Targeting Yield(s) for Fixed Income

March 11, 2009 - " My target minimum for fixed income is 6%, as I believe:

> This compares with a likely 8-10% multi-year return on equities from this year's average level. Fixed income would have lower but more consistent and "guaranteed" returns.
>Many public companies now offer dividends in the 5-8% range, along with price appreciation potential.
>I need 6% or more to get back to my sustainable returns/spending level.

On the downside, I expect heavy inflation to come back in 2-3 years from now as the hyperinflation of the economy and federal deficits have a predictable impact. With this perfectly reasonable expectation, I'd be looking for debt instruments with a 3-5 year payback.

Looking at the items below, nothing really fits these parameters. So here are the important questions to be considered.
1. Are my parameters unreasonable, or do we occasionally find 6% returns with a 3-5 year maturity?
2. Based on my goals, am I better off moving more of the IRA money into equities?
Your thoughts?"
Jim………

ANSWER: I like the way Jim thinks.... A 6%+ yield is doable.

- I am seeing 5% to 5.8% in Government Gtd MBSs. The higher yields are for average lives that range from 8 to 20 years.
- I am seeing some whole loan product 2003 and earlier that is as high as 8%.
- As you know, I bought some GE Industrial (not GE Credit) 4 yr @ 6.06% and 8 yr @ 7.37% yesterday. GE is still rated AAA
- There is investment grade corporate paper available that ranges up to 8%+
- You know where preferred stocks are trading - we can get good, non-financial, preferred stocks above 6%, up to probably 10%.
- There are non-leveraged closed end funds that are paying over 6%.

Structuring a portfolio for Jim depends on his risk tolerance. We can get the higher yields, but picking survivors will be the criteria. I think that it is too early to buy the bonds of most companies - to know if they will survive the GD II.

As far as equities are concerned, I would strongly recommend a very diversified portfolio of equities. A single portfolio of 20-40 stocks is not diversified, will be very volatile, and requires a "super" stock picker to make it profitable. This takes a lot of research capability and is not likely to be successful except for the very "best of the best". The coming years (2-4 Years) are likely to see a trading range market instead of a strong rising trend. My guess is that fixed income will be more profitable for the next couple of years, than equities.

Inflation: All of the usual predictors of inflation are in place today except for economic growth. It is useful to anticipate hyper-inflation. That being said, I don't think that hyper-inflation, or even inflation that exceeds perhaps 5-6% (which I think is very high) is in the cards. If it is, then equities will be the best place to invest. If Michael wants to discuss this, we should do it when we meet.

The limitation to Jim’s outline is the limitation he places on fixed income maturities, wanting to stay under 5 years. We can't get his 6% yield without looking out further than 5 years.

As an aside: From a retirement standpoint, a yield of 6% or greater for the next 30-40 years would be a very successful retirement plan. Of course, that depends on the portfolio size and on what other income goes with the portfolio distributions.

As far as moving more money into equities, now and in the next 2 years: I think that I would suggest that Jim think in terms of a risk profile that calls for 50% fixed income. If he wants more growth, he can lower the amount of fixed income, but, the older he gets, the closer he is to retirement, the more stability and predictability he needs in order to plan for his future. You cannot plan on periodic withdrawals - monthly or annually - unless the volatility of the portfolio is minimized. Higher percentages of equities cause greater volatility.

For Jim, a 50% fixed income risk profile, today, means that we would recommend increasing that by 30%, to 65% fixed income, and plan to work back to the 50% level when it is clear that the economy is secure - probably in a couple of years.

On the matter of historical returns at 8-10%, this only applies when you are in a "Hold 'til Death" mode. It doesn't apply to someone who needs to make periodic withdrawals. We can discuss this with Jim when we meet with him.

Lastly, as to stock dividends, before very long, these dividends will begin to be reduced as cash flow needs dictate reduced payout amounts. Expect lower dividends in the future.