The Income Investing Obstacle Course

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Topics

1. Income Investing: Problems and Solutions
2. The Risk of Rising Interest Rates

Income Investing
Problems and Solutions

OBSTACLE 1

Super-safe investments no longer provide a living

Three-Month CD Rates

1965 – 2018*

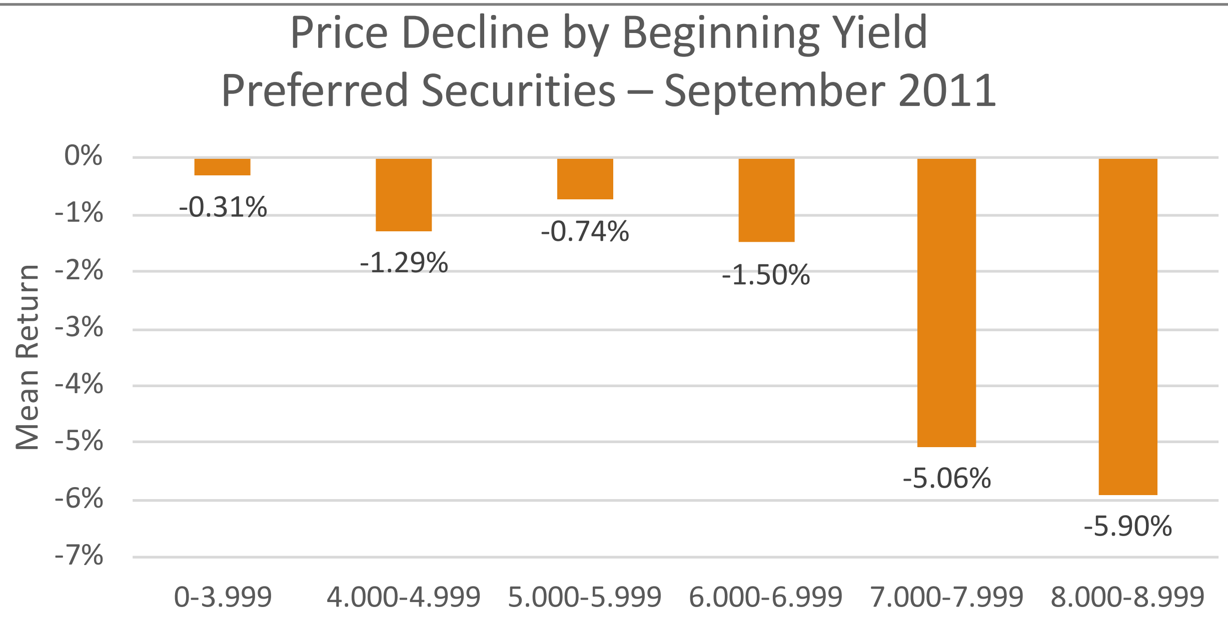
*Through September 2018

Source: Federal Reserve Bank of St. Louis

The decline in CD rates has coincided with a drop in the inflation rate.

OBSTACLE 2

Stretching for yield exposes investor to greater market risk.



Based on ICE BofA Merrill Lynch Fixed Rate Preferred Securities Index

Price change for the total index = -2.51%

Source: ICE BofA Merrill Lynch Global Research, used with permission.

In this one month, holders of preferreds with yields of 7% or greater saw 69% of their annual yield offset by price declines.

OBSTACLE 2

Getting a higher yield requires taking more risk

ASSET	Yield September 30, 2018	PRICE VOLATILITY* Monthly, 2007 - 2017
REITs	4.33%	23.7%
UTILITY STOCKS	3.49%	19.3%
“A” CORPORATE BONDS	3.88%	0.5%
TREASURY BILLS	2.17%	0.3%

*Standard Deviation / Average Price

Sources: Bloomberg; ICE BofA Merrill Lynch Index System, used with permission.

