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Seeking income? Chasing yields can be tricky territory

ON INVESTING
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Income-producing investments, bonds producing a lot of interest income and stocks paying large dividends have been on a tear over the last few years.

With yields on bonds falling to all-time lows, investors seeking income from their portfolios have been turning to master limited partnerships, real estate investment trusts, junk bonds and stocks with large dividend yields.

I have heard many investors reason that with the 10-year Treasury bond yielding less than 2 percent, there is no reason to own bonds. After all, you can get more income by holding a portfolio of blue chip stocks. For example, Procter & Gamble's stock yields over 3 percent currently. By using stocks instead of bonds, you not only get more income, but you also earn any upside appreciation from the stocks.

This sounds like a terrific idea, except for the fact that you also expose yourself to the downside risk of the stock market. Even though they may provide more income than high-quality bonds, the return characteristics of MLPs, REITs, junk bonds and higher yielding stocks are very different from safer government and high-quality corporate bonds. Historically, they have all experienced much greater volatility and downside risk, especially during bear markets.

It may not take much of a bear market for high-income investments to face significant losses, however. Given the popularity of these investments recently, their valuations have risen to record high levels that I believe are unsustainable.

REITs have been top performers in the stock market the past several quarters, driving their valuations to lofty levels. In fact, by two valuation measures, the Price to Funds from Operations ratio and the income yield, publicly-traded REITs are trading at all-time highs. These valuation levels seem inconsistent with underlying fundamentals that appear less than robust.

Office vacancy rates are still above historic norms, and they are just slightly better than the rate reached after the recession in 2010. Additionally, rent growth has been anemic. Certainly there are bright spots in the REIT industry, such as apartment buildings and some private REITs, but overall things are less than rosy. These shaky fundamentals are all the more concerning when shares of REITs are priced for perfection.

MLP valuations look similarly lofty. Returns have significantly outpaced the stock market over the last five years. While direct valuation data is hard to come by for the overall MLP industry, many of the larger underlying holdings in the JPMorgan Alerian MLP Index, such as Enterprise Products Partners, Kinder Morgan Energy Partners, Plains All American Pipeline and Energy Transfer Partners, trade at significant valuation premiums to the overall stock market, and particularly other energy stocks.

High-yield bond spreads, or the difference between the yields on junk bonds versus the yields on Treasury bonds is significantly below its longer-term average. This means that investors are willing to accept the elevated risk of junk bonds with relatively little compensation. Clearly, investors are reaching for yield wherever they can find it, regardless of the risks they assume.

Stocks with high dividend yields are another example. Higher-yielding stocks have previously outperformed lower-yielding stocks, but the rate of outperformance has accelerated meaningfully over the last 10 years, as interest rates declined. Anecdotally, the utility sector, which is traditionally one of the higher yielding parts of the stock market, was the best-performing sector last year. Traditionally, utilities are more of a defensive sector, so it is unusual for them to be the top performers during a bull market and economic expansion.

I believe investors reaching for income are driving these trends, pushing high-yielding investments to unsustainable levels and generally taking on more risk than they should be. First of all, moving money from high-quality bonds into REITs, MLPs, junk bonds, or high-dividend-paying stocks, requires a substantial increase in risk profile.

In fact, all of these strategies declined significantly, along with the stock market, during the 2008 bear market. From the peak in 2007 to the trough in early 2009, stocks, as measured by the S&P 500 index, lost just over 50 percent of their value. A portfolio of the high-yielding investments we've been discussing would have declined by over 40 percent. While that is better than the stock market, consider that bonds actually earned 6 percent over the same period. Yield-hungry investors need to consider whether they can live with significant declines before shifting out of high-quality bonds.

Additionally, with the Federal Reserve set to raise interest rates in the not-too-distant future, the risks for income investor are even more significant. All of the high-yield investments considered here are sensitive to interest rate fluctuations and have benefited from the current low interest rate environment. However, when that changes, it is likely that the high valuations they currently enjoy will start to come back down to earth.

I also believe that most income investors are chasing income unnecessarily. Unless you control a trust, which can be legally required to produce income, most investors would be better off investing for long-term growth. Investors may need money from their portfolios, but not necessarily income. Given that dividends and bond interest are often taxed at higher rates than long-term capital gains, withdrawal strategies beyond income production should be considered. Investors could realize long-term capital gains for their cash needs, or draw cash from principal.

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People with moderate risk profiles are taking on risky portfolios—ones they may not even be aware are risky—all in the name of yield enhancement. Further, most investors do not really need high yielding portfolios, so all this risk is in vain. Given where valuations are currently and how crowded this trade has become, the risk of significant underperformance, or even dramatic loss, are elevated in the months to come.

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