In Search of Yield

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One of the largest issues impacting investors today is the low interest rate environment we have been in for a few years. With rates not expected to rise quickly anytime soon, investors have been searching for yield.

Stretching for Yield

While additional yield can be obtained with a few strategies, we would caution investors against "stretching for yield." This is defined as implementing a portfolio allocation or vehicle that does not fit within the overall framework of the investor's risk/return profile, even though the income objectives may be met. As a simple example, we would not recommend investing a vast majority of your fixed income allocation into high yield bonds simply to earn the higher income.

Yield and Portfolio Allocation

Before jumping into potential sources for yield, remember that we believe investors should focus on a portfolio's total return, or the combination of income + capital appreciation, instead of just focusing on the income side of the equation.

There are some portfolio allocation and implementation adjustments that can be made within our recommended strategy to try and increase portfolio yield.

From a fixed income standpoint, we would generally expect most clients to have a fixed income portfolio of investment grade quality with an intermediate duration. Additional yield can generally be found by going out further on the yield curve or by investing in securities with a lower credit rating. Adding an allocation to emerging market debt is another example of how to potentially increase yield. However, we would caution investors to be careful of the potential downside risks of stretching for too much yield which can include interest rate risk and credit or default risk among others.

From an equity perspective, securities that are considered to be value-oriented tend to pay higher dividends vs. growth-oriented securities. This is because growth-oriented companies tend to reinvest extra cash back into the business instead of paying dividends. At RSM McGladrey LLC, we tend to recommend portfolio allocations that have an overweight to value vs. growth. Real Estate Investment Trusts (REITs) are another investment that tends to have higher yields. This is because REITs are required to distribute 90% of their taxable income to investors.

Separately, with bond yields at historic lows, many investors have thought about replacing some of their fixed income allocation with more equities in the hopes of receiving higher income. We would caution against this as equities have traditionally experienced significantly more volatility vs. fixed income instruments and have a much higher potential for loss. The equity to fixed income allocation in an investment portfolio should reflect both your ability and need to take investment risk as well as your tolerance for investment risk.

Understanding 'Dividend Focused' Investments

With so many investors concerned about income, investment companies have been strongly promoting the dividend-focused investments in their lineups. As with any investment, there are several items to consider before making an investment. Specifically, some of the items to consider as it relates to dividend-focused investments include the following:

- Be aware of sector/industry concentrations when evaluating investments. For example, mutual funds that pay higher dividend yields may have significant weights in defensive sectors like consumer staples or utilities while at the same time having minimal to no weight in other sectors like technology and consumer cyclicals. Sector concentrations can inject different types of risk into an otherwise well balanced portfolio.

- There are numerous investments with the word 'dividend' in the name. It is important to note that just because a mutual fund focuses on stocks that pay dividends, it does not necessarily mean the yield of the fund will be higher than another fund that doesn't specifically focus on dividend paying stocks.

- The dividend yield of a stock is calculated by dividing the income of the stock by the price of the stock. Therefore, a high dividend yield could simply be the result of a stock falling in value. In this case, you might receive a higher yield but at the expense of a negative total return.

Money market funds and CD's are currently not generating much income. Treasury bonds are at or near historic lows in terms of yield. Searching for yield has been common for investors of all ages and circumstances. Clearly there are certain tactics that can help improve the amount of portfolio income a portfolio generates. However, we would caution investors against stretching too far for yield or fundamentally changing the risk characteristics of their portfolio without fully understanding the new risks an income-focused portfolio may create.

As always, please contact your Wealth Management Advisor with any questions or comments.

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