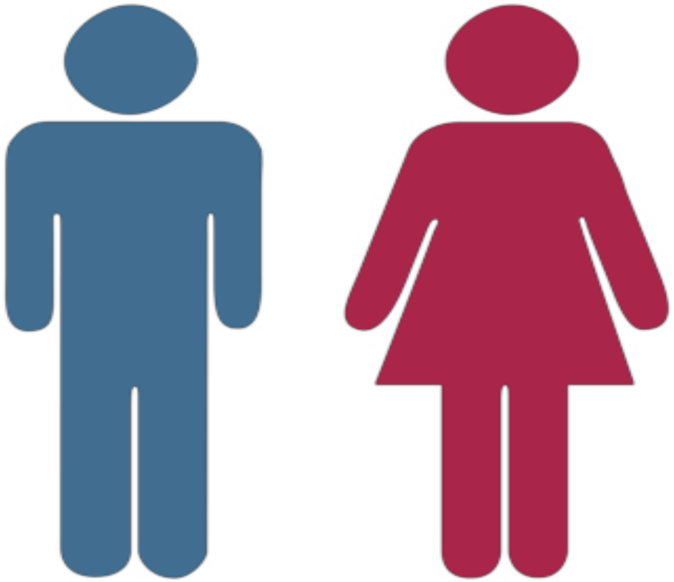
There is no free lunch in financial markets. The key point is to avoid stretching too far and incurring large losses of market value.

OBSTACLE 3

Long life expectancy means many years for inflation to erode purchasing power.

