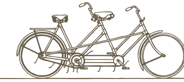
Manager Perspective

C. Angus Schaal, CFP®



TANDEM
WEALTH ADVISORS

MAY 2013

C. Angus Schaal, CFP®
Managing Director

Total Return Investing vs. Income Investing

With interest rates across the maturity spectrum near 50-year lows, many investors are struggling to attain sufficient returns to achieve their goals. This affects not only retirees, but pension funds, and any investor who traditionally focused on income.

Investing solely for income is extremely challenging in the current environment. Prudent investors are seeking alternatives to generational-low bond yields and zero returns on cash. The most pronounced shift has been away from government debt and high-quality corporate debt into lower rated "junk bonds". These securities are sold by companies with weaker balance sheets and are thought by rating agencies to have a lower chance of being able to repay the debt. This means the investor is accepting a higher initial yield but also accepting a higher chance of default by the issuer. The higher demand for income producing assets is primarily due to the very low interest rate environment. However, chasing higher yields entails proportionally higher risk.

INTEREST RATES AS OF EARLY MAY 2013

Treasury Security	Current Yield	Average Yield Since 1980
5-year Treasury Note	0.8%	6.3%
10-year Treasury Note	1.8%	6.8%
30-year Treasury Bond	3.0%	7.0%

Source: Bloomberg, Zacks

With rates this low, the most likely move over the next several years is for rates to move higher. Even if they do not get back to their average yield since 1980, investors could lose a significant portion of their principal. If interest rates were to rise by 100 basis points (1.00%) from the current levels, investors in a 10-year Treasury would lose 8.7% of their principal. Said another way, they would lose ***almost five years*** of coupon interest. The benchmark 30-year bond U.S Treasury bond would decline by an astounding 17.4% if rates were to increase by 100 basis points (1.00%). This is where we believe investors reaching for yield could be subject to major disappointments.

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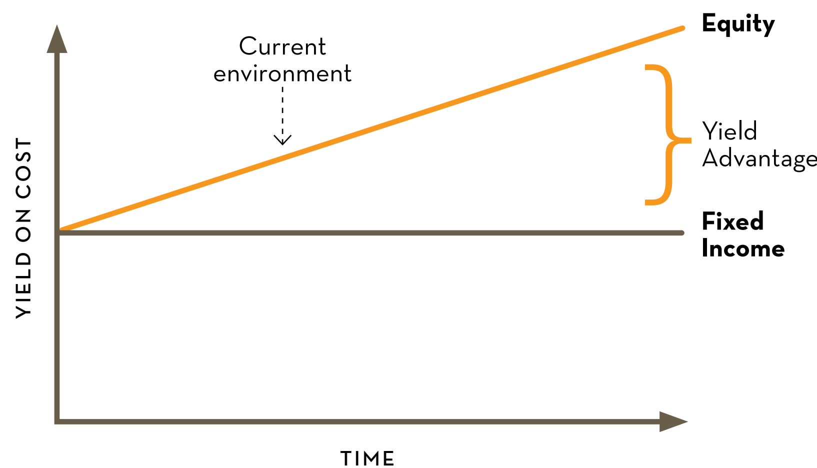
To summarize our current beliefs on fixed income, we counsel investors to have *reasonable* return expectations. While interest rates have declined substantially during the past five years, this implies that reasonable expectations of return should be meaningfully lower than they had been historically. We would add that simply because interest rates are low does not mean that they have to rise substantially from here. We can look to Japan which has had extremely low interest rates for over 20 years as they struggle with high debt levels, an aging population, and a stagnating economy. This is not our forecast, but it remains a remote possibility.

The following chart shows the difference between equity yield and fixed income yield over time. Equities tend to increase their dividends while fixed income instruments pay a steady, fixed payout. Over several years, the yield on cost for equities can increase significantly while the yield on cost for fixed income remains constant.



With rates so low and Tandem counseling investors not to increase their maturities or to move lower down the credit spectrum, how do investors achieve their investment goals? Income investors have three choices now:

1. Spend less
2. Reallocate to higher yield investments
3. Spend from total return rather than just from income.

Tandem favors the third option. We believe that investing more heavily in income-generating investments generates little to no portfolio growth in a low rate environment. Additionally – and more importantly – the portfolio is unlikely to keep pace with inflation. At the other end of the investing spectrum is a portfolio of growth-oriented investments with little or no current income. Tandem favors an investment strategy with a combination of both disciplines – income and capital appreciation – via total return investing. This methodology will best support an investor during his

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lifetime. By combining traditional income producing securities with proceeds from the sale of principal assets that have appreciated, investors can receive the best overall return while preserving the portfolio over the long-term. Focusing on the entire return generated by the portfolio (income return plus capital return), rather than just the income component, investors can achieve several benefits:

a) Maintain preferred length of maturity (duration) and credit quality in fixed income portion of portfolio.
b) Maintain targeted asset allocation of overall portfolio.
c) Allow the overall portfolio to be more tax-efficient.

Many investors become confused when the term "total return investing" is discussed in the context of post-retirement investing. Total return as an investing goal remains independent of any withdrawal strategy. Using historical equity total returns of approximately 9% per year and current short-term tax-free interest rates of about 2% annually, Tandem can construct a balanced portfolio that allows investors to withdraw funds annually for living expenses, while maintaining the structural integrity of the overall portfolio. While the investor will be selling or reducing some securities over time to help fund withdrawals, the overall portfolio is expected to keep pace with, or exceed the rate of withdrawals and thus not be reduced in value based on long-term expected returns.

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