by 1990, at which point they could have received a bond yield of 7.9%, which would yield an annual income of nearly $400,000 in retirement. An investor retiring in 2000 would have earned an equity return throughout the 1990s of 18.2%, which would have created an annual income in retirement of nearly $350,000. However, for an investor retiring this year, the equity return would have only been 2.9%, which, because of low interest rates, would generate an annual retirement income of only $12,000 – far less than their counterparts 10 and 20 years ago.

Table 1
Income earned in retirement for an investor with $1 million 10 years before retirement, an all U.S. equity strategy before retirement, and a five-year Treasury bond strategy in retirement.

Year Retired	1990	2000	2012
Annual equity return	17.5%	18.2%	2.9%
Portfolio value at retirement	$5,029,975	$5,329,333	$1,333,243
Bond yield at retirement	7.9%	6.5%	0.9%
Income yield in retirement	$397,368	$346,407	$11,999

Sources: Markov Processes International and the Federal Reserve Bank of St. Louis

The reason for the drastic reduction in retirement income for current retirees is two-fold – the low accumulation of equity wealth in the years leading up to retirement, and the low bond yield prevalent in today's market. One can quibble with the specifics of the scenario – for example, the results would not be as extreme if an investor used a more balanced strategy between stocks and bonds before retirement. However, the main point that can be learned from this example is that the income an investor can receive during retirement will be highly dependent on two factors: the equity returns that an investor earns in their last few years before retirement and the level of interest rates during retirement.

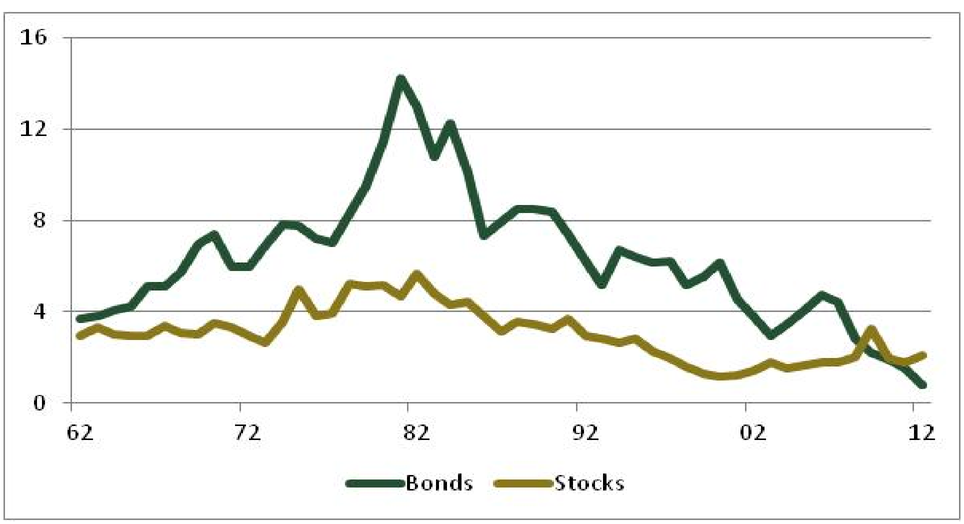
The Current Retirement Conundrum

As the example above shows, investors who are either nearing retirement or currently in retirement are facing hardships in meeting their retirement goals because of low recent equity returns and low interest rates. In addition, there are three other factors contributing to the difficulties facing current retirees. First, there is much uncertainty of amount of social security payments that will be received. Most analysts believe some cutback of benefits, such as raising the retirement age, reduction of cost of living adjustments, or a deduction for other income received, will be enacted. Second, life expectancy is on the rise, meaning the retirement savings have to last longer. Finally, the high equity returns in the 80s and 90s caused many investors to have unrealistic beliefs in doing their retirement planning – for example, surveys in the late 1990s indicated that over 80% of investors expected an annual return in the equity market of 25% over the next several years. Such unrealistic forecasts caused many individuals to underinvest and hold too high of a proportion of equity.

