BARRON'S COVER

Where to Find Yield

We rank the best—and worst—places for income in a rising-rate world. European dividend stocks and utilities look attractive. MLPs, not so much.

Income-oriented investors have plenty of choices going into 2017, following the selloff in the bond market and rate-sensitive areas of the stock market during the second half of 2016.

Table: Yield Plays for 2017

There now are yields of 3% to 7% on a range of stocks and bonds, including European equities, electric utilities, real estate investment trusts, municipal bonds, master limited partnerships, and junk debt. The opportunities in many cases are as good as or better than at the start of 2016, mostly due to the jump in bond yields following the election of Donald J. Trump in November.

This is *Barron's* fifth annual assessment of income-producing investments. This time, we'll take a look at 10 sectors and forecast which offer the best return prospects in the next 12 months.

Our top choice is depressed European stocks, which offer both high yields and appreciation potential. We haven't focused much on Europe before, but we like to highlight undervalued areas that aren't getting wide attention. After another year of underperforming their U.S. counterparts, European blue chips, including Nestlé(ticker: NSRGY), Royal Dutch Shell (RDSA), Novartis (NVS), and Unilever (UL) carry yields of 3% to 7%.

In the U.S., electric utilities, real estate investment trusts, municipals bonds, and preferred stock look appealing after a selloff in the second half of 2016. Utilities and REITs generally yield 3% to 4%; munis, 2% to 5%; and preferred stock and

junk bonds, 6%. Closed-end funds investing in these sectors often offer even higher yields, thanks to leveraged structures that also magnify risk.

We're less enamored of Treasuries, telecoms, and master limited partnerships. Even after a rise in interest rates, Treasury yields of 1% to 3% aren't enticing relative to inflation, now running at close to 2%. Telecom shares look more fully valued after a recent rally, while MLPs look rich relative to other income-producing areas of the equity market after a 60% rally in the widely followed AMZ index from its February lows.

Changes in tax laws could affect both stocks and bonds. A plan from House Republicans would benefit holders of taxable debt by setting a preferential rate of 16.5% on interest income (half the proposed top income-tax rate of 33%), compared with current rules subjecting this income to an individual's top marginal rate. Lower income-tax rates could dent demand for municipal bonds.

Last year, we ranked 10 sectors, and our record looks good. Our top choices—junk, high-dividend U.S. stocks, and electric utilities—each returned about 15%. And we weren't excited about most parts of the bond market, including Treasuries and preferred stocks, given low prevailing yields. We didn't get it all right, however. We ranked telecom stocks too low on the list, and we were unenthused by master limited partnerships, which returned about 15% in 2016 after a very rocky start.

What follows is our view of 10 income sectors in order of their appeal.

European Dividend Stocks
U.S. equity investors did best staying close to home in 2016, as the S&P 500 rose 9.5%, small and mid-cap indexes gained about 20%, and the major European index, the Stoxx 600, was down 1%.

The European outlook for 2017 looks better, with many European ADRs (American depositary receipts) having finished 2016 in the red, hurt in part by the dollar's rise. Valuations have gotten more reasonable and dividend yields are ample, especially relative to ultralow or even negative yields on European government bonds.

Novartis, for instance, trades for about 14 times estimated 2017 earnings and yields 3.7%. Unilever yields 3.5%, Sanofi (SNY), 4.1%, and Royal Dutch Shell, 6%. *Barron's*highlighted Novartis and Unilever among "Our 10 Favorite Stocks for

2017" (Dec. 3, 2016), and Royal Dutch in a cover story during the summer ("Shell: The Best Big Oil Stock Yields Juicy 6.6%," July 16, 2016).
The First Trust Stoxx European Select Dividend Income exchange-traded fund (FDD) holds 30 high-dividend stocks that have payout ratios (dividends divided by earnings) of 60% or less; it now yields 4.9%. Its largest holdings are Zurich Insurance Group and Royal Dutch. A broader ETF, the low-fee Vanguard FTSE Europe (VGK), yields 3.5%.

