BARRON'S COVER

# Best ETFs for Income

## ETFs offer a wide range of opportunities for income investors. Our experts offer 18 picks for all risk levels.

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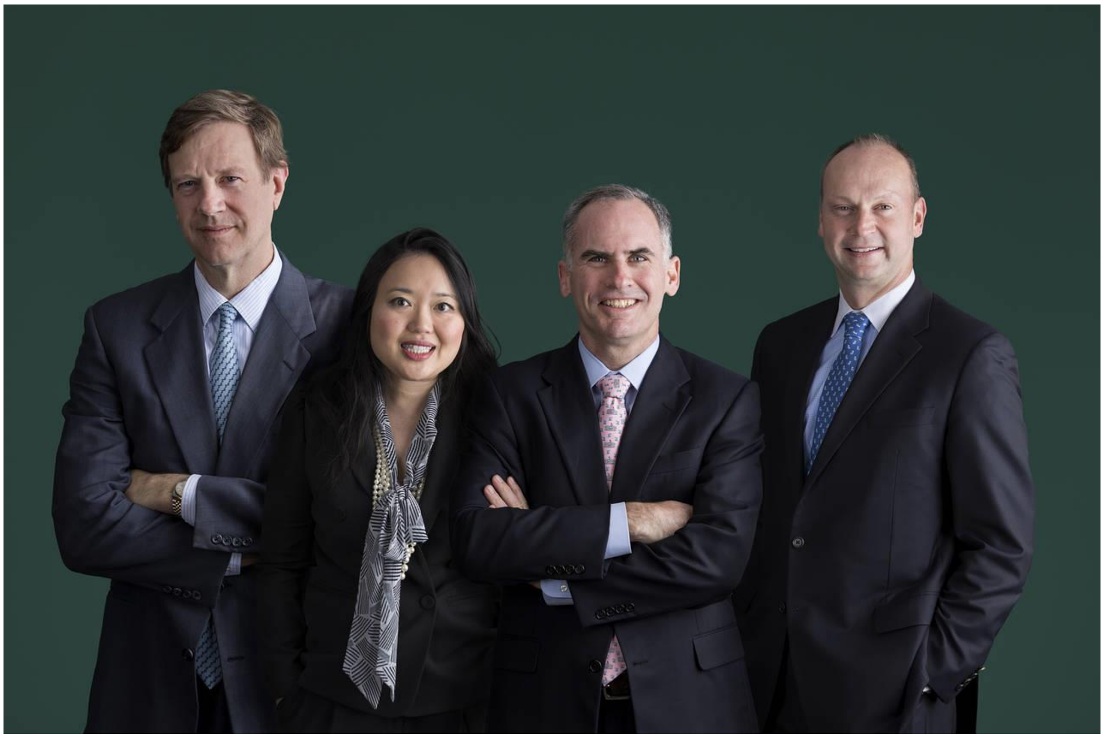

Jay Hatfield, Infrastructure Capital; Putri Pascualy, Paamco; Francis Rodilosso, VanEck; Michael Arone, State Street Global Advisors | Jenna Bascom for Barron's

For investors seeking income, it’s a jungle out there. The Federal Reserve is determined to keep raising interest rates even though economic growth remains stubbornly slow. And hopes are starting to fade that a pro-business Trump administration will immediately usher in faster growth. Bonds and dividend-paying stocks are expensive. So, investors must be both aggressive and defensive to meet their income goals, while remaining nimble and prepared for shifts.

To help traverse this tangled landscape, *Barron’s* convened a panel of income experts. They offer specific suggestions for boosting income with preferred securities, master limited partnerships, and emerging market debt—all by using exchange-traded funds. They also suggest ways to rein in risk, by laddering maturities or including a floating-rate bond ETF.

