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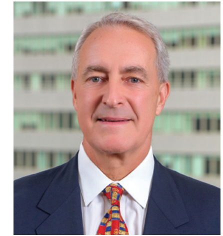

Thoughts for Investors

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"Chasing Yield" – The Cardinal Sin of Income Investors. Our Guide to the Major Risks

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"An investment in knowledge pays the best interest."

– **Benjamin Franklin**

Anyone want more income? "Chasing yield" is the derogatory term for taking known and unknown risks when trying to increase income. Identifying the risks of "chasing yield" is the topic of this letter.

The goal of investing is achieving an "acceptable level of total return," defined by your needs and wants, which often conflict. Acceptable total return derives from income (yield), appreciation (growth) or a combination. Typically, for financial assets, growth comes from stocks and income from bonds (fixed income). Dividend-paying stocks can be a combination of income and growth, though they rarely do both well. "Jack of all trades, master of none" as they say. I assume getting your money back, as a minimum, is a goal as well.

"Growth" scares some investors because of the chance of an investment "going down" or "depreciating" instead of "appreciating," such as recently happened with the stock market. On the other hand, "income" investors believe after years of paltry yields, they are on the verge of income nirvana and no longer need stocks (contrarian investor hint here).

Additionally, they push the limit, trying to squeeze an acceptable level of total return solely or mostly from income. Caution: rising interest rates can awaken long-dormant risks. There are **10** risks (that I am aware of) income investors face. Unique though related, they rise and recede in importance. All have roots in "chasing yield."

"The less prudence with which others conduct their affairs, the greater the prudence with which we should conduct our own affairs."

– **Warren Buffett**

#1: Credit or default risk, also known as **quality** or **safety risk**. It is the most apparent, yet investors often fail to monitor investments after they buy them, a concern in the face of potential recession.

While stocks make you an "owner" of a business, and you accept you may not get your money back, bonds make you a "loaner" to a business, municipality, the government, or an insurance company, meaning you expect your money back plus interest. Rising interest rates can increase financial stress on these entities, negatively affecting their credit rating, the price of their bonds and, in the extreme, jeopardizing the ability of "loaners" to "get their money back." Instead of being concerned, some income investors cheer the higher yields. Did you know S&P lowered the long-term debt rating of the US to AA+ from AAA in 2011?

#2: Inflation risk, often the most ignored and most insidious risk. Investors assume U.S. government bonds are the "least risky," and this is probably so. According to the U.S. Bureau of Labor Statistics, in June 2022 the average inflation rate was 9.1% and is currently 5%. 4 -month U.S. Treasury bonds currently yield ~5% and income investors cheer the higher yield. They are actually guaranteeing themselves a zero real return and potentially negative future real returns if inflation reaccelerates or they spend money on things with inflation rates higher than the "average." Remember also, you are only getting ~5%

yield for four months, and less if you lock in for a shorter or longer time. <u>You are still paying for 9.1% inflation from last year and will continue unless prices actually decline.</u> So a current, short-term ~5% yield doesn't seem like a long-term income solution worth cheering.*

#3: <u>Liquidity</u> risk, any difficulty in selling when you want your money back. It is also called **<u>accessibility</u> risk** and is, perhaps, the least understood. U.S. government bonds are the most liquid in the world. Many other fixed income investments are liquid as well, so investors tend to ignore this risk. But imagine trying to sell a Russian, Silicon Valley Bank, or Peleton bond or a business loan today as opposed to a year or so ago. Someone may eventually buy you out, likely at a steep discount. Liquidity risk can creep up on you. Higher yields can come with less liquidity and even "illiquidity." Investors do not need liquidity on every dollar, despite arguments to the contrary. Just know the tradeoffs.

Why is liquidity important? Even if you have no intention of selling, liquidity allows investors to see changing prices, an important hint of deterioration. Such is the case with annuities sold by recently indicted financier Greg Lindberg. <u>If you cannot see a price</u>, there is potential liquidity risk.

#4: <u>Interest rate</u> or <u>price</u> risk is the risk that as interest rates <u>rise</u>, you will be unhappy with the yield on your existing fixed income. As higher yields become available, your existing bonds also decline in price as they become less "attractive" to other investors if you decide to sell. Which means if interest rates <u>fall</u>, you will be happy, right? Not exactly. See risks #5 and #6.

#5: <u>Re-investment</u> risk. Periods of an "inverted yield curve," such as today when short-term yields are higher than long-term yields, often coincide with a recession. Inverted yield curves are not "normal." They eventually reverse, in which case short-term interest rates can decline. This forces investors to <u>reinvest</u> maturing short-term fixed income at lower rates, lowering income streams. Might all the money currently "parked" in short-term fixed income today be short-sighted?

