Debunking the Myths of Income Investing

For many investors, there is an intuitive appeal to owning income-producing investments and living on the cash flow they produce, while leaving the principal untouched. We all understand that taking only the milk every day can sustain us far longer than eating the cow, and the investing brain views portfolios and income in just the same way. The appeal is so strong that financial marketers happily package up products to capitalize on this way of thinking.

Intuitive appeal may help sell products, but in investing it rarely provides the best basis for making decisions. For investors looking to fund living expenses through retirement—ground zero for income products—the bett er approach is to simply seek the best overall return possible, consistent with acceptable risk, and use the return to fund what is required for spending. The milk and cow analogy seems applicable, but it's not. When it comes to investing, all sources of return, once earned, become part of a broader portfolio measured in dollars, and a dollar taken from that portfolio and used to fund living expenses doesn't know or care where it came from or how it's classified. In the article ahead we will walk through specific reasons why we believe a total return approach is a better option than a pure income approach for funding living expenses, particularly in a low-interest-rate environment. We hope that convincing investors of this will pay them dividends in the form of better returns.

WHAT'S WRONG WITH JUST LIVING ON THE INCOME?

In short, the answer—at least for those without a very high ratio of asset to income needs—is there isn't enough income. For most investors seeking income, the goal isn't just to fund living expenses, it is to have enough money to last the rest of their life and to keep inflation from eroding the value of their principal. A portfolio limited to vehicles that cast off income will be a less reliable way to achieve those goals, for several reasons.

1. An exclusive focus on income limits the opportunity set and rules out sources of return that may be higher. Is an investor really prepared to accept a lower overall return just to have more of it come from income?
2. In today's environment, very low yielding high-quality bonds not only generate little income, they expose investors to losses in the value of their bonds when interest rates eventually rise (further).
3. Reaching for higher yields may sometimes generate better near-term returns, but at a cost of higher credit risk and less downside protection in an ugly environment for risk assets. There are no free lunches in investing.

Consider these points in the context of our earlier observations about the marketing appeal of income strategies, and imagine a product pitch about a portfolio that provided less diversification *and* a lower expected return. Yet that is the profile of many income-focused strategies.

The risk side of the equation is of particular concern. Over the years, there have been many examples of products introduced by investment firms that were designed to generate high income returns that subsequently "blew up," suffering losses far above what investors expected or could tolerate relative to their goals. (Just look back to 2008 and the dismal returns of some so-called lower-risk short-maturity income funds.) Today, some of the popular ideas—and ones on which we've gotten many questions—are REITs, MLPs, closed-end bond funds, or flexible bond funds that take on various types of risk, including credit risk or interest-rate risk. While these may have a legitimate place in a portfolio, they need to be evaluated in a broader portfolio context that takes into account an investor's goals and risk tolerance as well as other investment opportunities available at the time. In the current environment of very low bond yields, we've seen too many examples of investors shifting away from bonds toward higher-income investments that present very different risk profiles. Emerging-markets debt, for example, has been another likely recipient of yield-seeking dollars and as these markets have declined it seems investors have realized too late the risk they are taking.

WHAT'S BETTER ABOUT A TOTAL RETURN APPROACH?

An investor might cite income as a goal. But what that investor typically means is they are in withdrawal mode and require cash flow from their portfolio to fund living expenses. What really matters is having a sustainable withdrawal plan to determine how much they can realistically take out over time.

Our approach has always been to try to generate the highest return without exceeding a client's risk tolerance. We'll talk more about how we build and manage portfolios, but first we'll summarize the reasons we build portfolios with risk and return, as opposed to income, as our primary focus.

1. Seeking the best return for a given level of risk lets us build better-diversified portfolios. This is especially important because there is always a range of potential economic and market outcomes, and no one can be sure how things will play out. We work hard to get a sense of probabilities and downside severity, but good diversification lets us build portfolios better suited to a variety of outcomes.

2. A total return approach can be more tax efficient. Rebalancing to raise cash by trimming appreciated investments back to target levels can result in gains that are typically taxed at much lower rates than the ordinary income thrown off by an income portfolio. A further opportunity exists to offset gains by realizing losses when it makes sense to do so.

3. An investor who is regularly withdrawing living expenses needs a portfolio that will provide for them far into the future. The term "capital sufficiency" refers to how long a portfolio will last at a given return and withdrawal rate (and, helping make our point, the source of return is irrelevant in computing this). All the while, inflation steadily erodes the value of those dollars. Trading return potential for the sake of current income makes the challenge of meeting financial goals even tougher.

Now we'll go into more detail on each of these areas in the context of building and managing portfolios.

MANAGING PORTFOLIOS IN WITHDRAWAL MODE

Our Conservative Balanced portfolio is often the starting point for an investor in the distribution phase. More recently in our history, we've also launched an even more conservative strategy, the Defensive Balanced portfolio, which has an 80% bonds/20% stocks strategic target allocation. Both strategies are skewed toward income-generating investments, but the overall portfolio for each is constructed to maximize total return within the stated level of risk, which we define as a 12-month loss threshold (a 5% loss for Conservative Balanced; a 2.5% loss for Defensive Balanced). We don't explicitly own any investments for the sole purpose of generating income. Instead, in seeking total return, we own a variety of investments (including bonds) that have varying degrees of correlation with one another. By mixing these assets in different configurations, we can create a portfolio with volatility characteristics that coincide with an individual's risk tolerance.

