US EQUITY

A Potpourri of Income Investing Ideas

By ROBERT POWELL Follow | OCT 23, 2017 | 3:31 PM EDT

Stock quotes in this article: DON, DES, DEM, MTUM, SPHD, NOBL, CSHIX, AFRAX, GIFAX, GSDAX, NRIAX, NPSAX, VNQ, FRIRX

With interest rates still low, and expected to be so for longer, investors need to be creative to earn decent yield levels, said Steven Mula, the chief investment officer of JJ Burns & Company. "Focusing on low-cost investments such as ETFs, if appropriate, may be part of an income strategy," he said in a recent interview.

See the Daily Treasury Yield Curve Rates here.

For Active and Long-Term Investors
For active and long-term investors seeking income, Mula said there are a number of factor ETF and equity-dividend strategies that may make sense. "Market yields in the U.S. are about 2%, and higher overseas," he said. "It's possible to buy segmented strategies that isolate actual payout yield as well as concepts such as growing yield or payouts, that is, rising dividends. Note that this latter example may be a closet equity factor such as quality, and may not necessarily have a high distribution yield."

JJ Burns & Company has some allocations to WisdomTree funds -- US MidCap Dividend (DON) and SmallCap Dividend (DES) ETFs, as well as their Emerging Markets High Dividend (DEM) ETF. "Again, not core positions, but meant to add exposure to a sub-asset class and add some yield, he said. The firm also has some exposure to the iShares MSCI USA Momentum Factor (MTUM) ETF, the PowerShares S&P 500 High Div. Low Volatility (SPHD) ETF, and the ProShares S&P 500 Dividend Aristocrats (NOBL) . "We use the latter as a proxy for quality, not for a yield play," said Mula. "Dividends must have a long record of growth for stocks to be included in this portfolio."

In factor investing, assets are viewed as bundles of underlying risk factors, according to the CFA Institute. Read Investors Need to Understand the Risks of Smart Beta from the CFA Institute, and Eugene Fama: Stick with Basic Factors.

In addition, Mula said some options strategies may be appropriate for some investors. "Covered-call writing is a popular strategy to add income, but comes with risks if the market runs and position are called away; some tax issues may result from this strategy, too," he said. "If investors think the market will move sideways or drop, this might be a good strategy for them."

According to the CBOE, covered call writing is either the simultaneous purchase of stock and the sale of a call option, or the sale of a call option covered by underlying shares currently held by an investor. Generally, one call option is written for every 100 shares of stock owned. Read more from the CBOE here.

Active and long-term investors must, however, be mindful of what they're buying with respect to 1) strategy, 2) expected yield and (3) intended and unintended bets. For example, he said an international dividend-focused ETF may have concentrations in sectors (financials, natural resources, for example) or currencies (Australian dollar) that will add industry and currency risk to portfolios. "Remembering the old adage that nothing is free in this business -- especially risk -- is a good starting point for analysis and evaluation," he said.

For Current Income Investors
Current income investors, meanwhile, have a different set of challenges, Mula said. High-quality yields (those found in a total U.S. bond market index fund, for example) are less than 3% and carry a lot of interest-rate risk. "For those investors, blending different income exposures is most likely the best solution," he said. "This would include adding investment-grade and high-yield credit exposure to portfolios, but as complementary positions, not core holdings. Credit quality is important, and understanding where the income comes from is also important."

For example, he said, a high-yield bond fund that minimizes sector and position bets and focuses on BB and B credits will offer a different capital return and yield profile than a fund that holds lots of distressed or CCC credits.

Mula also said floating-rate loans and bank-loans may be good investments here, as they are responsive to moves in short-term rates -- usually LIBOR. As always, credit-quality and portfolio fit are appropriate due-diligence points.

JJ Burns & Company has some exposure to the Credit Suisse Floating Rate High Income (CSHIX) and INVESCO Floating Rate funds (AFRAX) ; Guggenheim Floating Rate Strategies (GIFAX) is something the firm has looked at, too.

For those with more risk appetite, limited positions in emerging-markets debt -- local and U.S.D.-denominated -- may be appropriate, said Mula. "Yields are high, emerging market growth is improving and the dollar is moving in a range now with down pressure that may exist for a period longer," he said. "As U.S. rates increase, this currency spread may disappear, so that's an important caveat." Mula said the Goldman Sachs Emerging Markets Debt Fund (GSDAX) is one fund to consider. Read more about emerging markets bond funds from Morningstar.

Also, some interval business development company (BDC) and mezzanine-debt products are very popular now, said Mula. "These yields are very high, some over 10%, but come with liquidity, business and economic risk. That is, he said, we are in the latter part of our expansionary cycle. A word to the wise, however, is in order: "These are research-intensive products and may have very limited liquidity, but can certainly provide lots of income in a portfolio," he said, noting that Goldman Sachs has a fund that JJ Burns & Company looked at. The firm is also looking at some income-producing private equity strategies from GPB Capital.

Preferred stock, REITs (especially non-U.S. REITs) and real-asset income mutual funds and ETFs have attractive yields, but court economic, currency and interest-rate risk. "I would recommend these in limited allocations; no more than 2-3% per holding, that is, in a portfolio," he said. Consider: Nuveen Real Asset Income (NRIAX) , Nuveen Preferred Securities and Income (NPSAX) , Vanguard REIT ETF (VNQ) , and Fidelity Advisor Real Estate Income (FRIRX) . Refer to this list of publicly traded REITs and REOCs.

Finally, after years of virtual flatlining, Mula said short-term money market rates are worth investigating. "High-yielding CDs and money-market funds may be appropriate for cash holdings to augment longer-term holdings," he said. "Caution is advised here, too, as money-market fund rules have changed and NAVs on some funds may fluctuate.

As for CDs, he said investors may want to ladder maturities to take advantage of the expected increases the Fed is managing, which may take place over several years. "Investing prudently within FDIC guidelines is recommended," Mula said.

According to the FDIC, banks have traditionally offered consumers deposit products, such as checking, savings and money market deposit accounts, and certificates of deposit (CDs) for which each depositor is insured by the FDIC up to at least $250,000. Increasingly, banks, along with investment firms, are also offering consumers a broad array of investment products that are not deposits, such as mutual funds, annuities, life insurance policies, stocks and bonds. Unlike the traditional checking or savings account, however, these nondeposit investment products are not insured by the FDIC. Read more from the FDIC about these products and risks.

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