US Life Expectancy at Age 65

MALE FEMALE



18 Years 20.5 Years

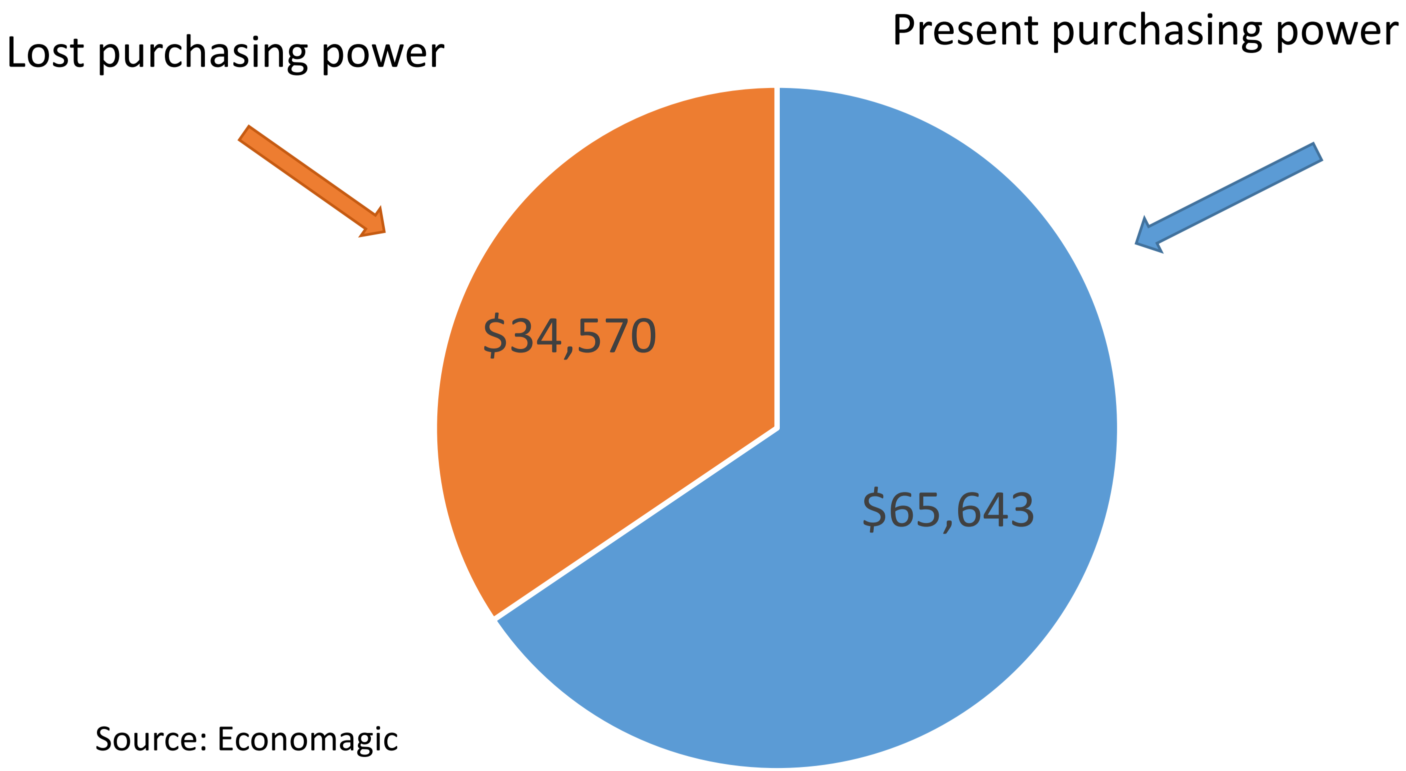
Source: Society of Actuaries

The Society of Actuaries says there is a 25% chance that one spouse in a 65-year-old couple will live to 98.

In light of this, investors must consider how much purchasing power a completely fixed income portfolio will lose over two decades.

Loss of Purchasing Power in Past 20 Years

$100,000 Annual Income as of December 1997



With inflation averaging only 2% per year over the last 20 years, people living on a fixed income have lost 35% of their purchasing power. The outcome over the next 20 years will be much worse if Fed policy returns CPI-based inflation to its 50-year average of 4% (= 56% loss of purchasing power over 20 years).

Source: Economagic

SOLUTION 1

Utilize asset classes that offer higher current income

Example:

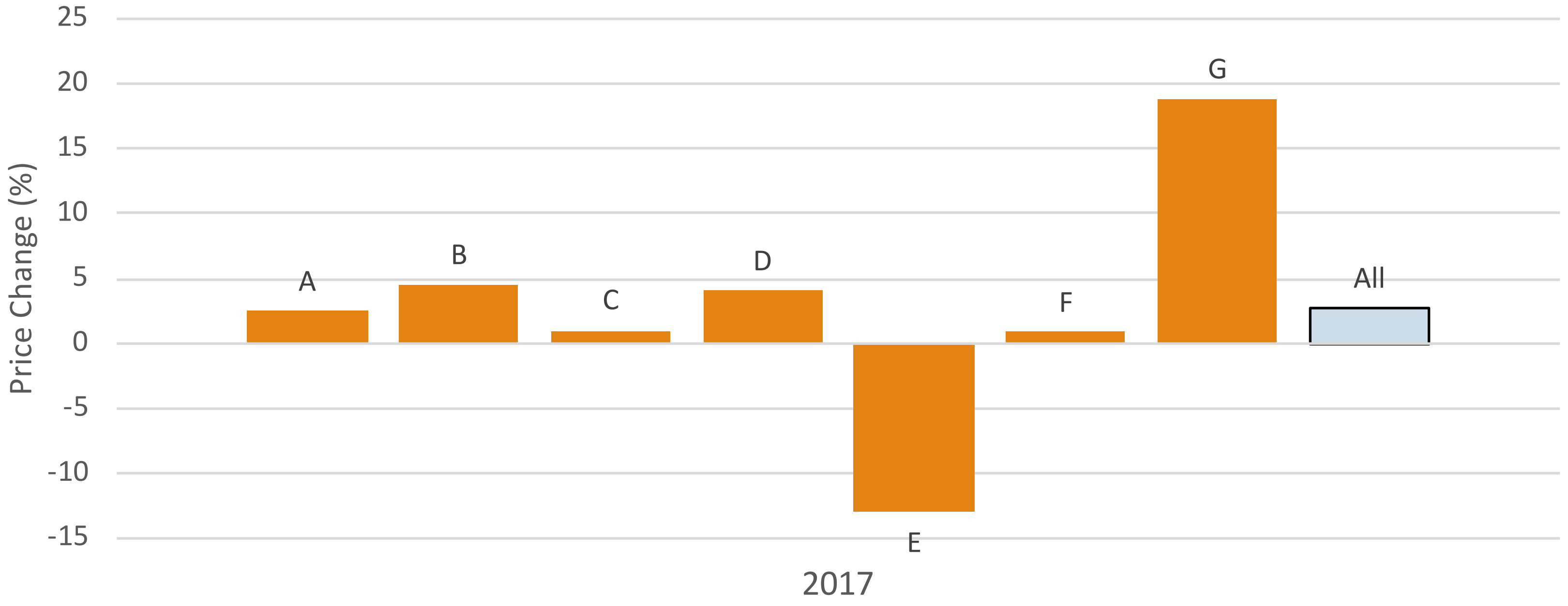
	Yield (October 31, 2018)
Master Limited Partnerships	8.29%
High Yield Bonds	6.82%
Real Estate Investment Trusts	4.51%