Our panel includes pros who manage portfolios using ETFs and who also run ETFs themselves. Yes, they recommend some funds from their own companies, but we asked them to recommend products from their competitors, too. We included Michael Arone, chief investment strategist at State Street Global Advisors, which offers the SPDR ETFs; Jay Hatfield, co-founder of investment firm Infrastructure Capital Management, which manages private funds, as well as a few niche ETFs; Putri Pascualy, who runs a credit fund at Paamco; and Fran Rodilosso, head of fixed-income ETF portfolio management at VanEck.

Michael Arone: "Investors can feel comfortable in intermediate-term bonds and corporate credit." | Jenna Bascom for Barron's

**Barron's:** *The best place to start a conversation about income investing is with interest rates. Where do you see them headed?*

**Putri Pascualy:** At this point, all signs point to up. The question is how we get there. A lot of recent economic news, plus events to come later in the year, like Federal Reserve policy and elections in Europe, will determine how we get from here to there.

**Michael Arone:** Rates are headed higher, but there is a cap on how high rates can get. We've been saying that all year; we thought this administration would implement pro-growth policies but that tougher immigration rules, trade restrictions, a rising dollar, and worsening deficits would put a cap on economic growth, as well as how high rates could get. Instead, what's really surprised me is how this has played out: The pro-growth agenda is being pushed further out on the horizon, while some of the tough talk on immigration and trade has been only that, tough talk. As a result, hopes for both economic growth rates and inflation have really started to taper off. While we always thought rates would remain fairly well behaved, we don't anticipate them moving up aggressively from today's levels.

*In other words, you don't expect bond prices to fall as investors flock to stocks. Does that mean it's safe to stay in long-term Treasuries, even with the Fed hiking?*

**Arone:**Given the contradictory dynamics, investors can feel comfortable in intermediate-term bonds and also in corporate credit. They shouldn't take significant risk on the long end, because we are uncertain about the interest-rate outlook. It makes sense to begin to move up in quality and shorten duration a bit. If you don't want credit risk, there's theiShares 7-10 Year Treasury Bond [ticker: IEF], or the SPDR Bloomberg Barclays Intermediate Term Treasury [ITE].

**Jay Hatfield:** We're not recommending iShares 20+ Year Treasury Bond [TLT], but we are bullish on the economy because of the pro-business government, and we're not superbearish on long-term rates—for a different reason than Michael. We continue to focus on a superpowerful long-term dynamic, which is the aging population, not just in the U.S., but in developed nations globally. Pension assets are growing about 4% globally and 5% in the U.S., so that creates tremendous demand for Treasury securities. States that had underfunded their pension liabilities are now contributing more to their pensions. It's not just Fed policy that has driven down rates the last 10 years.

But now the Fed is raising rates and also starting to talk about shrinking its balance sheet by selling the bonds it has been buying since the financial crisis, which can drive down prices, sending yields higher.

Jay Hatfield, Infrastructure Capital | Jenna Bascom for Barron's

*What do you see coming from the Fed?*

**Fran Rodilosso:** Two more rate hikes is my expectation for the rest of this year. I do think it's worth mentioning that Fed rate hikes can be bullish for long-term rates. I'm not predicting that, but it is entirely possible that the yield curve could flatten, with long-term rates coming down while short rates rise. It has happened before. Next year is a much bigger question. I don’t think the Fed is prepared to continue hikes at this pace at the same time they are reducing the huge balance sheet of Treasuries and mortgage-backed securities that they accumulated during quantitative easing. The “how” it will shrink the balance sheet is still largely unanswered, but we’ve started the conversation about when.

**Pascualy:** It’s not just the Fed shrinking its balance sheet. Keep in mind that the European Central Bank is on a path to reduce reinvestment of corporate-bond purchases, and there is talk about potential tightening from the Bank of England, as well. There is potential for that to lead investors to reprice risk in the bond market. That creates risk that rates could rise.

*What should investors do in that case?*

**Pascualy:** Rather than putting all your eggs in a long-term basket, laddering your bond portfolio makes sense, and ETFs can help. You can use funds with maturities in the five-year, 10-year, up to 30-year bonds. If rates rise, you can reinvest at higher rates. I like the shorter-duration ETF on the corporate side.
**Rodilosso:** At VanEck, we have a suite of municipal-bond ETFs that are a great tool if you want to target various durations. BlackRock and Guggenheim also have target-maturity ETFs that can be laddered.

