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How to find high income in a low interest rate world

Retirees, particularly those over age 70 usually begin to rely on the income they can generate from their investments, to supplement Social Security payments, pensions and the like. When interest rates were last as low as they are now, today's 70 year old was in her '20's (1958), an age when few people have money to invest. So for all intents and purposes, the current environment offers the poorest income potential in a lifetime, just at a time when this income is most desired. What to do? In this issue of Trusted Advisor we look at some real life challenges, as seen from the view point of different income investors, and offer some thoughts and possible solutions.[1]

"Sam" VS "Judy"

Conservative investors, those who lost a lot of money in the stock market, sometimes go to extremes to avoid loss. A prospective client, Sam, recently asked me if I could help him find Certificates of Deposit for his IRA. Sam explained that he had invested in stocks with a friend, lost money and as a result has parked his funds in a brokerage money market fund for two years. He was not interested in my approach, outlined in the response to "Barbara" found below. As it turns out, when I offered to help find him the best yielding CD's and charge only for my time (as opposed to a quarterly management fee), Sam demurred, saying he could do that himself. After this conversation, I hung up the phone and wondered, why then has he been sitting in a lousy money market fund for two years? Sam is an investor who definitely needs a pro-active guide to get him moving again, as paralysis, a function of fear, is causing him to lose purchasing power after taxes and inflation take their toll on his meager interest earnings.

Less frightened investors have been trying all sorts of things to regain the great income they remember from the "good old days" when a bank CD paid 8% or more. Without recognizing the potential risks, people allow themselves to be talked into investments based on flashy interest rate quotations. An in-law of mine invested her money with a broker but now is fretting about a sharp decline in the value of her high dividend paying investments. I was asked to review her portfolio and offer a second opinion. In this case the broker, stretching for yield, positioned Judy in closed end funds (AKA Exchange Traded Funds) which offered eye popping dividend rates like 9-10%! Remembering the adage that there is "no free lunch", I was not surprised when I looked inside the black boxes of these miracle funds to discover some creepy things: the funds were invested in bonds issued by the Russian Federation, the Republic of Bulgaria and Tenet Healthcare. While we all pray that former Communist nations are successful in converting to the capitalist system, this does not mean a retiree should risk her life savings by lending them money, does it? And here's what an independent analyst says about Tenet:

"Suspicion about the legitimacy of Tenet's pricing policies has caused a cascade of lawsuits and investigations, turnover in management, and falling revenue. It has created significant legal expenses, and contributed to deteriorating

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operating results. As a result, Tenet is cutting costs and selling assets. Its credit rating has fallen to a speculative grade of B-, and its liquidity position is tenuous."[2]

I questioned holdings like the above, which can properly be described as junk bonds. Fortunately not everything in Judy's portfolio was junk, but many of her holdings, have lost over 12% in value this year!

When investing for income, it is important to have a conversation with your advisor. Explain the amount of income you feel you need and the amount of risk you are willing to take. Better still, have a cash flow analysis conducted by a financial planner so you know your needs in specific dollar terms. A good advisor will tell you if this level of income is attainable for your risk comfort level. A good advisor will give you the facts allowing you to make a smart decision, rather than suffering a surprise. Once you have set clear parameters, watch how he or she invests your money to be sure it is consistent with your expressed wishes.

Selection Criteria for Fixed Income Investments

Here's the ***Trusted Financial*** approach to income investing, with guidelines for three different types of investors:

Conservative Investor:

Seek Guaranteed income from debt instruments. Government bonds, maximum five year maturity; Investment grade corporate bonds are also good choices. Significant allocation to "Cash" (money market funds, U.S. Treasury Bills and short term insured Certificates of Deposit.) Current expected yield: 3.5%-4.0% annualized.

Normal Risk Level Investor:

To the above instruments, add Real Estate Investment Trusts (REIT) that are fully covering their dividend and which carry low debt levels; invest in utility stocks, both corporate and "Master Limited Partnership" structures. Also add a few super high quality common stocks that pay dividends and have a long history of building shareholder equity and dividend increases. Current expected yield: 5.0%-6.0% annualized.

