Income Alternatives for a Low Interest Rate World

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In the current low-interest-rate environment prevalent in many developed market economies it makes little sense to park one's investment money in conservative fixed income investments that offer poor yields; perhaps even yields lower than expected inflation rates. Given the fact that the first few years of Baby-Boomers are now retiring, and people in retirement tend to favor income-producing investments, it seems there should be considerable demand for alternatives to bonds.

These alternatives should pay a good income stream, should be relatively conservative, should be able to withstand an inflationary environment, and should offer diversification benefits to stocks.

This is a tall order and the fact is, as we saw in the panic of late 2008, nothing offers the diversification benefits of US Treasury Bonds or gold; pretty much all other assets fell during this time period. Nevertheless, panics aside, there are a number of investments that offer at least some diversification and have many of the other properties in which we might be interested - so let's have a look at a few of these.

It should be stressed that all of the income alternatives mentioned below are likely more volatile than most fixed income investments, and certainly more volatile than Treasury bonds. But risk comes in many forms; and these days perhaps we should be more concerned about inflation risk than volatility.

Preferred Stock: These securities are generally mid-way between equity and bonds in terms of risk although in a panic they tend to behave more like stocks. Preferred shares pay a higher dividend than common shares and receive dividend payments before any such payments are made to common stock investors. Many US bank preferreds offer current yields in the 6% to 8% range. European bank preferreds offer even higher yields because they are considered quite risky these days. Of note are so-called "floating-rate" preferreds that offer a dividend that is the greater of a fixed amount or a floating amount based on Libor or a similar interest rate benchmark – thereby offering protection against rising interest rates.

Real Estate Investment Trusts: These come in two flavors; mortgage trusts and equity trusts. Mortgage trusts get their cash flow from mortgages and therefore their fortunes are tied to the spread between their borrowing rates and their lending rates. As inflation increases, generally short-term interest rates also rise (although these days there is considerable manipulation by Central Banks). At some point short-term rates rise faster than long-term rates and this is when mortgage REITs underperform. Equity REITs get their cash flow from property rents and sales, which tend to increase with inflation, so these are less sensitive to rising interest rates. Some mortgage REITS offer dividends over 10%, but this is because they are leveraged investments on the mortgage market – if we end up in another credit crunch or housing bust like we did in 2008 then these REITs will suffer.

Royalty Trusts and Master Limited Partnerships: These are similar to REITs but the income stream comes from other types of assets, mostly from oil and natural gas producing properties.

Canadian Royalty Trusts (most of which have actually converted to corporations and therefore are no longer technically Royalty Trusts) generally try to replenish their reserves, whereas US Royalty Trusts generally do not. This leads to differences in taxation of dividends and obviously the US Trusts have a finite life. MLPs may replenish their reserves and are structured as limited partnerships; which means different tax treatment again. These investments may currently yield in the 7% to 9% range and offer a cash flow that might be inflation-protected by virtue of the fact that it is linked to oil and gas prices.

US Business Development Companies: This is basically a private equity investment for the common man. Normally private equity investments have high minimums but certain companies have in essence created funds that invest in private rather than public companies - these are BDCs. Some, but not all, BDCs have good yields; currently in the 10% range. We can expect that BDC share prices will be highly correlated and probably somewhat more volatile than the S&P500, but the high dividends give us a cash-like, uncorrelated, income stream (as long as they are paid).

Infrastructure Funds: These funds invest in certain infrastructure plays. For example, they might be toll-road operators, getting a cash flow from the tolls, or railroad or port operators. Generally they pay good dividends, are somewhat less volatile than stocks, and may offer inflation protection if they can increase the price of their services with inflation.

Dividend paying common stock: Let's not forget these - you can get a 5% plus yield in some blue chip companies these days, and others are increasing their dividend payouts as their business improves. Generally such companies tend to be less volatile than the stock market as a whole; although of course highly correlated to the stock market.

It is important to note that while the investments mentioned above are all more volatile than conservative bonds and better correlated to the stock market, the income stream that comes from the dividends has practically zero correlation to any stock market. This is an important and little-understood point.

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