The Classic Investment Strategy

The way investors typically allocate their investments is to create two "buckets" of investments - a bond allocation and a stock allocation, and to allocate between them in such a way as to meet their overall risk tolerance and generate any income needs. While such a strategy makes sense for investors before retirement, when income needs from their portfolio are either non-existent or minimal, and might have been sufficient in the past for retirees, in current times such a strategy will fall short in generating sufficient income to meet most retirees' income needs. Figure 1 shows the income yields on bonds and stocks over the past 50 years. As can be seen, we are currently in an unusual time in that bond yields are lower than the yields on common stocks. This means that the common approach to shift money from stocks to bonds during retirement in order to generate a higher cash flow is not effective today. It is difficult for an investor to plan on generating any more than 1%-2% in income for a classically allocated portfolio.

Figure 1
Average yields from U.S. stocks and five-year Treasury bonds between 1962 and 2012.



Sources: Markov Processes International and the Federal Reserve Bank of St. Louis

One aspect that we have ignored thus far is that the income yield is only a portion of the rate of return on a portfolio. Particularly with respect to the equity allocation, investors expect to achieve growth in equity value through price appreciation in addition to the income yield. With that in mind, retirees can sell off portions of the equity to generate the income needed for expenses. However, there are three problems with this strategy. First, many investors have a psychological hesitation (perhaps justifiably) to sell off assets in retirement. Second, the requirement to sell stocks to meet income needs requires an investor to make continual transactions in the stock market, which exposes them to periodic swings in the market. In late 2008 and early 2009, this would have required investors to sell at the bottom of a 50% market decline – an action that most investment advisors discourage. Finally, in order to be able to sell the equities needed to generate sufficient income, a retiree would have to invest a substantial portion of the portfolio in equities, which is contrary to what is recommended by most investment advisors because of the higher volatility of equity markets.

Consequently, an investor in retirement using a classic bond and stock allocation strategy is stuck with a portfolio that is currently generating a very low yield – one that is unlikely to meet most retiree's needs. It is for this reason that Savant Investment Group, LLC introduces a High Income Strategy that will help alleviate the income shortfall for many retirees.

The Three Bucket Strategy

Along with the classic bond and stock strategy, a third "high income" bucket can be created with four main objectives:

1) Each strategy within the bucket should have a yield between 6% and 8% to generate as much income as possible
2) Risk in between that of bonds and stocks, so that an allocation to this bucket will not necessarily change the overall risk of the portfolio
3) Broad diversification within the bucket to keep risk as low as possible
4) Relatively low correlations with bonds and stocks to reduce overall portfolio risk

To implement this strategy, we chose six different investment types to be part of the high income bucket:

1) High yield bonds, investing in U.S. corporate bonds rated BB or lower
2) Preferred stocks, mostly in the financial sector, in U.S. and non U.S. companies
3) Master limited partnerships, focusing primarily on U.S. energy infrastructure
4) High dividend stocks, focusing on U.S. and international stocks with an expected yield in excess of 6%
5) A tactical strategy focusing primary on bonds in the U.S., developed and emerging markets
6) A strategic income strategy, focusing on stocks and bonds generating a high yield

While there is some overlap between the last two strategies and the first four, the tactical nature and allocation across different specific managers should reduce the correlations between the strategies to reasonable levels. Each of the individual strategies has an expected yield in excess of 6%, and each has risk in between those of bonds and stocks. Also, each strategy is chosen to have no leverage, to reduce the possibility of any extreme shock in volatility.

Table 2 shows the correlations of the various strategies with each other, as well as traditional equity indexes such as the S&P 500 (large cap stocks), Russell 2000 (small cap stocks), and MSCI EAFE (international stocks). The grey shaded region shows the correlations between the individual strategies, while the green shaded regions show the correlations between the traditional indexes. As can be seen, there is much broader diversification across the six individual strategies than is found in most equity portfolios.