Somewhat Aggressive Investor

Same instruments as for the "Conservative" and "Normal" risk takers, but with greater allocation to preferred stocks and common stocks that pay dividends and are of good quality. Small allocations to low grade bonds Lower allocation to cash. Current expected yield 6.0%-7.0% annualized.

Do Annuities Make Sense for Income Investors?

Annuities do serve the needs of specific situations. They can be found with reasonable terms at discount brokers like Charles Schwab or Fidelity. An "immediate" annuity (so-called because it pays income right away) may make sense for someone who is not confident about managing and investing their own money, and who wants to receive a monthly check. When analyzed closely, however, most immediate annuities have implied interest crediting rates of only about 4% or less. There are usually better alternatives.

For building assets in the years prior to retirement, annuities are often suggested by brokers and insurance agents. Annuities are an insurance company sponsored product that have been in the marketplace for many years. They are not government guaranteed but as with Certificates of Deposit, there are severe penalties (one year or more interest) if you exit prior to maturity. I have a skeptical view of Annuities. This product pays large commissions, usually 5% to the broker or insurance agent, so that's why you hear about them so often. They are deceptively advertised, showing "teaser" rates like 7%. Read the fine print: that 7% is usually for the first year only, then the rate slips to something less than attractive, and you are locked in to this low rate for years. Over at the local Automobile Club office, I saw a sign advertising annuities in this deceptive manner. I thought it was me, not my money, that is supposed to go on a long vacation!!

I frequently meet people who purchased annuities and regret the decision a short time later. Often, it's worth busting out of the contract, paying the penalty and investing your money more productively. After a few years, you may well surpass the return you would have realized by remaining bound to the annuity contract.

Summary

Recently a long time client who relies on her investments for income asked about my approach to finding good income in her account. This was an e mail I received from her:

"Dear Gary,
The business section of the La Times today 5/16th had an article on bonds. It said the interest on long term U.S. treasury bonds is going up. I know we do have bonds. Should we invest more? Barbara"

Here was my reply:

"Hi Barbara
Your question is a good one. With regard to financial advice found in the popular press, please take it with a small grain of salt. Still, your question is an opportunity to help explain how I've been managing your accounts. Long term Treasury Bonds are now close to a 5% interest rate.[3]

Generally we are getting a better yield for you in other investments. For example, the purchase of additional shares of Valero L.P. last week was made to take advantage of rising interest rates. That stock pays a 7% dividend. Unlike a Treasury bond, which locks you in at 5% forever, Valero regularly raises the dividend.

That being said, you have a large allocation to bonds, about 30%. I've been finding better yields elsewhere so much of what you own pays better income than bonds. These include utilities such as Kinder Morgan, Valero and National Fuel Gas, and Real Estate Investment Trusts such as Archstone Smith and Prologis. When you consider the other high dividend paying investments, you actually have about 74% in income producing assets, a very high allocation.[4] *All of the companies mentioned have been carefully screened to assure they have strong financial capabilities and I am confident your dividends can be relied upon. In fact these companies manage their balance sheets a lot better than does the U.S. government. Gary"*

Here's hoping the above discussion serves as a guide to fixed income investing at a challenging time. I'd love to be of service to investors who need to focus on income from their portfolio, so please feel free to call for a no obligation

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Bumper Stickers We'd Like to See:

Some people just don't know how to drive... I call these people "Everybody But Me,"

Try not to let your mind wander...It is too small and fragile to be out by itself.

I used to have a handle on life... but it broke off.

Everyone has a photographic memory... Some just don't have any film.

(Footnotes)
1 None of the investments mentioned herein should be taken as investment advice. Readers are cautioned to not make investments based on situations discussed herein. Investment advice is rendered under written contract only.
2 Morningstar on line, June 7 2004
3 This exchange occurred in May, 2004 at a time interest rates had risen rapidly; as of the date of this newsletter, July 9 2004 the yield on the benchmark 10 year U.S. Treasury Bond has dropped to 4.46%.
4. This client requires a particularly high income from her investments.