**Hatfield:** It’s a real advantage of ETFs that, since you can’t reinvest your dividends automatically, you can take that income, if you don’t need it for expenses, and make a reallocation decision without having to sell securities. You can choose to reduce your risk or reinvest at higher rates. Now investors should focus on bond ETFs that offer some yield spread over Treasuries, like longer-duration corporate bonds. That yield gives you some insurance if we’re wrong on our call that interest rates will stay low.

Fran Rodilosso: What I like about preferreds now is you get extra yield without taking on too much risk. | Jenna Bascom for Barron's

*Let's jump to the corporate side, since none of you are excited about U.S. government bonds.*

**Pascualy:** Fundamentally, corporate credit is actually getting better. Companies' ability to service their debt is actually good; earnings are rising. That's not to say there aren't sectors facing headwinds, like retail and select parts of health care, but in general, fundamentals are good.
But I have concerns about valuation. High-yield bonds aren't cheap, and there are political risks. To balance that out, I like the shorter-term ETFs, such as SPDR Bloomberg Barclays Short Term High Yield Bond [SJNK] and iShares 0-5 Year High Yield Corporate Bond [SHYG]. They are both large, liquid, and yield over 5%. If you compare these shorter-term ETFs versus their longer-term brethren, SPDR Bloomberg Barclays High Yield Bond [JNK] and iShares iBoxx $ High Yield Corporate Bond [HYG], you may not give up any yield.

**Rodilosso:** Credit is most exciting when it's obviously cheap, and we're not at that point in the cycle. The good news is that you can earn a spread over Treasuries. We're not at the lows in terms of spread, even if in terms of absolute yield it is not very compelling.

*What about the fallen-angel strategy for high yield? Your fund*, VanEck Vectors Fallen Angel High Yield Bond *[ANGL], has been a top-performing high-yield fund for the past three- and five-year periods*.

**Rodilosso:** ANGL, a passive ETF, buys bonds that were previously rated investment-grade that have been downgraded to high-yield status. These bonds have generally experienced selling in the last six months, and usually these are out-of-favor industries. So, the index finds value in the high-yield market, which makes it an interesting play. You also get higher average credit quality, so there's a quality component and a value component in there. It yields 4.7%. We do like that as a part of a high-yield allocation.

**Arone:** Our view is that it is a bit later in the credit cycle, and many credit instruments have become expensive. So we're in a hold position within high-yield, not adding to that right now. One way we recommend getting credit exposure is through bank loans. We have an actively managed bank-loan ETF, SPDR Blackstone/GSO Senior Loan [SRLN]. It yields nearly 4%, so a little less than high-yield bonds. But you move up the capital structure [since loans are senior to bonds in a restructuring] and get access to the floating-rate mechanism. That gives you some protection against rising rates.

Putri Pascualy: “Laddering your bond portfolio makes sense, and ETFs can help.” | Jenna Bascom for Barron's

**Pascualy:** I like PowerShares Senior Loan Portfolio [BKLN], the biggest bank-loan ETF out there, at about $9 billion. It has performed well, and it yields about 4%.

*None of you are talking about investment-grade bonds?*

**Rodilosso:** The problem with investment-grade credit now is that spreads are so low over Treasuries that they are basically tied to interest rates at this point. But there are floating-rate options in both investment-grade and high-yield. Michael talked about bank loans, which are issued by high-yield companies, but some of the floating-rate investment-grade funds offer yields in the 1.5% to 2% range. They are not a bad low-risk alternative.

These are bonds, not loans, so they settle in three days; loans take a lot longer. That means there is less concern about underlying liquidity. We have VanEck Vectors Investment Grade Floating Rate [FLTR], and there is iShares Floating Rate Bond [FLOT] and SPDR Bloomberg Barclays Investment Grade Floating Rate [FLRN].