Sources: Bloomberg; ICE BofA Merrill Lynch Index System, used with permission

Based on Alerian MLP Index, ICE BofA Merrill Lynch US High Yield Index, MSCI US REIT Index, ICE BofA Merrill Lynch Preferred Stock Fixed Rate High Yield Index, ICE BofA Merrill Lynch Fixed Rate Preferred Securities Index, MSCI US REIT Index.

SOLUTION 2

Limit price exposure through asset diversification



KEY

A: IG Bonds[1]	D. HY Preferreds[4]	G. DIV Growth Stocks[7]
B. IG Preferreds[2]	E. MLP[5]	
C. HY Bonds[3]	F. REIT[6]	

Even when one sector's fundamentals declined drastically, the temporary loss in market value was limited by diversifying by asset type.

1 ICE BAML US Corporate Index 2 ICE BAML Fixed Rate Preferred Securities Index 3 ICE BAML US High Yield Index 4 BAML High Yield Fixed Rate Preferred Securities Index 5 Alerian MLP Index 6 MSCI US REIT Index 7 S&P500 Dividend Aristocrats Index

Sources: ICE BofA Merrill Lynch Global Research, used with permission, Bloomberg

SOLUTION 3

Mitigate risk through fine points of security selection.

Examples

REITs – Focus on nontraditional types such as assisted living, cellular towers.

MLPs – Concentrate on pipelines, with further selectivity based on low-cost production regions, contracts with users rather than producers, negotiated rather than regulated pricing.

Preferreds – Include non-financial issuers and pay close attention to call prices.

Closed End Funds – Take into account historical discount to Net Asset Value and manager's past performance.

Diversification of types of risk

Asset	Key Risk
IG Corporate Bonds	Interest rates
IG Preferreds	Financial institutions
High Yield Bonds	Recession
High Yield Preferreds	Financial institutions
Master Limited Partnerships	Energy prices
Real Estate Investment Trusts	Real estate prices
Dividend Growth Stocks	Recession

In any given economic environment, weakness in one asset class will tend to be mitigated by stability, or even strength, in others. For example, interest rates tend to decline during a recession, boosting assets that are sensitive to that factor.