Electric Utilities

Electric companies remain a good spot for income following an 8% pullback in the Utilities Select Sector SPDR (XLU) since its July peak. Utilities trade for an average of 17 times estimated 2017 earnings, which is close to a market multiple. Their average yield of 3.6% is almost double that of the S&P 500. Utility dividends usually are secure, given regulated returns.

"U.S. electric utilities offer better value relative to other defensive industries," wroteMorgan Stanley utility analysts in a recent note, citing work by the firm's chief domestic strategist, Adam Parker, that shows utilities have low earnings variability relative to other traditionally defensive industry groups. Reflecting this, Parker argues that utility P/Es ought to be three to four multiple points higher than they are now.
While growth is hardly robust, many utilities are capable of mid-single-digit expansion in earnings per share keyed to new generating facilities and infrastructure spending, with higher-growth utilities like California's Sempra Energy (SRE) targeting 12% annual gains through 2020.
In a recent interview with *Barrons.com*, John Bartlett, a portfolio manager at Reaves Asset Management, said utilities are better than bonds. While further rate increases likely would be negative, he argued that utilities "are common stocks and have the ability to grow earnings and dividends so those head winds can be overcome." Reaves runs several funds, including the Reaves Utility Income fund (UTG), a $1 billion closed-end fund that yields 6.2% (reflecting a leveraged structure) and trades around $31, a 5% discount to its net asset value. Bartlett is partial to California utilities like Sempra and PG&E (PCG) and Michigan's DTE Energy (DTE) due to a favorable regulatory environment.

U.S. Dividend Stocks

In a low-rate environment, it generally has paid to get income in stocks rather than bonds. That was the case in 2016, as stocks bested bonds by a wide margin—with junk debt the exception. Our view has been that bonds didn't offer enough yield to compensate for the price risk. Investors were reminded of that danger in the second half of 2016, as long-term bond prices fell sharply.

Even after rallying in 2016, high dividend-paying stocks still look appealing. One place to look is the out-of-favor health-care group, where yields are in the 3% to 4% range, including Pfizer (PFE), Merck (MRK), and AbbVie (ABBV). Investors also can get bond-like yields in the consumer sector. Coca-Cola (KO) yields 3.4%; Procter & Gamble(PG), 3.2%; and Anheuser-Busch InBev (BUD), 3.3%. Financial stocks don't look as attractive following their late-year run-up. Industry leader JPMorgan Chase (JPM), for example, now yields just 2.2%.
Among the numerous dividend-oriented funds and ETFs, there is the large Vanguard High-Dividend Yield ETF (VYM), which is dominated by megacap dividend payers likeMicrosoft and Exxon Mobil. The ProShares S&P 500 Dividend Aristocrats (NOBL) features companies with a history of 25 years of annual dividend increases, like Nucorand Sysco. (For more on the Dividend Aristocrats, see Speaking of Dividends.)

YIELD PLAYS FOR 2017

Here are more than 30 income investments across ten major sectors, including stocks, ETFs and closed-end funds. European shares, U.S. health-care and consumer stocks and utilities all look like good plays for the year.

EUROPEAN DIVIDEND STOCKS AND FUNDS Investment / Ticker	Recent Price	YTD Return	Yield	Discount to NAV
First Trust Stoxx European Select Dividend / FDD	$11.83	1.9%	4.9%	
Vanguard FTSE Europe / VGK	47.68	-0.9	3.5	
Vodafone Group / VOD	24.53	-20.0	6.1	
Royal Dutch Shell / RDSA	54.56	28.6	5.8	

ELECTRIC UTILITIES Investment / Ticker	Recent Price	YTD Return	Yield	Discount to NAV
Reaves Utility Income / UTG	$31.00	30.8%	6.2%	4.8%
Duke Energy / DUK	78.02	14.1	4.4	
Sempra Energy / SRE	100.99	10.5	3.0	
Utilities Select Sector SPDR / XLU	48.84	16.7	3.4	

U.S. DIVIDEND STOCKS AND FUNDS Investment / Ticker	Recent Price	YTD Return	Yield	Discount to NAV
ProShares S&P 500 Dividend Aristrocrats / NOBL	$54.01	11.9%	2.1%	
Vanguard High-Dividend Yield / VYM	75.98	17.4	2.9	
Coca-Cola / KO	41.60	0.0	3.4	
Anheuser-Busch InBev / BUD	104.89	-13.1	3.3	
Pfizer / PFE	32.49	4.5	3.9	

