Evoke | ARIS Insights: I Need Income!

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US interest rates have steadily declined over the past four decades and now sit at historic lows. Investors long for the days when cash was yielding double-digits (early 1980s) or even mid-single-digits (early 2000s). Today, we live in a completely different world. Cash offers near zero return and a guaranteed loss after inflation. Longer-term government guaranteed bonds are not much better as a 10-year Treasury currently yields about 1.5%.[1] If we trust bond market discounting of expected cash rates and the Federal Reserve's repeated promises to hold rates down for an indefinite period, the low yield issue investors face appears likely to persist for the foreseeable future. As a natural response to the lack of yield offered by high quality assets, investors have been screaming "I need income!" and seeking increasingly risky investments to find it.

The natural reaction from an investment standpoint has been to replace safer, lower yielding securities with riskier, higher income alternatives such as high yield bonds, real estate investment trusts (REITs), master limited partnerships (MLPs), preferred stocks and even common stocks. A greater focus on riskier income-producing investments may sound intuitive, but it creates two main problems:

1. Decreases portfolio diversification; and
2. Increases taxes.

The objective of this edition of *Insights* is to propose an alternative approach that can provide the desired cash needs with better diversification and lower taxes.

Conventional Thinking: Yield Focus

We begin with the conventional thought process that leads investors down the path of seeking higher yielding investments in today's low yield environment. The total return of a portfolio can be broken up into two components: income and capital appreciation. The former is generally thought to be stable and dependable, while the latter is considered volatile and unpredictable. Therefore, the conventional thinking goes, income should be emphasized for shorter-term needs and capital appreciation for longer-term objectives. This also lines up with the typical investment horizon for each return component.

Psychologically, investors view income like salary from a well-paying job that can be counted on without the need to invade principal. The challenge is this line of thinking is not strongly supported by sound portfolio construction practices, which generally seek optimization of diversification (return relative to risk) and tax-efficiency.

Problem #1: Less Diversification

The main issue of focusing on higher yielding investments is it severely constrains the universe of viable investment options on which to build a prudently diversified portfolio. Investors focused on the total level of income in the portfolio will be dissuaded from including low- or zero- yielding investments, such as high-quality bonds, inflation-linked bonds, and gold. These investments are likely to bring down the average yield of a portfolio, but offer strong diversification benefits.

The difficulty is that higher yielding investments tend to be more correlated to equities and therefore less diversifying. Exhibit 1 lists four popular market segments typically sought after by yield-hungry investors: high yield bonds, REITs,

[1] Source: Bloomberg, as of 03/01/21.

MLPs, and preferred stocks. We compare the total returns (yield plus capital appreciation/depreciation) of these asset classes to stocks during the past four notable equity market downturns.

Exhibit 1: Bear Market Returns of High-Income Markets vs. Equities[2]

Bear Market Returns	COVID-19 Pandemic Jan. '20 – Mar. '20	Fed Tightening Oct. '18 – Dec. '18	Eurozone Crisis May '11 – Sep. '11	Global Financial Crisis Nov. '07 – Feb. '09
High Yield	-13%	-5%	-7%	-26%
REITs	-27%	-7%	-16%	-65%
MLPs	-57%	-17%	-11%	-33%
Preferred Stocks	-9%	-5%	-2%	-53%
Equal-Weighted Mix	**-27%**	**-8%**	**-9%**	**-44%**
Global Stocks	-21%	-13%	-20%	-54%

Clearly, these market segments have exhibited high correlation to stocks precisely when diversification was most needed. The income may have been minimally affected, but the hit to principal was material and, in several cases, worse on the downside than the stock market. For instance, MLPs lost over half their value in a single quarter in early 2020. REITs and preferred stocks suffered similar drawdowns during the 2008 financial crisis. The comparable negative returns of an equal-weighted mix of these four asset classes to equities illustrates the lack of diversification and puts into question the benefit of a high yield when the risk of capital loss can be so pronounced.

We believe maintaining strong diversification is particularly important today. Consider that the low yield environment that has created the desperate search for income is indicative of an unusual and precarious period. Interest rates are near zero due to deflationary pressures from record high debt levels, aging demographics, and technological advancements. With limited ability to stimulate further by lowering interest rates, the Federal Reserve is now printing trillions of dollars to finance the largest fiscal deficit in history. Fueled by years of stimulus, many asset markets are near all-time highs, weighing on forward looking expected returns. These conditions are not normal, and the associated risks should be seriously considered. Generally speaking, this backdrop does not suggest an opportune time to decrease diversification and increase risk!

Problem #2: Higher Taxes

An emphasis on higher yielding strategies results in a larger tax liability due to greater realization of current income. To make matters worse, taxable investors face the prospects of even higher tax rates over time as the government seeks ways to reduce large fiscal deficits. The growing income inequality adds further momentum to the mounting movement to redistribute wealth from the rich (via higher taxes). Consequently, individuals should target more, not less, tax efficiency in their portfolios.

[2] Source: Bloomberg. For all periods measured: High Yield represents the Bloomberg Barclays U.S. Corporate High Yield Index (LF98TRUU), REITs represent the FTSE NAREIT Index (FNRETR), MLPs represents the Alerian MLP Index (AMZ), Preferred Stocks represents the Merrill Lynch Fixed Rate Preferred Securities, and Global Stocks represent the MSCI World Index (NDDUWI). The Equal-Weighted Mix represents an average of the four index returns listed in the table (High Yield, REITs, MLPs, Preferred Stocks).