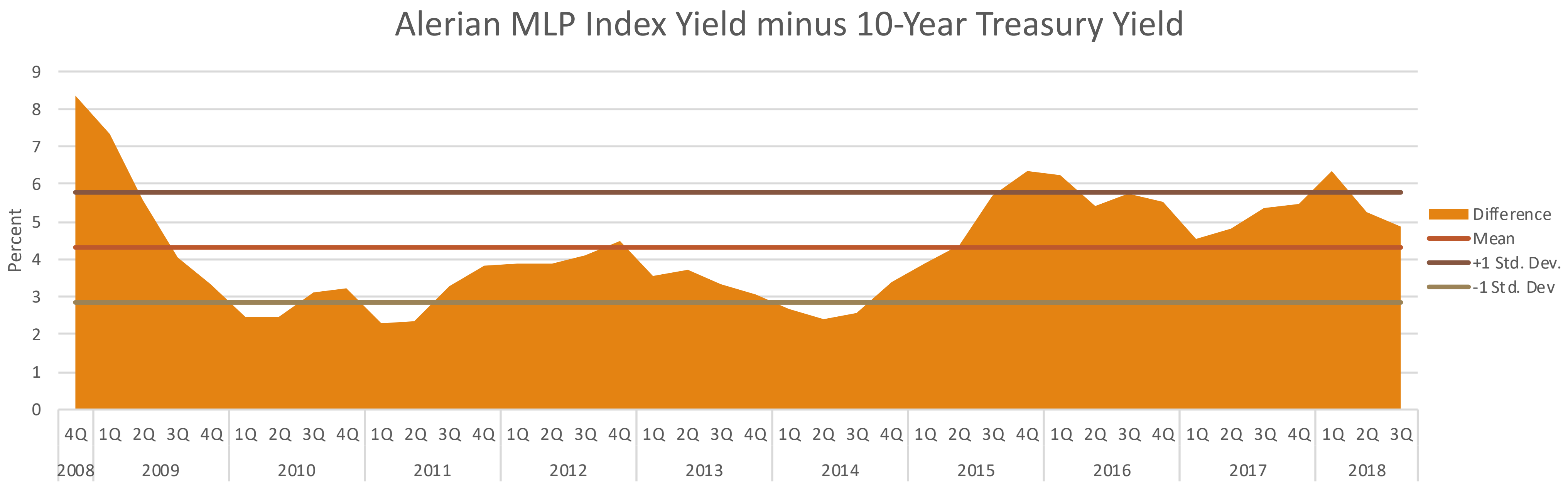
EXTRA! Harnessing technology to improve security selection

LLFA Rich-Cheap Model for Preferreds

- Universe of nearly 1,000 issues
- Four factors explain almost 77% of a preferred security’s yield:
  - Dividend rate
  - Credit rating
  - Industry sector
  - Price momentum
- Many other factors were tested and rejected, e.g., cumulative dividend, call features, tax-advantaged dividend, liquidity, trading volume, etc.
- Statistically cheap issues are subjected to fundamental analysis (business, financial statements, management).

EXTRA! Using valuation to enhance returns

Increase allocation to an asset class when its relative yield is high by historical standards.



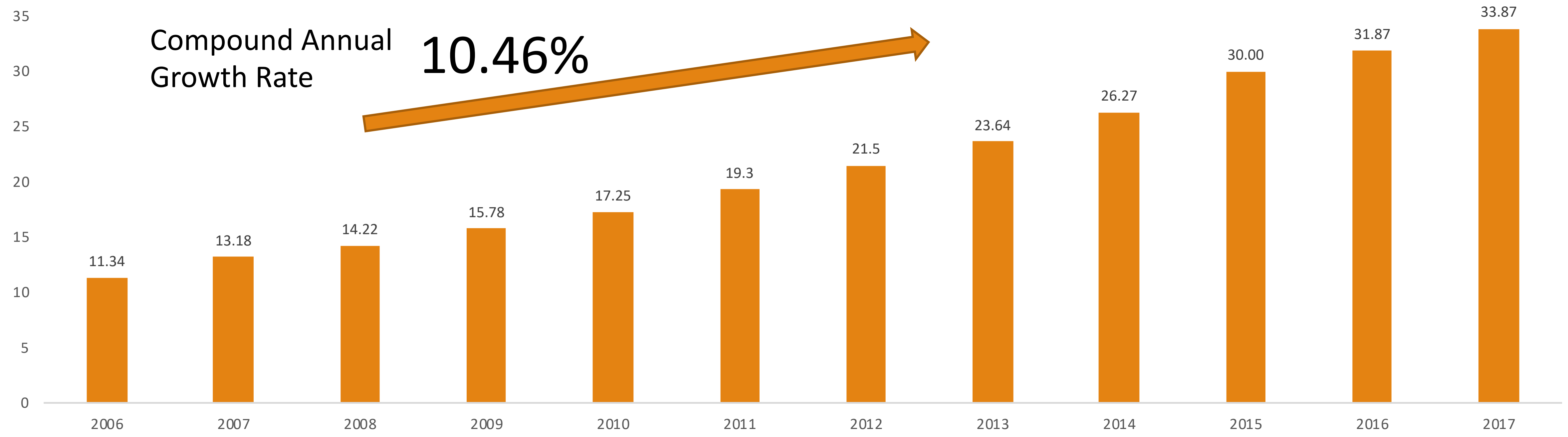
Source: Bloomberg; ICE BofA Merrill Lynch Index System, used with permission

