Income Investing Strategies for a Higher-Yield Marketplace

For many years, the income-seeker's lot was a discouraging one. Bank deposits and government bonds paid little or nothing before and even after inflation spiked as a consequence of the pandemic. However, and fortunately, from 2009 until 2020, and in COVID's aftermath, robust U.S. economic growth and a tsunami of cash chasing after better returns continues to reward strategies and tactics centered on high-dividend-paying stocks, real estate investment trusts, oil and gas partnerships, high-interest-rate lenders, preferred stocks and high-yield corporate bonds. *Kiplinger Investing for Income* newsletter stands squarely behind the so-called global hunt for yield and will always favor higher-paying investments over lower-yielding options.

This has been a successful philosophy since we launched the publication in 2012. Books and commentators that preach that "reaching for yield" is treacherous are living in the past. For besides ample interest and dividends, higher-yielding assets have added substantial market value. In 2019, for example, property-owning REITs returned 28%, with all but 4% from capital appreciation. In 2021, the main REIT index rebounded from the COVID shock of 2020 to return 40% and after a lull, is back in the market's graces with a 42% recovery (total return, which means price gains plus their 4% dividend yield). High-yield corporate bonds, which have outgrown their "junk" tag, have also been on a tear, with a return of close to 15% over the last one year. And utility shares have turned things around after a rare two-year slump while raising dividends 5% to 10% every year. With demand for power soaring due to electric vehicles and applications of artificial intelligence, utility investors are in the best spot they have been in since before COVID.

We know how easy it still is to collect 4% today holding cash in the bank or a money-market fund, even with the Federal Reserve already into its rate-cutting program and inflation readings once again lower than the risk-free cash return. So we do advise readers who have accumulated enough savings for life to limit or eliminate portfolio risk despite our confidence in those

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aforementioned high-paying categories that critics or pessimists deem to be chancy. Our expression for this de-risking is "take a knee," in the manner of the quarterback declaring victory by kneeling as time expires. Or you may partially achieve this by reducing your exposure to stocks and long-term debt to 25%, say, from 50%.

But few of us, even if retired or semi-retired, ever admit we are financially or emotionally prepared for a full-on investment lockdown. Investing is intellectually stimulating. We benefit from an amazing array of liquid and accessible alternatives that provide excellent income. And even with today's falling bank rates, the days of lending your savings to the bank or to the government for next to nothing are not returning; we doubt the Fed will cut money-market rates below 3%. The rebirth of visible cash yields therefore raises the bar on our quality standards for dividend stocks, bonds, funds, and specialties such as REITs and pipelines. We are aware that if you lose 10% of your principal on a questionable investment, in truth this is like dropping 14% because you can earn 4% for free. So, yes, these are not risk-free times.

Besides our steadfast support for yield, we also bring value by identifying and explaining clever or overlooked or misunderstood ideas across this wide range of income opportunities. We follow dozens of investment categories and revisit them several times a year in the context of the ever-changing market conditions. Our primary emphasis is immediate and reliable income. Capital growth is welcome but is secondary or incidental. Each month we offer a Timely Tactic investment idea, but in-and-out trading is not our style, particularly when this can mean you miss a dividend or interest payment. And we are patient and forgiving when a proven investment suffers a rough spell. Every security or category we follow is going to have a bad year or two out of every 10 and so losses such as everyone suffered in 2022 merely come with the territory. But if you were reading us then, you know that we emphatically advised our clients to keep time-tested holdings because they would surely recover, such as utilities, real estate trusts, and energy stocks.

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That said, we are adaptable. The financial world is in a rocky transition from the "lower for longer" inflation and interest-rate climate of the 2010s. The Fed is cutting rates and a new administration will enter in 2025 and, though we do not opine on legislative outcomes, may shake up certain industries and elements of the tax laws.

Three events of the last few years inform our viewpoints and expectations for the years ahead. First, in some ways the markets are still feeling the pandemic. The economic shutdown in spring 2020, followed by massive government and Federal Reserve rescues, transformed calm markets into volatile ones. Second, the reappearance of high inflation, even though it is back to between 2% and 3%, affects sectors differently and in ways unseen since the 2008 fiscal crisis. Third, we watch the shape and direction of the yield curve, with short-term yields now dropping while long-term rates such as on 30-year bonds and mortgages once again threatening to regain their normal relationship to cash, which is to say you should earn more interest in exchange for taking the extra risk of a longer maturity.