We constructed a high income portfolio using a combination of the six individual strategies. Table 3 shows its volatility and correlation with traditional bond (Barclay's Aggregate) and stock (S&P 500) indexes. The high income portfolio has volatility about half way in between bonds and stocks, and has correlations low enough to offer diversification from traditional bond and stock strategies. Consequently, we are able to construct a portfolio that meets the four stated objectives we had at the outset.

Table 2
Correlations between high income strategies and various equity indexes – 2003-2012

	High Divid	Tact	Strat Inc	High Yield	Prefd Stock	Mast Ltd Ptn	S&P 500	Russ 2000	MSCI EAFE
High Dividend	1.00	0.75	0.75	0.76	0.63	0.42	0.91	0.82	0.95
Tactical	0.75	1.00	0.82	0.74	0.71	0.33	0.69	0.63	0.74
Strategic Income	0.75	0.82	1.00	0.80	0.60	0.48	0.69	0.65	0.74
High Yield	0.76	0.74	0.80	1.00	0.66	0.57	0.74	0.70	0.74
Preferred Stock	0.63	0.71	0.60	0.66	1.00	0.48	0.59	0.52	0.63
Master Ltd Pshp	0.42	0.33	0.48	0.57	0.48	1.00	0.40	0.38	0.40
S&P 500	0.91	0.69	0.69	0.74	0.59	0.40	1.00	0.93	0.91
Russell 2000	0.82	0.63	0.65	0.70	0.52	0.38	0.93	1.00	0.82
MSCI EAFE	0.95	0.74	0.74	0.74	0.63	0.40	0.91	0.82	1.00

Source: For the first five strategies, a sample portfolio of mutual funds; for MLPs, the Tortoise Master Limited Partnership Index; for the last three indexes, Markov Processes International

Table 3
Volatility and Correlations of High Income Portfolio,
Barclay's Aggregate, and S&P 500 – 2003-2012

	Barclays' Aggregate	S&P 500	High Income
Standard Deviation	3.67	15.17	9.91
Correlations:			
Barclays' Aggregate	1.00	0.06	0.21
S&P 500	0.06	1.00	0.78
High Income	0.21	0.78	1.00

Sources: Markov Processes International, and a portfolio comprised of various high income strategies

The Importance of Manager Diversification

The low correlations between the six high income groups indicate the importance of diversifying across those groups. It is just as important to diversify across managers and fund families. Even though two separate funds within a mutual fund family might have different specific objectives and different individual personnel involved with managing the funds, they are likely to be influenced by similar economic outlooks, security selection philosophies, and trading strategies. Consequently, two separate funds within a fund family are likely to have higher correlations than funds with similar objectives in two different fund families.

Consider the following two cases. The PIMCO All Asset fund has an objective consistent with the tactical group. PIMCO and Franklin have suitable funds to fit the high yield strategy, but the PIMCO High Yield fund has a correlation with the PIMCO All Asset fund of 0.8, while the Franklin High Income fund has a correlation of 0.7, which means Franklin does a better job of diversification. Similarly, the Nuveen Preferred Securities fund is a candidate for the preferred stock group. Nuveen and John Hancock have suitable funds for the strategic income group, but the Nuveen Strategic Income fund has a correlation with the Nuveen Preferred Securities fund of 0.8, while the John Hancock Strategic Income fund has a correlation of 0.6.

Because of the higher correlations across strategies within the same money management family, it is important to not simply choose a diversified income strategy with an individual money manager. It is also important whenever possible to invest across a variety of individual managers.

Roles of the Buckets

Beyond having three distinct risk and return profiles, and having low enough correlations with each other to provide diversifications, the bond, stock, and high income buckets each provide a separate role in the planning for retirement income.

