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RETIREMENT WATCH
Mark Okada

# Seeking income in a low-rate world

*Dividend-paying stocks, bank loans, short-term Treasuries also can provide an inflation hedge*

Sixty is the new 40. At least that's how some investors at or near retirement would like to think of their portfolio's asset allocation model and its potential returns.

As baby boomers migrate out of the traditional 60/40 allocation model — 60% stocks and 40% bonds — and into a more conservative 40/60, the quest for equitylike returns and the need for alternative income sources have intensified.

By cutting their equity position, investors and advisers have reduced the growth and capital gains components of their portfolios, which they typically rely on for returns. That, coupled with quantitative easing, has investors wondering how they should deal with interest rate exposure and inflation potential.

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Recently, yields on Treasuries and some other fixed-income products have risen from near multiyear lows, providing an attractive entry point for investors. New issuance of shorter-duration paper has come to market, offering liquidity and less downside if rates rise unexpectedly.

Even if the Fed reduces its quantitative-easing program, shorter maturities shouldn't be affected significantly. In addition, the credit spread on shorter corporate debt would tighten in an improving economy. Shorter-term Treasuries could offer some protection with limited upside if the market becomes defensive. Investors, however, would be placing an expensive hedge by holding Treasuries when considering the opportunity cost associated with such a low-yield product.

## ATTRACTIVE RETURNS

Dividend equity funds and bank loans are two other alternative income solutions that can give attractive returns while mitigating the effects of rising interest rates and inflation.

Dividend equity funds typically invest in the shares of high-quality companies across multiple sectors that regularly pay dividend income.

Dividends historically have been a large part of equity market total returns. Dividend-paying securities offer the potential for both capital growth and income. They have lower variability of returns than non-dividend-paying companies and have helped buffer portfolio losses when equity prices decline. In a low-interest-rate environment, some investors have used dividend equity funds to augment their fixed-income allocation, making them a plausible source of alternative income.

Last year, falling rates were a large part of total returns in fixed-income portfolios. But the massive gains in fixed-income products are unsustainable as rates hover near historic lows. Thus there is a strong argument for positioning fixed-income-credit portfolios to capture the value and opportunity the bank loan asset class offers.

Many investors believe that they should allocate to bank loans because they're a floating-rate instrument. While that is true, the primary reason to consider bank debt is because it will enhance the yield of a portfolio without adding substantial risk. In fact, the asset could reduce risk if the investor is rotating out of high-yield bonds. The outlook for bank debt appears healthy, in the 5% to 6% range.

## LOW DEFAULT RATES

Bank loans also are secured against the issuers' underlying assets, and their low default rates and high recovery rates translate into reduced risk of credit loss. Contrarily, high-yield bonds are lower in their capital structure, and most are fixed-rate.

Over the past 20 years, bank loans have had only one negative-return year (2008), while high-yield bonds, investment-grade bonds and Treasuries have had three negative years.

We believe that all the upside potential related to interest rates has been priced into the bond market and that the downside risks are significant. We also think that credit migration is inevitable in the coming years and that rotating out of high yield — which is going to be more credit-sensitive and could have higher defaults and lower recoveries — is something to consider. High yield isn't going to experience the interest rate move it has in the past, and it lacks the senior structure that bank loans provide.

Investors searching for yield and diversity without wishing to increase the risk profile of their portfolio greatly should consider the income opportunities offered within dividend equity funds and bank loans. Those seeking simply to protect and preserve capital should look at shorter-term Treasuries.

Sixty may be the new 40, but that doesn't mean investors have to sacrifice return and diversity in their portfolio.

*Mark Okada is the co-founder and chief investment officer of Highland Capital Management LP.*

InvestmentNewsWebcast

Finding Risks and Opportunities in Fixed Income

Tuesday, March 12, 2013
4:00 p.m. - 5:00 p.m. ET

With interest rates at historic lows, how much risk is lurking in fixed income, and how can advisers position their clients for a rising rate environment?

This webcast will look at fixed-income investing from a variety of perspectives, including individual bonds, ETFs and mutual funds. Our panelists will offer outlooks for the bond market as well as investing strategies.

Specifically, our experts will discuss:

- Identifying risks inside bond portfolios
- Finding yield if rates stay flat, and the associated risks
- Pros and cons of laddered bond portfolios
- How bond ETFs will handle rising rates
- The inflation outlook
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