**Arone:** Floating-rate bond funds do tick a lot of the boxes for folks, in that they are investment grade, shorter duration, and floating rate. Should rates continue to tick up on the short end, you will be compensated for it. Bank loans are taking more credit risk, but you get a higher yield. We’ve tried to address concerns about liquidity and structure by partnering with an active manager for [SPDR Blackstone/GSO Senior Loan]. In some segments of the market where you have some potential risks, having a more conservative, active-management option is the best kind of approach.

*Let's address liquidity concerns among fixed-income ETFs.*

**Rodilosso:** When you talk about bank loans and ETFs, that's a separate conversation from talking about bonds and ETFs. Before there were so many ETFs, we had plenty of selloffs in which there were no bids for bonds. Liquidity now isn't much different from what it was in the past.

**Hatfield:** ETFs have actually reduced the risk in the market. Before, if a hedge fund trader wanted to reduce risk, he had to sell individual bonds [which often resulted in large spreads and potentially lower prices]. Now you can short the ETF. You don't have to sell the bonds. There is also less risk of front-running, because with ETFs, you don't need to call a floor trader who might scream.

*Tell us more about where you think credit is attractive.*

**Hatfield:** We're at the back end of the business cycle, but not at the end. We're OK with taking credit and duration risk. We would recommend JNK. If you go with floating-rate ETFs, you're overpaying for the insurance that floating-rate provides against rising interest rates.

We also like preferred securities. It would be very unusual to have a midcycle default or suspension of payment among preferred issuers, but that happens with high-yield and bank-loan issuers. Preferreds are long duration, but they are not usually a very volatile asset class. If the stock market is up, you end up with very low volatility. The largest preferred ETF is iShares U.S. Preferred Stock [PFF], and we launched InfraCap REIT Preferred [PFFR] this year, which owns all real estate preferreds. They yield 5.6% and 7.1%, respectively. This is a unique asset class in that long term, it has modest interest-rate risk and modest credit risk.

**Pascualy:** Preferreds have been popular, and it is good to use an ETF here for diversification among preferreds. With individual preferreds, the company could turn off the coupon. Some are cumulative—meaning that they still owe it to you even if they don't pay—but some preferreds are not.

**Hatfield:** Also, some are mandatory preferreds, which convert to equity. Some of those creep into the ETFs.

**Rodilosso:** What I like about preferreds now is that you're going down the capital structure [preferred shares fall between equity and debt in priority in a recovery]. So you get extra yield for that without taking on too much risk, since this is a fairly high-quality group of issuers. You are more than compensated for what you give up in seniority. We have one that is ex-financials,VanEck Vectors Preferred Securities ex Financials [PFXF], which yields more than 4%.

**Arone:** That's true. But preferreds got hit hard when rates ran up last fall after the election. It's not just with preferreds, but it illustrates a risk with high-yielding securities in general: A lot of hot money has come in searching for yield. When sentiment changes, the hot money can leave. The true holders of preferreds stayed and are now being rewarded for it. Preferreds have done very, very well this year.

*You don’t sound convinced*.

**Arone:** I want to bring up another area we haven’t touched on yet that isn’t quite so popular—convertible bonds. They aren’t incredibly cheap, but this sector could be a complement to a core position within a fixed-income portfolio. They have some yield but also equity-like characteristics. If you believe in the pro-growth story, these securities should benefit. It’s like having that equity option going forward. Our ETF is SPDR Bloomberg Barclays Convertible Securities [CWB], which is passive. Whereas in bank loans you need active management, in convertibles simply buying the benchmark gets you the exposure that you need. The yield is now around 2%. For investors who prefer an actively managed approach, another is First Trust SSI Strategic Convertible SecuritiesETF (FCVT).

**Hatfield:** My problem with convertibles is that if you are buying an ETF for income, it should be substantial. [Convertibles are typically issued at lower yields than straight bonds because they have an equity kicker.] Preferreds offer that. But no doubt about it: If you are getting a 6% yield, you have to be prepared for panics and you better be getting paid for taking that kind of risk. But this should not be 50% of your portfolio. It should be 4% or 5%, and you can add to it in a panic when people are selling.

