Income Investing

Are Bonds the Best Tool for Generating Income?

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I don't make many bold market predictions but I'll make one today: Interest rates are likely to increase in the future. OK, perhaps this is not so bold. In reality, most investors agree with this statement. Yet many individual investors have portfolios loaded up with investments that will hurt them when interest rates rise.

So what are these "risky" investments? They are long-term, high-quality bonds, a tool that has been considered exceptionally safe for the last 30 years. Yet as rates rise, investors will see the market value of their long-term bonds drop sharply. A 1 percent increase in interest rates will knock off close to 7 percent of the market value of a 10-year treasury bond, and close to 15 percent off the market value of a 30-year bond. It would take three to five years of bond interest payments just to get back to where you started.

Nevertheless, bonds do have a place in most investment portfolios. Over the past three decades of generally falling interest rates, bonds provided stability, capital appreciation and reasonable income. But as we move toward a rising interest rate environment, the risk-return profile of long-term bonds changes dramatically. Short-term, high-quality bonds will likely stay as one of the best tools for portfolio stability. Stretching for more income by extending maturities, however, could prove dangerous. Keep your short-term, high-quality bonds for stability but consider using other tools for income.

Three alternatives worth considering for investment income include:

Dividend-paying Stocks (yield: 2-4 percent per year)

Quality dividend-paying stocks tend to increase their dividend payments at a rate faster than inflation. Over the past 10 years, inflation has averaged 2.35 percent, while dividend-paying stocks in the S&P 500 have increased their dividends by 6.5 percent per year—more than double the pace of inflation. A retiree living off dividends from high-quality stocks has seen his or her purchasing power dramatically increase over time.

Yet there is a tradeoff: Dividend stocks are subject to stock market volatility. Additionally, there is no guarantee that a company will continue to pay dividends at its current level.

Master Limited Partnerships (yield: 5-7 percent per year)

MLPs are tax-efficient investments that typically involve the transportation, processing or storage of oil and gas—such as pipelines. Pipelines function as a toll road and are mostly indifferent to the price of the material they transport. That said, supply and demand does impact them. If either drops, so will revenue, reducing cash flows available to investors and negatively impacting the firm's stock price. Like dividend stocks, MLPs are subject to market volatility.

Private Debt Business Development Companies (yield: 7-10 percent per year)

BDCs are funds that pursue a variety of strategies. One is providing debt financing to privately held, medium-sized companies. These firms typically pay higher interest rates on their loans than would larger public companies. BDC investments may include leverage and pursue a wide range of businesses from risky startups to safer, more mature companies. Because of this, the market price of BDCs can be volatile.

Look for BDCs that provide floating-rate loans to larger companies; floating rates will help protect you from rising interest rates, and larger companies tend to have more alternatives if difficult economic times return.

Research and Understanding

Every investment requires research and an understanding of the underlying business. Are dividend stocks, MLPs and BDCs less risky than high-quality, short-duration bonds? Absolutely not. Are they riskier than long-term bonds? That depends. This is not a recommendation for you to sell all your bonds. Rather, it's a suggestion that most investors are better served by separating the role of "stability" from "income." Ten years ago, investors could get both stability and income with bonds; today they cannot. Use high-quality, short-duration bonds for stability but think carefully about using long-term bonds for income.

One final caution. An investment portfolio of just short-term, high-quality bonds has its own risk—the risk of underperformance. If an investor needs a 5 percent per year return to achieve his or her goals, investing only in short-term treasuries guarantees this investor will fall short (one-year treasuries yield just 0.15 percent).

That is the challenge with "safe" investments—you sleep soundly each night as you drift further and further away from reaching your investment goals. Most investors need some exposure to stocks/equities to reach their goals. The challenge is determining what asset allocation—what mix of stocks and bonds—is right for you. Asset allocation is one of the most important factors in determining your investment success. Now, at the start of a new year, is a good time to touch base with your financial advisor and have this discussion. UB