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Challenges of Being an Income Investor
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Many folks consider themselves "income investors" and prefer to live off of portfolio income, such as dividends and interest, while preserving their principal. For retirees in particular, this is an ideal way to get consistent, sustainable income from the investment portfolio they have spent so many years accumulating.

However, today's low interest rate environment makes this approach very challenging. To be a so-called income investor, you're often forced into adopting a less-than-desirable lifestyle to be assured you will never deplete your portfolio. Is there another solution? Can better decisions be made so you can have a comfortable lifestyle today while not sacrificing long-term financial goals?

It may help to review where we stand today. The current yield on 10-year US Treasuries is 2.03 percent, and the dividend yield on the S&P 500 stock index is 1.9 percent. To illustrate the challenge, a 50/50 portfolio comprised of only these two asset classes can be expected to produce income yield of slightly below 2 percent. On a $1 million investment, that's around $20,000 of pre-tax income. If $40,000 (4 percent withdrawal rate) were required to meet spending goals, this income only gets half of the job done. Principal would have to be spent down to cover the remaining obligation.

How do you increase portfolio income? There are several ways you can deviate from the simple portfolio described above. In fixed income, you can take on more term and credit risk. An example would be shifting to positions in 20-year investment grade corporate bonds or higher yielding, non-investment grade bonds. In equities, you could tilt away from the index towards higher dividend paying stocks and pick up greater dividend yield. U.S. and international real estate will also typically yield more portfolio income than their respective equity counterparts. These are just a few options worth considering, as long as you realize there are potential tradeoffs in risk and capital appreciation.

One problem with stretching for yield is that it might negatively affect the total return of your portfolio over time, where the return includes both yield and growth. You have to be careful when introducing new risks to manage. For example, the fixed income solutions above come with increased interest rate risk and default risk. Notably, if we're in a low interest rate environment now, we are more likely to experience rising interest rates looking forward. Rising rates particularly impact longer term bonds.

Of course interest rates can stay low for a very long time, sometimes despite actions from the Federal Reserve to the contrary. It comes down to what types of risks do you want to take and where should you take them? The argument can be made that taking equity risk has a better chance of being rewarded than fixed income risk. If you're a risk-averse investor, that may not ease your mind. But if it is the reality we face today, expectations can be set accordingly.

Furthermore, stretching for yield in the wrong way can actually reduce your total expected return and at the same time, increase the risk you're taking. So if you're ultimately getting paid less for taking on the same amount of risk, what do you do? We believe the better approach is to manage your portfolio from a total return perspective. Here, bonds serve a higher purpose than to simply produce income. They are a shock absorber that helps you most when equities decline. You may still need to draw down more principal to achieve desired cash flows, but the evidence suggests you are more likely to reach all your financial goals. The key to making this strategy work is to combine it with ongoing rebalancing and tax efficient decision making.

We often advocate taking a total return approach instead of focusing too much on generating income. But through our conversations with clients every day, we realize it can be a challenging mindset to adopt. It requires a disciplined investment approach and frequent reminders that there is no free lunch when it comes to investing. In the end, we think the rewards are well worth the effort.

Sources:

1. 10-Year Treasury: http://www.bloomberg.com/quote/USGG10YR:IND
2. S&P 500 dividend yield: http://www.multpl.com/s-p-500-dividend-yield/

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