Applying this analysis to several income categories (preferreds, REITs, municipals, etc.) enables the investor to overweight currently cheap market segments.

SOLUTION 4

Include a growing-income component to offset erosion in purchasing power.

Annual Dividend: Selected Dividend Growth Stocks*

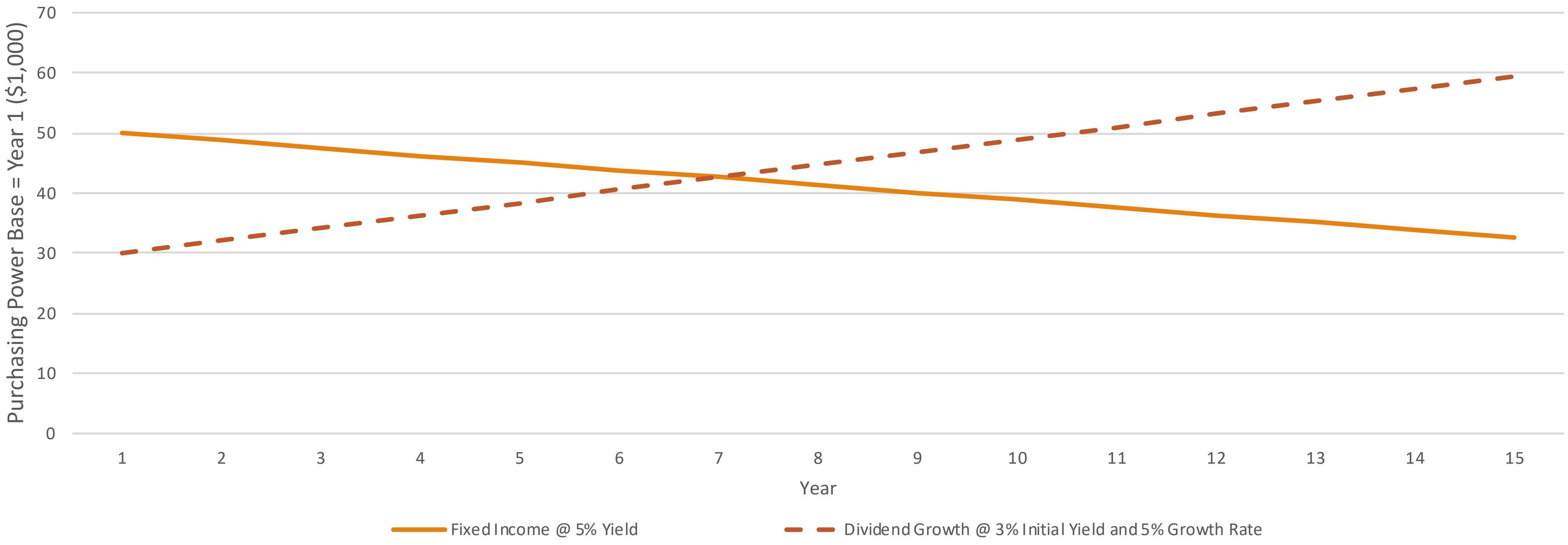


Source: Bloomberg

*Portfolio of 13 large-cap stocks that paid dividends as early as 2006

The income investor's use of equities should focus on stocks with long records of raising dividends and good prospects for continuing to raise them.