JUNK BONDS Investment / Ticker	Recent Price	YTD Return	Yield	Discount to NAV
Osterweis Strategic Income / OSTIX	$11.21	11.0%	5.2%	
BlackRock Corporate High Yield / HYT	10.80	20.3	7.8	8.6%
Invesco Dynamic Credit Opportunities / VTA	12.23	25.8	6.9	7.2
SPDR Bloomberg Barclays High Yield Bond / JNK	36.40	14.3	6.1	

MUNICIPAL BONDS Investment / Ticker	Recent Price	YTD Return	Yield	Discount to NAV
Nuveen Quality Municipal Income / NAD	$13.94	1.4%	5.5%	5.8%
BlackRock Municipal 2030 Target Term Trust / BTT	21.83	5.5	4.4	4.3
Vanguard Intermediate-Term Tax-Exempt / VWIUX	13.88	0.1	2.9	
Pimco High-Yield Municipal Bond / PHMIX	8.63	2.1	4.2	

REAL ESTATE INVESTMENT TRUSTS Investment / Ticker	Recent Price	YTD Return	Yield	Discount to NAV
Simon Property Group / SPG	$175.98	-6.4%	3.8%	
Boston Properties / BXP	123.67	-1.0	2.4	
Equity Residential / EQR	63.68	-6.0	3.2	
Vanguard REIT / VNQ	81.50	7.3	4.9	

PREFERRED STOCK Investment / Ticker	Recent Price	YTD Return	Yield	Discount to NAV
Bank of America 7.25% L Series / BAC Pfd L	$1,161.00	12.8%	6.2%	
iShares US Preferred Stock / PFF	37.14	1.1	5.9	
Nuveen Preferred & Income Term / JPI	22.88	9.1	8.5	5.0%

TREASURIES Investment / Ticker	Recent TPrice	YTD Return	Yield	Discount to NAV
iShares TIPS Bond / TIP	$112.80	4.3%	1.5%	
iShares 20+ Year Treasury Bond / TLT	118.95	1.0	2.6	

TELECOM Investment/ Ticker	Recent Price	YTD Return	Yield	Discount to NAV
AT&T / T	$42.66	30.3%	4.6%	
Verizon Communications / VZ	53.74	21.5	4.3	

MLPs Investment / Ticker	Recent Price	YTD Return	Yield	Discount to NAV
Enterprise Products Partners / EPD	$26.87	11.7%	6.0%	
Alerian MLP / AMLP	12.61	14.9	7.6	
Boardwalk Pipeline Partners / BWP	17.57	39.1	2.3	

Through 12/29

Source: Bloomberg

Click table for larger PDF version.

Junk Bonds

The junk-bond market is coming off its best year since 2012, with 2016 returns at around 15%. That reflected the high average yield of 9% entering the year after a tough 2015, when many energy and commodity bonds were hit.

Junk yields still look good at an average of 6.3%. The interest-rate gap relative to Treasuries is still appealing at nearly 4.5%, but absolute yields are modest by historical standards. “I think you can get close to a 10% return” in 2017, says Carl Kaufman, manager of the Osterweis Strategic Income fund (OSTIX), a go-anywhere bond fund with a heavy junk weighting. “It wouldn’t take a lot to get you there. The economic momentum is positive.”
Andy Johnson, a manager of the Neuberger Berman Strategic Income fund (NSTAX), is partial to so-called leveraged loans made to junk-grade companies. These floating-rate loans, pegged to Libor (a key short rate), now yield an average of 5.5% to 5.75%. “The spread between high-yield debt and loans is very narrow. You’re not getting paid for the additional interest-rate risk of high yield” bonds, he says. Loans are usually the most senior debt of a junk-grade company and carry lower rate risk.

Junk plays include closed-end funds like the BlackRock Corporate High Yield (HYT) and Invesco Dynamic Credit Opportunities (VTA), a leveraged loan fund, and ETFs like the SPDR Bloomberg Barclays High Yield Bond (JNK).