*We’ve gone from bonds to hybrid securities; now I want to ask you about getting income from equity ETFs*.

**Hatfield:** Master limited partnerships are extraordinarily attractive. The Alerian MLP Infrastructure Index is yielding around 7%. You can buy that via the Alerian MLP ETF (AMLP). Our active ETF, InfraCap MLP (AMZA), yields more because we own higher yielding MLPs and also because we use leverage and write covered calls to boost income. It is sort of supercharged. You look at other equity income opportunities and they’re not really as attractive. Utilities Select Sector SPDR [XLU] is 3%; iShares U.S. Real Estate [IYR] is 3.7%. Right now, those sectors are pretty fully valued.
MLPs are an exception. You take commodity risk. Most investors don’t have portfolios that are heavy on commodities, so it is reasonable for investors to have a 3% to 5% allocation of MLPs, recognizing that if there’s a problem in the oil market, those securities aren’t going to perform well. But we are very bullish about oil prices. Oil prices are going in the $60 to $70 range.

*Any other equity-income plays?*

**Hatfield:** My No. 1 pick, if someone asks me for a stock recommendation, is SPDR S&P Dividend [SDY], which yields about 2%. It owns the companies in the S&P 1500 index that have increased their dividend every year for 20 years. You only get a little bit of yield pickup relative to the SPDR S&P 500 Trust [SPY], but you get the upside of the market, no interest-rate risk, and high-quality companies that are likely to increase their dividends over time.
If you want something that is going to perform well in a down market, you are not going to get it from equity-income securities. You’d be better off in bonds.

**Arone:** That's a good point, that due to the incredible thirst for yield, interest-rate risk can show up in different places—including in stocks. That's why we prefer dividend growers over high-yielding equities. An interesting statistic is that if you look at the top 10% of stocks that are most correlated with moves in the 10-year Treasury each year, in 2007, those made up 1% of total equity-market capitalization in the U.S. At the end of 2016, it was closer to 20%.

**Rodilosso:** Your fixed-income portfolio has a role to play to hedge against equity risk. Those are your singles hitters, to use a baseball analogy.

*What about for investors who want doubles and triples?*

**Rodilosso:** My pick there, if you have risk appetite and sophistication, is emerging market local debt. There are two components of return to a fund like this; your local returns on the bonds and the currency impact. VanEck Vectors J.P. Morgan EM Local Currency Bond[EMLC] is the largest U.S. fund that invests in this debt. It includes debt from 17 countries, at least four of which have central banks that are probably easing this year. It should benefit from positive global growth. Plus, we're seeing a longer-term strategic-allocation trend from institutional investors. This is a diversification play within your fixed-income portfolio. It has very low correlation with U.S. rates and a yield of 5.1%, but it comes with risks.

*Putri, what do you recommend for higher yields?*

**Pascualy:** He took my idea—or close to it. I'm in the slightly more conservative camp, so I prefer to isolate the credit risk without the currency exposure. The two largest emerging market ETFs that buy dollar-denominated bonds are iShares J.P. Morgan USD Emerging Markets Bond [EMB] and PowerShares Emerging Markets Sovereign Debt Portfolio[PCY]. These will add juice to a portfolio.

**Rodilosso:** Just keep in mind that the bonds tend to be higher rated when issued in their local currency versus the dollar market. That's because they can print their own currency to pay their debts.
**Hatfield:** One last point I'd like to make about using ETFs for income: One way for investors to deal with volatility is to have a smaller position size. That is especially true for these riskier ideas like emerging market bonds.

*Thanks to all of you.*

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**You should consider the fund's investment objectives, risks, and charges and expenses carefully before investing. Contact ETF Distributors LLC at 1-888-3834184 or visit www.infracapmlp.com to obtain a prospectus which contains this and other information about the fund. The prospectus should be read carefully before investing.**

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