Bonds: Because some of the high income bucket is invested in high yield and international bonds, the bond portfolio is more precisely defined as U.S. government and investment grade corporate bonds. In the past, these bonds provided stability and a yield sufficient for investors to generate much of their income needs. In the current capital market environment, bonds provide a small amount of income, but their main role is to provide stability, which is important from a risk perspective and as a source of future cash should the portfolio not provide overall income sufficient to meet the needs of the retiree.

Stocks: Stocks also provide a small amount of income to the portfolio – currently more income than bonds provide – but their main role is to provide some growth to the portfolio. That growth can be used in the future to help hedge against increases in inflation, and to help replenish bonds in case they are needed to be sold to provide additional cash flow.

High Income: The high income bucket, by definition, is designed to provide most of the income needs of the retiree (with some supplement from the bond and stock buckets). For this bucket, stability is essential, but it is more important to focus on stability of income instead of stability of asset values. Because this bucket is the income generator for the portfolio, every effort should be made not to touch the principal. Because some of the high income bucket is allocated to equities (the master limited partnership and high dividend stock groups), there will be some growth in principal, but not as much as in the equity bucket.

Examples

To see how the three buckets can be used to help an investor meet their cash flow needs, consider the following two examples. In both examples bonds and stocks are assumed to provide an income return of 2% per year (stocks will provide a higher overall return because of capital gains), and the high income bucket is assumed to provide an income return of 6%. In the first example, the investor has a $2 million portfolio, with an income need from portfolio of $80,000, or 4% of the portfolio value. Our solution is to invest 50% in the high income bucket, 20% in bonds, and 30% in stocks. In this case, the income will match the needs of the portfolio. Bonds offer additional stability to the portfolio. Stocks should provide some growth – if desired, a portion can occasionally be sold to allocate more funds to high income and bonds, thereby increasing income.

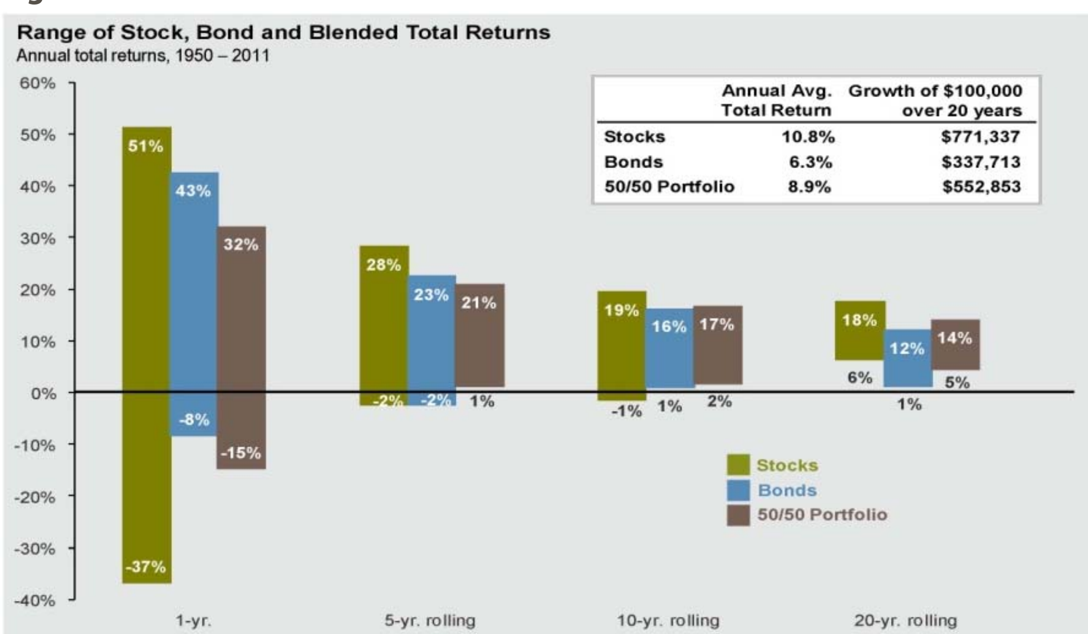
In the second example, the income needs from portfolio are increased from $80,000 to $120,000, or a 6% yield. Our solution is to invest 50% in the high income bucket, 30% in bonds, and 20% in stocks. In this case, the income will fall short of the needs by $40,000 per year. This shortfall will be alleviated by selling off a portion of the bond portfolio, which is why the stability of bonds is a critical portion facet of the strategy. The $600,000 of bonds offer 15 years of additional income supplement, even if the growth in assets in the other two buckets is never cultivated. However stocks can occasionally be sold to replenish the bond portion of the portfolio, lengthening the amount of time that bonds can supplement the income from the portfolio.