All this, however, is consistent with our bedrock approach to investing for income. We call it the Kiplinger 50/50. A sound long-term income plan is equally balanced between cash and debt (interest income) and equity (dividends and cash flows from rents and energy and other commodities). At times, one side of this divide has more price momentum; in 2024, stocks have outreturned bonds and by a wide margin. But, again, you can find hefty and reliable income flows on both sides and we will not abandon this concept.

Here is what you can expect us to discuss and some of our current recommendations:

BONDS AND LOANS. Many of us have lifelong experience owning Treasury bonds, or perhaps as kids, our families gifted us U.S. savings bonds. There is nothing horribly wrong with those: in November 2024, Series I savings bonds paid 3.11%. It is also likely that you may have IRA or 401(k) contributions in a general broad-based bond index fund with a mix of government and corporate bonds across the maturity spectrum. The popular Vanguard Total Bond Market ETF, symbol BND, pays out 3.5% and has an average maturity of eight years.

But we believe actively managed bond funds, where teams of analysts, traders, and managers have wide leeway to pick and choose among maturities and credit-ratings tiers, are better deals over time than bond indexes or Treasury and savings bonds. We pay close attention to scores of these funds from many brands and constantly interview the men and women who know how to add a percentage point or two of excess return year after year.

We also encourage readers to consider owning individual bonds, perhaps by building a ladder of maturities such as three, five, 10, 15 and 20 years, so you can control in advance how much interest you earn and when you stand to receive your principal back to reinvest instead of worrying that the value of bond-fund investments may decline either due to financial-markets gyrations or poor fund management.

Another idea is to build a barbell, which is what it sounds like: a combination of excellent short-term bond funds or ETFs with an equal dollar commitment to longer-term and high-yielding funds. For example, a combination of the PGIM Short-Term Corporate Fund (PBSMX) and the PGIM Total Return Bond (PDBAX), accompanied by a duet of Fidelity Capital & Income (FAGIX) and TCW High Yield Bond (TGHYX) gives you four distinct types of portfolios from two splendid fixed-income teams. The quartet has a one-year total return through early November 2024 of 12.0% and a composite 4.75% yield. The growth of the principal may not continue at this rate, but as interest rates fall, short-term bond fund net asset values will inch up and offset possible small declines in monthly distributions. This, or a similar grouping if you are partial to other fund brands, is an ideal bond-fund foundation for everyone.

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Another option is to invest in pools of government-guaranteed home mortgages. Financial conditions are such that homebuyers pay over 7% for 30-year fixed-rate loans although 30-year Treasury bonds yield just 4.56%. That unusually high spread—usually only 1.5 to 2 percentage points—means mortgages are a buyer's market. The simplest approach is funds of GNMA (Government National Mortgage Association) securities, which bundle these loans. Issuers include Fidelity, Vanguard, T. Rowe Price, Pimco, and other familiar providers. The funds do not pass through the full 7% because they include older mortgages with lower rates, but monthly payouts should improve as higher-rate pools replace lower-rate ones.

Finally, given the booming economy, you should be comfortable with some credit risk (borrowers' creditworthiness and propensity for ratings downgrades or defaults). So we continue to see merit in funds such as FFRHX, the Fidelity Floating Rate High Income fund. It and others like it own parts of hundreds of syndicated variable-rate loans to borrowers in all kinds of industries. In November, its current yield was 8.4%, so even if lending rates edge lower in concert with Federal Reserve moves, and the fund thus trims its distributions, you can still count on a large income stream. The underlying loans have been appreciating due to the global search for yield, so FFRHX's net asset value per share is up from $8.98 at the start of 2023 to $9.30. In general, all floating-rate investments are not just popular. They are performing well.