Municipal Bonds
Munis are looking better after a disappointing 2016, when total returns were roughly flat as interest income offset modest price declines on intermediate and long-term debt. Yields generally rose ¼ to ½ percentage point. Triple-A-rated 10-year debt now yields about 2.4%, and 30-year triple-A debt, 3.15%.

Lower-rated debt yields more. Port Authority of New York and New Jersey’s long-term debt, with double-A ratings, yields about 3.5% assuming an early redemption in about 10 years. New Jersey’s financial woes cost the state in December when the New Jersey State Economic Development Authority sold $900 million of debt and paid a rate of more than 5% for 25-year debt.

There are a lot of tax uncertainties in 2017, notably whether the top income tax rate will be cut to 33% from 39.6%, modestly reducing the appeal of munis. And munis could get more competition from corporate bonds, Treasuries, and mortgage securities if taxes on interest income on taxable debt are reduced.

The tax changes, however, seem to be reflected in the market, with top-rated munis trading at about the same yield as Treasuries. “I expect a lot of volatility and uncertainty given the new administration,” says Alan Schankel, muni analyst at Janney Capital Markets. He’s partial to transportation debt for turnpikes and airports.

Muni plays include higher-yielding leveraged closed-end funds like the Nuveen Quality Municipal Income (NAD) yielding 5.5% and the BlackRock Municipal 2030 Target Term Trust (BTT), yielding 4.4% with wind-up date in 2030—an appealing feature that makes the fund more like a bond. Vanguard Intermediate Term Tax Exempt (VWIUX), the industry’s largest open-end fund, yields 2.9%, and Pimco High-Yield Municipal Bond (PHMIX) yields 4.2%.

Real Estate Investment Trusts

After making a nearly complete round trip in 2016, the sector looks good, with an average yield of 4% and reasonable growth prospects in 2017 and 2018. Adjusted funds from operations, a key REIT financial measure, are expected to show an average increase in the mid-single-digits in 2017.

HOW WE FARED LAST YEAR

Junk bonds, high-dividend stocks, and utilities worked nicely for us in 2016, but we were too careful on telecoms.

How We Ranked Them Last Year	Asset Class	2016 Return*	Benchmark ETF
1.	Junk Bonds	14.3%	JNK
2.	High-Dividend Stocks	17.4	VYM
3.	Electric Utilities	16.7	XLU
4.	Municipal Bonds	-0.1	MUB
5.	REITs	7.3	VNQ
6.	Convertibles	11.1	CWB
7.	Telecom	24.1	XTL
8.	Preferrred Stock	1.1	PFF
9.	Treasuries	1.0	TLT
10.	MLPs	14.9	AMLP

*Through 12/29

Source: Bloomberg

REITs now are on the inexpensive side of a fair-value range as calculated by Green Street Advisors, the Newport Beach, Calif., real estate research firm. REITs also look good versus private-market transactions. One way to gauge this is to look at implied capitalization rates for major REITs like Boston Properties (BXP), Equity Residential(EQR), and Simon Property Group (SPG), which now are 5% or higher. The cap rate is what an unleveraged investor would earn owning each company's assets. Cap rates for private transactions involving top malls, office buildings, and apartments often are in the 4% range. A lower cap rate translates into a higher price.

Mall REITs have been weak lately, as investors start to discount the death of malls at the hands of e-commerce. Industry leader Simon Property hit a 52-week low of $173 last week; it yields 3.8%. The bull case for the mall REITs is that they hold prime properties that should be largely immune from Internet retailing threat. Simon Property's funds from operations, an industry cash-flow measure, are

expected to rise a healthy 8% in 2017 and its valuation has contracted. Boston Properties arguably is the top office REIT and trades at a marked discount to its estimated private market value. The Vanguard REIT ETF (VNQ) returned about 7% in 2016 and yields more than 4%.

Preferred Stock

With yields up about a percentage point from summer lows, to around 6% on many leading bank preferreds, the sector looks more attractive. Preferred yields are almost double the rate on long-term Treasuries—a nice spread given the rising security of preferred dividends amid stronger bank earnings and capital positions. Banks are the leading preferred issuers.