The reality is, of course, that these portfolios will likely own a lot of bonds due to their lower risk profiles. (Even with their vulnerability to rising rates, bonds are far less risky than stocks.) But, even in our strategies with large strategic allocations to core bonds, we hold other investments and we take advantage of tactical opportunities that we believe will enhance returns without undue risk. At times they may include income investments. We've held both REITs and high-yield bonds, for example, but did so when they were particularly attractive from a return perspective (because they were selling very cheaply after a big decline).

We currently own a number of flexible and absolute-return-oriented bond funds in these portfolios, but added them only after conducting lengthy due diligence to understand where and when the fund managers will take on risk. We evaluated these funds' potential contributions from a total return perspective and in the context of their overall investment strategy and targeted risk levels. Given the portfolios' total-return mandate, we are also able to incorporate small allocations to riskier investments we think have higher return potential. This is only possible in a broader portfolio context where we are able to offset this risk with lower risk holdings and with positions that have low correlation with one another. Emerging-markets stocks and bonds are a current example of something we own as a long-term return opportunity even within our conservative strategies.

Our risk discipline is of paramount importance in order to manage short-term volatility, which is of particular concern to investors that rely on their investment portfolio to supply their living expenses. Other investors may have a large financial obligation coming up in the near future (such as the down payment on a house, a new car purchase, or sending their kids to college), and they would be negatively impacted by a short-term drop in their portfolio's value. These investors need to own a portfolio that is unlikely to perform poorly if the stock market takes a spill, otherwise they could be in the unfortunate situation of having to sell equities from their portfolio right after suffering a big loss, and that can be potentially harmful in the long run because it depletes the portfolio's capital at the worst possible time. Because bonds generally are not very volatile, they provide investors with an asset in their portfolio that is likely to hold up at least fairly well, even if their equity holdings are getting hammered by a bear market. When we do take on risk in our conservative strategies (and in all of our portfolios to varying degrees) we undertake extensive stress testing as part of our evaluation process. We want to have very high

conviction that the return potential warrants taking on the risk and that we are managing the overall portfolio to stay within its loss thresholds in most market environments.

DISTRIBUTIONS AND TAXES

In order to handle actual distributions from a practical standpoint, we employ a couple of strategies. First, we allow the investments we own to pay interest and dividends to cash instead of being reinvested, which creates a cash buffer for upcoming portfolio distributions. Second, if at the time an investor needs to take money out for living expenses and there isn't enough cash, we take the opportunity to rebalance their portfolio. If stocks have done well in relation to bonds, they would likely be overweighted relative to their target allocations, and we can trim them back to meet the investor's withdrawal needs. Similarly, if the equity markets were down, the investor's bond positions would probably be overweighted, and so we'd sell some of their bond funds.

Admittedly, this is a bit more work than having a steady stream of income coming in all the time, but it has a couple of key advantages. As we've discussed, in a total-return approach a portfolio can be more diversified and own all kinds of investments: domestic and international equities, smaller-cap stocks, both high-yield and investment-grade bonds, and so on. This diversification has advantages for distributions because it offers more options for rebalancing (it's more likely that something is up—and something is down—in a more diversified portfolio). In contrast, focusing solely on income-oriented investments casts a narrower net and offers fewer options from which to choose.

Furthermore, as we noted earlier, focusing on income generation isn't always very tax efficient. Obviously municipal bonds generate tax-exempt interest, but the yields on those bonds—and indeed most bonds these days—are not very high, so an investor would need to own a lot of them to fund their living expenses (unless they had a very large investment portfolio). A total-return approach enables investors to shift a meaningful portion of their tax liability to long-term gains. Whenever cash is needed to cover additional expenses, the portfolio can be reviewed for securities that can be sold with the least onerous tax consequences associated with them. This could include investments with long-term gains (which are taxed at a lower rate than income), or possibly even investments that are underwater and generate tax losses. In a diversified, total-return-oriented portfolio, an investor has more control, and greater potential, to maximize after-tax returns.

CAPITAL SUFFICIENCY—NOT EVERYTHING LASTS A LIFETIME

The other essential part of investing during the distribution phase is truly understanding each investor's income needs and evaluating their resources for meeting them. In our private client business, we use capital sufficiency analysis software to assess sustainable retirement income withdrawals. In what we believe is likely to be a lower return environment for some years ahead, it is critical to use realistic and conservative assumptions in determining what rate of withdrawal is possible over longer periods. But returns are only a guess, and ultimately, the only factor that can be controlled with any certainty is the investor's rate of withdrawal and spending. We always hope to generate returns that are better than our assumptions, and reassessments over time can generate confidence that higher withdrawals can be taken safely. But getting the trajectory wrong early on can create lasting problems. Therefore, opting for a realistic, conservative withdrawal rate is essential.

A FINAL WORD

Letting go of the idea that income distributions must by definition come from investment income (bond coupon payments, dividends, etc.) creates the opportunity to build a more diversified, more durable, potentially higher-returning portfolio strategy. In the end, we believe that whether an investor meets investment objectives and capital sufficiency will be driven by overall return, not from where it came.

—Francis Financial and the Litman Gregory Investment Team (3/3/14)