Projected Purchasing Power at 3% Inflation



In this simulation, Dividend Growth overtakes Fixed Income in purchasing power in Year 7, despite lower initial yield. Income investors should assess this tradeoff in devising a portfolio that both provides high income and combats inflation.

Conclusion

To earn satisfactory income and preserve purchasing power in today's low-interest-rate environment:

1) Look beyond super-safe bonds

2) Diversify by asset class

3) Provide for growth in income to preserve purchasing power

The Risk
of
Rising Interest Rates

What Drives Interest Rates?

Nominal Interest Rate

=

Real Interest Rate

+

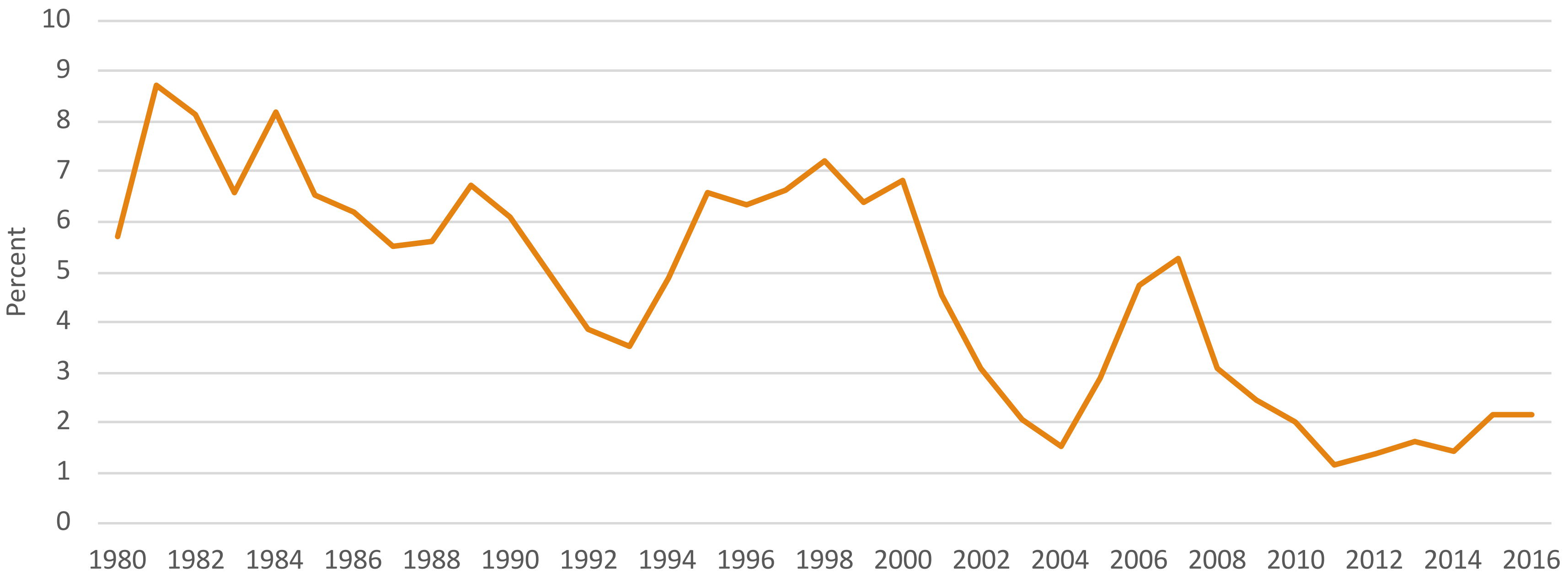
Expected Inflation Rate

The real interest rate reflects such factors as savings rates, productivity of capital, and the riskiness of capital expenditures. An inflation premium exists because lenders demand compensation for their expected future loss of purchasing power. If neither component is about to escalate sharply, investors should not bet that nominal rates will skyrocket.