An Alternative Approach: Total Return Focus

Rather than emphasize yield, investors should think in terms of "total return." Instead of focusing on the income generated by a portfolio, they can concentrate on the cash flow it can provide since ultimately investors need cash (not income). With this approach, the needed cash can be generated with a combination of the yield of the portfolio plus sale of existing positions to cover any cash shortfall. The attention shifts to producing the necessary cash flow through a split between income and capital gains as opposed to forcing the portfolio to move towards high income-oriented investments.

The rationale for a more balanced, tax-sensitive solution is to combat the two major flaws (poor diversification and higher taxes) with the conventional thinking while producing sufficient cash to cover income needs. To illustrate the power of this alternative approach, we compare the total return and risk of two simple hypothetical portfolios,[3] each of which holds two assets with equal weight. The first portfolio is split between equities and high yield bonds; the second portfolio is allocated to equities and gold. Both high yield and gold have earned comparable returns with similar risk over the past 25 years. High yield offers attractive income, but poor diversification characteristics relative to equities while gold provides zero income but strong diversification attributes. We will first compare the total return and risk of the two portfolios over the past 25 years, highlighting return, volatility, and performance during historical bear markets. The results are summarized in Exhibit 2.

Exhibit 2: Equities/High Yield vs. Equities/Gold[4]

25-year Performance 12/31/95 - 12/31/20	Total Return	Total Risk	Bear Market Returns			
			Jan. '20 - Mar. '20	Oct. '18 - Dec. '18	May '11 - Sept. '11	Nov. '07 - Feb. '09
Global Stocks	7.2%	18%	-21%	-13%	-20%	-54%
High Yield	7.1%	15%	-13%	-5%	-7%	-26%
Gold	6.6%	15%	+4%	+8%	+4%	+18%
Equities/High Yield	**7.4%**	**15%**	**-17%**	**-9%**	**-13%**	**-41%**
Equities/Gold	**7.6%**	**12%**	**-9%**	**-3%**	**-8%**	**-22%**

Even though gold slightly underperformed high yield over the past 25 years (by about 0.5% per year), the portfolio with gold marginally outperformed the one with high yield. Importantly, the Equities/Gold Portfolio achieved these results with much less risk, both in terms of lower volatility and far less downside exposure during historical bear markets. In fact, the ability to protect capital in more challenging environments is precisely what allowed it to outperform over the full period.

From a tax-perspective, the portfolio that includes gold is more tax-efficient because of the significantly lower yield. Even if we sell principal to raise cash to match the cash flow of the Equities/High Yield Portfolio, the net to investors is still

[3] *Hypothetical portfolios are for illustrative purposes only.*

[4] Source: Bloomberg. For all periods measured: Global Stocks represent the MSCI World Index (NDDUWI), High Yield represents the Barclays US Corporate High Yield (LF98TRUU) and Gold represents the percent change in the spot price of gold (XAU). The Equities/High Yield mix represents a portfolio split equally between the MSCI World Index and the Barclays US Corporate High Yield Index, and the Equities/Gold mix represents a portfolio split equally between the MSCI World Index and Gold (% change in spot price), rebalanced annually on the first of January.

greater. The top marginal federal tax rate on income generated from high yield is 40.8%, which is higher than that applied to selling gold (31.8%) to produce the needed cash flow.[5] The simple difference in tax rates illustrates the tax-efficiency of selling gains to generate yield as opposed to relying on the high income produced by high yield bonds.

The tax advantage further distances Equities/Gold over Equities/High Yield on an *after-tax* total return basis. The annual after-tax return edge compounds to result in materially more capital over time. This simple example demonstrates the portfolio efficiency that can be attained by shifting focus from high income to high total return. By incorporating additional diverse asset classes, further improvements can be made.

Another advantage of a total return approach to managing cash needs is greater flexibility to manage taxes. The high-income model has high taxes all the time while the alternative method has a lower ongoing tax burden. The choices to raise the additional requisite cash are numerous. First, it's possible that the cash is not needed or less is required than originally expected, in which case there is no excess income and no excess tax. Second, whatever shortfall occurs can be covered by selling and generating long-term capital gains, which are currently taxed at more favorable rates than income. There is also the possibility that capital losses can be taken to raise the needed cash, assuming it is supported by a compelling investment rationale. Finally, even if capital gains are generated, there is often the potential to offset some of those gains before year end with capital losses to minimize the annual tax burden. A similar opportunity generally does not exist for income, which is far less likely to be offset with a loss.

There are two main advantages from minimizing taxes. A benefit accrues over time since there are less taxes paid and therefore more dollars remain invested, which then compound for longer. Additionally, a lower total tax rate for total dollars earned is likely given that income is charged the highest rate. Both benefits eventually result in more dollars to the investor. As a famous saying goes, "It's not what you make, it's what you keep."

Psychological Hurdles

To this point we have engaged in a simple math exercise to demonstrate the benefits of a total return approach to solving investor cash flow needs. If we were all objective beings without emotions and potential psychological hurdles, then the discussion could end there. The reality is investors are accustomed to earning income and may feel more secure with receiving regular checks in the mail. The key to overcoming these obstacles is to appreciate that the total return on the portfolio is ultimately all that matters. As long as investors withdraw (either as income or by selling principal) out of their pool of money less than it earns on average over time, the portfolio will continue to grow. Minimizing portfolio volatility across good and bad market environments with a well-diversified portfolio that minimizes (not maximizes) income generally results in better diversification and tax efficiency. We hope that shedding light on some of these common misperceptions and offering a potentially better all-around approach will help investors successfully navigate a volatile market environment while achieving desired cash needs.

[5] These figures include 3.8% net investment income tax on income and capital gains. Gold is taxed at a higher collectibles tax rate (28% vs. 20%).
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