CASH AND CASH EQUIVALENTS. Two years ago, and certainly when we started this letter in 2012, we did not count cash as an investment. A reservoir to tap into other investments, a resting place, a store of value, perhaps (as in early 2020) a bomb shelter, but an investment? Yet while money-market funds post 30-day yields over 4% and six-month and one-year certificates of deposit still sometimes quote 4.5%, savings offers honest total-return competition. Every four months we publish a portfolio called Juiced-Up Cash, which strives to improve upon bank and money-fund yields without risk to the principal.

There is no universal rule on how much cash (or cash equivalents) to have as a proportion of an overall portfolio. The more urgent question is how long to assure yourself of current cash rates by using a device such as a ladder of CDs (equal amounts in ascending maturities such as three, six, nine and 12 months and two years), or to maintain maximum liquidity and flexibility with variable-rate money-market funds and bank savings. As

we write this, the Federal Reserve looks poised to reduce the rates it controls by another 0.5% to 1%, so it still makes sense to lock in at least some one-to two-year returns.

EQUITY. Our mission here is how best to position high-dividend stocks, commodity pass throughs, real estate trusts, and other cash cows opposite your cash, bonds, and mortgages. We do not issue buy-sell-hold listings, but occasionally in our Timely Tactic of The Month we will tag a sensible or overlooked income-stock or fund buying opportunity. Often this is when shares of a company with a healthy dividend are beaten down in price with no evident threat to the payout. When AT&T, for example, traded at or near long-time lows and its current dividend yield hit 8%, we commented that this looked like the shares were priced for a depression. Over the last six months, AT&T shares have inched up from $15 to $22 while retaining the quarterly payout rate. AT&T was a disappointment to its shareholders for many years, but once it appeared to be an inexpensive source of income, we reasoned that the rewards exceeded the risks insofar as the company changed management and its business strategy.

But isolated opportunistic ideas take a back seat to our three-pronged philosophy on the equity side: One, accumulate and hold blue-chip stocks with ever-growing dividends to build a high yield on your original cost. We call this program BHCG, for buy, hold, collect, and grow, and there are examples all over where the dividend yield on new money is 2% but if you have owned the stock for 10 years you are collecting 6% or even better.

Two, invest in high-yield businesses such as pipelines and real estate and stay with them through inevitable cyclical downturns. Three, filter in closed-end funds or other gadgets that create high current distributions through techniques such

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as leverage and options-writing. For example, instead of the nearly yield-free shares of the tech highflyers, we suggest you tag along by using QYLD, the Global X Nasdaq 100 Covered Call ETF. This strategy will never equal, or even come close, to the stocks' actual returns in a rising market, but the options-writing creates monthly distributions of 11%. There are similar funds for the S&P 500 and a sound idea is to pair them with some individual shares.

We pay close attention to stock categories where either the tax rules dictate, or the investment policy leans towards passing through a substantial percentage of the net income. Real estate investment trusts and business development companies (specialized high-interest-rate lenders) are required to pay dividends of 90% of their taxable income or lose their tax-deferred status. BDCs such as Ares Capital (ARCC) borrow money at middling rates and lend it for 10% to 12%. Property-owning REITs come in nearly 20 varieties. Our favorites are apartments, self-storage spaces, single-use retail, warehousing and distribution, and data centers. By owning a single-property landlord's shares, such as Realty Income (O) or NNN REIT (NNN), you get regular and growing income from a collection of CVS and Dollar General and Whole Foods and convenience store buildings. The leases include built-in rent increases, and you need not worry about skipped rents or vacant premises. These kinds of REITs regularly yield at least 5% and the properties can appreciate as well.

The same logic holds with pipelines. Regardless of the price of oil and gas, there is always demand, so an income investor can confidently place 5% to 10% of the principal in stocks or partnerships that pass through these enormous cash flows from processing, handling, storing, transporting, and distributing fuels. This sector, along with much of real estate and other high-dividend stocks, is recovering from 2022's losses while the growing U.S. economy stokes demand for everything energy-related and America expands its unaccustomed role as a major natural gas exporter. Such exemplars as Energy Transfer (ET), ONEOK (OKE), and Plains All-American Pipeline (PAA) are core holdings. The energy business has its cycles, but one of the key principles of investing for income is to watch where money is flowing through the economy and put yourself in position to collect some of it as you watch. That has worked well for our readers for 150 monthly letters, and we will be here to keep the ideas coming. Happy investing!

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