In the back of investors' mind – Weimar Germany hyperinflation: 1921 - 1923

An attempt to get the currency to rise

U.S. real interest rate is historically low



Source: World Bank

The U.S. real interest rate has been declining since the 1980s. A global savings glut is one explanation that has been advanced.

No breakout in U.S. inflation expectations

5 Year TIPS Breakeven Rate
2002 – 2018*, monthly

*Through September

Source: Bloomberg

The yield difference between Treasury Inflation-Protected Securities and conventional Treasuries of the same maturity indicates investors' future expected inflation rate. There is no current expectation of an impending takeoff in U.S. inflation.

Long-Term Interest Rate Equilibrium

Ben Bernanke's Model		Nominal GDP Growth Rate	
Forward one-year real rate	1.00%	Real GDP growth rate	2.50%
+ Expected inflation rate	2.00%	+ Inflation rate	2.00%
+ Term spread	1.00%	= Equilibrium 10-year rate	4.50%
= Equilibrium 10-year rate	4.00%		

Source: Lehmann Livian Fridson Advisors LLC

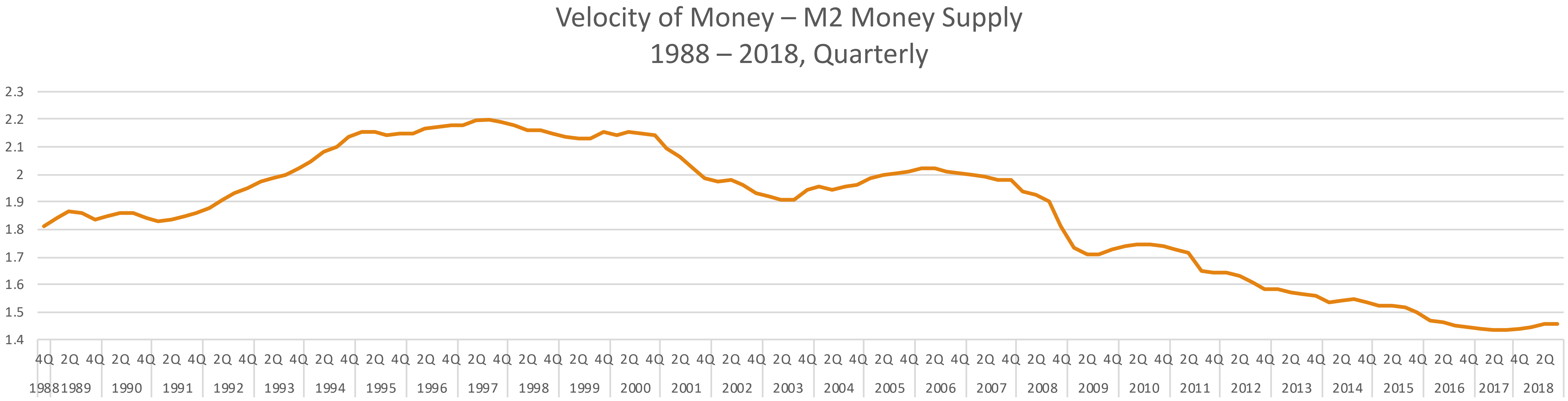
Globalization Has Restrained Inflation

"One would expect the entry of lower-cost producers and of cheaper labor into the global economy to have put persistent downward pressure on inflation, especially in advanced economies and at least until costs converge."

--Claudio Borio, Chief Economist,

Bank for International Settlements

Velocity of money has collapsed



Source: Bloomberg

The price level is a function not only of the quantity of money created by monetary policy, but also by its velocity, i.e., the rate of turnover. The Fed's aggressive money creation has not created runaway inflation because velocity has fallen off a cliff.

Conclusion

Long-term interest rates are likely to head upward, but investors should not gear their planning to dire inflation scenarios

Thank you

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