#6: <u>Prepayment</u> risk. If interest rates decline, fixed income issuers like the government, municipalities or corporations look to save money by retiring or "calling" their existing fixed income and refinancing at lower rates, just as you might with your mortgage. Then investors no longer have those higher yields. On the other hand, if interest rates rise, you wish they would retire lower-yielding fixed income, but they will not, just as you should think twice about paying down your mortgage early if it has a low rate.

The whole *point* of "fixed" income is "certainty." Both rising and falling interest rates can bring "uncertainty" to <u>financial plans</u> containing fixed income. "Past performance is no guarantee of future results" for <u>any</u> asset class (we call it driving through the rearview mirror). The past 40 years of <u>declining</u> interest rates exaggerated positive returns for fixed income because <u>declining interest rates increase the price</u> of existing fixed income. Thus, it should be no surprise (it was not for us) that <u>rising interest rates decrease the price</u> of existing fixed income, making the use of <u>historical</u> fixed income returns for building financial plans inaccurate. If historical returns were used, the 40% allocation to bonds in the traditional 60% stocks/40% bonds "asset allocation" ratio did not save financial plans last year.

"It is a terrible mistake for investors with long-term horizons to measure their investment 'risk' by their portfolio's ratio of bonds to stocks. Often, high-grade bonds in an investment portfolio increase its risk."

– **Warren Buffett**

#7: <u>Duration</u> risk. Duration is a bond's "price sensitivity" to changes in interest rates. It considers factors such as maturity, yield, coupon, and call features when pricing bonds. The higher the duration the more bond prices will <u>fall</u> as interest rates rise. Duration risk is immaterial to bonds "held to maturity," as most individual bond owners should aspire to do. In that case, and assuming

the bond does not default, it will pay off in full at maturity.

#8: Community risk refers to the risk of actions by fellow fixed income investors, especially those in mutual funds. Funds own and manage portfolios on behalf of many shareowners with different agendas. While offering "diversification," they are subject to the emotions of participating investors. When interest rates rise, investors who own individual fixed income can "hold to maturity." Increased redemption requests force fund managers to sell prematurely. The highest quality, most liquid investments are typically sold first, so make sure you are not the last one out! Falling interest rates force existing fund shareowners to "share the gain" of higher yields and rising prices on older fixed income with new investors. Rising interest rates force new shareowners to "share the pain" of lower yield and declining prices for older fixed income already in the portfolio. Are you a new or existing shareowner?

#9: Monetary policy risk is the risk of government actions and interventions. While stock investors have long faced this risk, actions by the Treasury Secretary and the Federal Reserve to either rescue failed banks (or not) or bail out uninsured depositors (or not) highlight this risk.

#10: Fear of missing out (FOMO) on higher yields incorporates parts of all the risks. And you thought it only affected stock investors.

"Bond selection is primarily a negative art. It is a process of exclusion and rejection, rather than of search and acceptance."

– **Benjamin Graham**

In summary, who knew fixed income had so many risks? The good news is that while the risks are varied and can be complicated, the solutions can be summarized by the advice, "don't chase yield." It is the cardinal sin of fixed income investors. "Yield" is a function of "price" not "value." As we've seen with the Silicon Valley Bank episode, things are good until they are not! Stocks often (but not always) "telegraph" a deterioration in "value" through a declining price. With fixed income, unless an investment is "liquid," investors can't easily monitor price. If they can't monitor price, they can't identify deterioration until too late. Bank depositors and annuity investors take note. Stick with quality and liquidity and monitor your portfolio. "Trust but verify." For the most part, save "making money" for stocks. If you own mutual funds of fixed income, know what they (meaning you) own. Do not lock in negative total returns by ignoring inflation's risk. Seven percent inflation reduces one's "purchasing power" to half in about 10 years, a tough deal if you have children, are retired, or just haven't saved and invested enough. The actions of fellow fixed income investors in mutual funds can also be a risk. Investors using "past performance" to build financial plans for the future invite risk by "driving through the rearview mirror."

If you need or want to own fixed income securities, consider owning individual securities if you can. Hold them to maturity and stagger the maturities in a "bond ladder" to help provide diversification, liquidity, higher yields and help protect from reinvestment, interest rate, price and inflation risks. It takes guessing interest rate moves out of the equation too.

Above all for income investors, remember the return of your money is more important than the return on your money.

"In the end, how your investments behave is much less important than how you behave."

– **Benjamin Graham**

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“HEAR THE OTHER SIDE”

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*https://www.usinflationcalculator.com/inflation/current-inflation-rates/#:~:text=The%20annual%20inflation%20rate%20for,data%20published%20March%2014%2C%202023.