The main negative is interest-rate risk. Most preferreds have long maturities or are perpetual, making them very sensitive to rate changes. Some have fallen 15% in price since the bond-market peak in July. Preferreds generally are callable in five years at face value, normally $25. The combination of perpetual maturities and five-year calls favors issuers and disadvantages investors. Since preferred is equity, dividends are typically taxed preferentially like common stock dividends, although REIT preferreds are an exception. Liquidity usually is good because preferred trades like stock on exchanges, usually the New York Stock Exchange. It often pays to buy preferred at a discount from face value to reduce redemption risk and create a more attractive risk/reward. Wells Fargo's series X issue, for instance, has a 5.5% dividend rate and trades around $22.70 (with a face value of $25) for a yield of 6.1%. Public Storage's4.9% issue (series E) trades around $21, for a yield of 5.80%.

One unusual high-rate bank convertible issue, the Bank of America 7.25% Series L, is appealing. It trades above its face value of $1,000 but can't be converted unless the common stock more than doubles from the current $22. And even in a redemption scenario, it can only be called at a 30% premium above $1,000, pros say.

The largest sector ETF, iShares US Preferred Stock (PFF), yields almost 6%. And there are several preferred-oriented closed-end funds, like the Nuveen Preferred & Income Term fund (JPI), that yield more. The Nuveen fund yields 8.5%, reflecting leverage, and has an attractive wind-up-date feature with a scheduled maturity in 2024.

Treasuries

The one-percentage point rate rise in the second half of 2016 turned a great year into a mediocre one, as the two leading ETFs, the iShares 20+ Year Treasury

Bond (TLT) andiShares 7-10 Year Treasury (IEF), both returned 1% for the year. Treasury Inflation Protected Securities did better, with the iShares TIPS Bond (TIP) ETF returning about 4% amid rising inflation expectations.
If Trump's fiscal and economic policies prove inflationary, Treasuries are apt to suffer. TIPS offer a hedge against higher inflation, although they likely would drop in a bond bear market.

Telecom

The two main telecom stocks, AT&T (T) and Verizon Communications (VZ), are coming off a strong 2016 when AT&T returned 30% and Verizon 21%. Neither is expensive now. Verizon, at $53, changes hands at 13 times projected 2017 earnings and yields 4.3%. AT&T, at $42, has a 2017 P/E of 14 and a yield of 4.6%. There may, however, be better values in other high-yielding parts of the stock market and in overseas telecom issues. The U.S. wireless market remains very competitive, with little or no revenue growth projected in 2017 for the top companies amid inroads by T-Mobile US andSprint, which offer lower-cost plans.
AT&T will be focused in 2017 in trying to get antitrust approval for its $85 billion deal forTime Warner and the rollout of its low-cost, $35-a-month TV offering.
Verizon is expected to buy Yahoo's core business, and there is speculation that the company may look at an even bigger target: Charter Communications, the No. 2 cable outfit.
Alternatives to the major U.S. telecoms include Deutsche Telekom (DTEGY), which holds a valuable stake in T-Mobile and yields 3.7%. Vodafone Group (VOD), yields 6.1%.

Master Limited Partnerships

Energy infrastructure MLPs recovered from sharp early-year losses to finish 2016 with a total return of 15%, as the industry stabilized amid higher oil and natural-gas prices.

MLP yields remain elevated with the Alerian MLP ETF (AMLP) yielding more than 7%, comfortably exceeding those of electric utilities and REITs. But distribution growth is moderating, leverage remains high at many companies and valuations are expensive based on enterprise value/cash flow. MLPs trade for around 15 times 2017 earnings before interest, taxes, depreciation, and amortization (Ebitda), versus about 10 for utilities and seven for Verizon and AT&T.
"We expect muted distribution growth from most MLPs, given the rising cost of capital and leverage," wrote JPMorgan analysts last month. The firm sees most of 26 MLPs it covers generating annualized distribution growth of 5% or less over the coming three years, with nearly half at 2% or less. Enterprise Products

Partners (EPD), a laggard in 2016, remains an industry leader with a strong pipeline network and a yield of 6%.Boardwalk Pipeline Partners (BWP) has a conservative distribution policy, yielding just 2%. But it could boost its payout in 2018, when major construction projects end.