

Finding Yield in a Low-Yield Environment

Written by Rob Copeland

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Not that long ago, retirees and others who needed adequate, reliable income knew they could get it by simply investing in bank CDs, Treasury bonds and other high-grade bonds.

But with interest rates at historic lows—in combination with the rating agencies' increasingly conservative approach—it's a different ballgame. Yields on the traditional go-to bonds are too low to provide enough income for retirement and other needs—yet investors still need that income to avoid outliving their nest eggs.

The good news is that there are many lesser-known options for income beyond the usual bond categories. Let's take a look at a few of them. Please note that these aren't specific recommendations for any particular investor. The right investments for you depend on your investment objectives, your time horizon, your risk tolerances and other factors.

Residential mortgage-backed securities. These packages of hundreds of mortgage loans may frighten those who associate them with the 2008 financial crisis and housing bust, but not all RMBS are created equal. Some contain too many weak loans, while others have a healthy percentage of quality loans and, if chosen carefully, they can produce above-average returns. But many investors have thrown out the baby with the bathwater: RMBS are still available at discount prices (which decreases the chances of losing money in the case of default) and present the potential for yields of 5% to 7% with durations less than three years. And the fact that the housing market has shown signs of firming up—and even appreciating in some places—is also good news because it creates price stability in the RMBS market.

"CoCo" bonds. Contingent convertible bonds, used by banks to raise capital, are issued as debt but convert into equity when a bank gets into significant financial trouble. Some of these bonds are riskier than others: Barclays, the largest British bank, recently sold CoCo's that immediately lose their value if the bank's core equity capital falls well below its historical lows. However, these bonds can be a win/win proposition, giving an investor a high yielding security and providing the bank with a loan that converts to equity in times of significant trouble. Those bonds have been in demand among savvy income-seekers because of their high yield, currently above 7.5%.

Dividend-paying stocks. Dividend-paying stocks have been a popular asset category for some time now, and investors have recently bid up the prices of many of these stocks due to the

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historically low tax on dividends for earners under the highest tax bracket. But it's still possible to find undervalued, dividend paying stocks with at least two times the yield of 10-year Treasuries (currently around 4%).

Distressed debt. This is the debt of companies that have filed for bankruptcy or have a significant chance of doing so in the near future. Why would investors buy this sort of debt? Because it pays such a high yield and trades at such a discount that the potential upside is worth the risk. Ameren Energy Generating Company is one example. The company's beaten-down debt is currently yielding above 13%. Analysts believe that even if the firm files for bankruptcy, bondholders would receive 70 cents on the dollar—for debt that is now selling at just 50 to 60 cents on the dollar. (This investment is not for the weak-hearted, as the risk of volatility can be high.)

Junk bonds. The junk bond category has its name for a reason. But smart shopping within the category can garner high yield with an acceptable level of risk. Specifically, investors should look for companies with improving financials. These companies can provide investors with yields north of 5%, and if and when they are upgraded by the ratings agencies, their prices will increase, meaning investors stand to earn capital gains as well as income.

Again, investments like these aren't what many folks have in mind when they think about generating income for retirement or other expenses. But the period of super-low interest rates that we're in makes it necessary to look at options that may not be familiar.

If you'd like to discuss options for generating income through investments that are appropriate for your situation, just give us a call. Together we'll figure out what's right for you.