In the present capital market environment, we believe the 6% income yield is the maximum an investor should hope to achieve with this strategy. We can generate more income by allocating more than 50% to the portfolio to high income, but we believe this would be taking on too much risk. For investors with lower cash flow needs than 4%, we suggest allocating less than 50% the portfolio to the high income strategy. For example, a portfolio allocation of 25% to high income will generate an income yield of 3%.

The Importance of Income Yield

An alternative to using a high income bucket is to achieve the desired income needs by systematically liquidating portions of the portfolio. Instead of achieving an extra 1%-2% in yield, each year an investor can sell 1%-2% of the bond and stock portfolio, hoping to make up the difference in the long term through the growth in the stock portion. However, this systematic sell off inflicts additional risk on the investor. This is best evidenced by looking at Figure 2, which shows the range of security returns over various time intervals. A strategy that forces the investor to liquidate a portion of their portfolio every year will occasionally result in a portfolio loss – in 2008, that loss would have been 15%. If that need for liquidation can be put off to every five or ten years, the risk of incurring a portfolio loss is greatly reduced.

Figure 2



	Annual Avg. Total Return	Growth of $100,000 over 20 years
Stocks	10.8%	$771,337
Bonds	6.3%	$337,713
50/50 Portfolio	8.9%	$552,853

Sources: Barclays Capital, FactSet, Robert Shiller, Strategas/Ibbotson, Federal Reserve, J.P. Morgan Asset Management.

The Uniqueness of this Strategy

A fair question to ask is if the high income strategy is such a good idea, why isn't every investment manager offering a similar product. The answer is two-fold. First, we point out that we are not creating anything new here, just finding specific investment groups that are part of the broader bond and stock universe, but are typically not combined in such a fashion. In some cases, such as high yield bonds, these strategies are often specifically allocated as a portion of an investor's portfolio. However, in other cases, such as high dividend stocks, preferred stocks, and master limited partnerships, the sectors are overlooked, either because the make up a very small segment of the capital market, or because they are not of interest to larger institutional investors (for example, many pension funds cannot own master limited partnerships). By focusing on the specific problem of generating larger income yields, we have been able to identify these investments, and combine them in a manner that fits in with other portfolio objectives.

The second part of the answer is that there are mutual fund families that are beginning to offer high income strategies. However these strategies are flawed for two reasons. First, no individual mutual fund family offers strategies in each of the six groups we have identified – for example, there are only three fund families that offer a preferred stock fund, and none of those has a fund that focuses on high dividend stocks – only an independent advisor can reach across the various fund families to span the set of desired investments. Secondly, even if there was a fund family that had investments in each of the six groups, our research cited earlier suggests that they would not provide as much diversification because of the higher correlations for funds within a fund family – this would mean the fund family high income strategy would have greater risk.

Conclusion

Most investors in retirement today are unable to generate sufficient cash flow from their portfolio to meet their income needs. By creating a high income allocation as part of an investment strategy, we are able to create an overall portfolio that is consistent with common risk and return objectives, and also generates appropriate cash flow for retirees. Such a portfolio can use several money managers spread across six well-defined investment groups to provide solid diversification while supporting overall return and income yield goals.