Digging deep for income streams

Using multiple investment strategies can create dependable distributions

By Thomas Applegate and Rachael Camargo InvestmentNews
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Recent studies have shown that about 78% of the financial assets in the United States are held by retirees and baby boomers over 50. A large portion of this group isn't covered by a traditional pension plan. They will need to rely on personal savings and rollovers from their 401(k) plans to support themselves during retirement, which could last 20 years or longer. As such, it is urgent for financial advisers to help clients construct portfolio solutions that provide steady, consistent income while maintaining or increasing principal to help ensure that they don't outlive their assets.

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In today's low-interest-rate environment, creating such a portfolio seems like a Herculean feat. Traditionally, retirement portfolios have consisted of an ample weighting to safe, income-yielding investments — such as Treasury or high-quality corporate bonds for income, and dividend-paying stocks — to add a little growth and income.

However, with 10-year Treasuries and the Barclays Capital U.S. Aggregate Index yielding 3.2% and 2.8%, respectively, and dividend yields from the S&P 500 near 2%, the opportunity to generate sufficient income from traditional retirement investments alone is questionable. Further complicating the issue is the negative impact on principal that bonds face, should interest rates rise.

Although the search for a consistent payment stream may seem daunting, if we expand our idea of what an income portfolio should look like, and utilize the full range of investment alternatives and financial tools available, we can construct a portfolio designed to provide dependable distributions and the potential for capital appreciation.

DIVERSIFICATION REVISITED

To start, we need to rediscover the concept of diversification. In modern portfolio theory, diversification is used to help improve the risk-adjusted return of a portfolio. It also can play an important role when focusing on generating income.

Combining multiple sources of income, we can create a portfolio that provides a regular payment stream by relying on different sources during various economic and market cycles.

Diverse income sources can be drawn from a robust list of asset classes beyond traditional stocks and bonds. For example, we can generate interest from floating-rate loans, and high-yield and global bonds, while dividends can come from international developed, emerging-markets and small-cap stocks, as well as from real estate investment trusts.

Including alternative investments also may improve diversification.

Using mutual funds to construct such a portfolio makes gaining exposure to these asset classes relatively easy and efficient. Yields from funds in these categories — which can be estimated based on current averages, historical trends and market conditions — can be allocated to create a relatively predictable “base case” portfolio yield.

To capture additional payment sources, we can expand our income opportunity set further to include such items as capital gains, premiums from writing call options and the potential return of capital.

VOLATILE MARKETS

Using a covered-call strategy to generate income in a portfolio is a common practice for advisers and investors alike.

Writing call options on indexes that track the underlying holdings in a portfolio or mutual fund closely also can help generate income and provide a source of distributions during volatile or down equity markets.

Returning capital can be an additional way to support a dependable payment stream if all other sources within a portfolio fall short of distribution needs. When the net asset value of the portfolio is rising, returning capital merely represents a return of unrealized gains, and the original principal is maintained or increased.

However, if capital is returned to cover distributions and the net asset value falls, the capital returned actually reduces the balance of the investor's principal, in essence returning a portion of the original investment.

As the boomers move into retirement, advisers will be increasingly called upon to create endowmentlike portfolios that deliver a consistent payment stream while also maintaining or increasing principal balances.

Combining several of these concepts and techniques may help provide a solution.

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