The Great Debate: Income vs. Total Return

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One of the contested issues in financial planning is whether income generated by investments matters beyond its contribution to total return (i.e., income plus price changes). In theory, investors should be indifferent, but in practice many care how much of their return comes in the form of income since this represents their ability to spend.

Income is always positive and comes primarily in the form of dividends from stocks and bond coupon interest payments. Price changes may be positive or negative, and are realized when some or all of an investment is sold. Price appreciation has been abundant in both stocks and bonds over the past six years, but there is a scarcity of high income producing securities today. Treasury bond yields are near record lows, and the yield on the S&P500 is well below its historical average. Investors, particularly those who require regular distributions from their portfolios, are challenged by the fact that a traditional stock/bond balanced allocation provides very little income. Investors must decide whether they are willing to bet that price appreciation will continue to be sufficiently high to offset low income levels or whether to seek securities that provide higher income.

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This issue has the potential to have implications for portfolio construction, and there are well-regarded experts on both sides of this debate.[1] We conclude that a successful investment program will offer a balance of income generation and price appreciation, and the overall allocation should be determined by the specific needs and objectives of the client.

Total Return Approach

The core of the total return argument is that the capital markets are efficient. This means that the consensus view of the value of a firm represented by the market price is the best estimate available. A company that pays a dividend, for example, has less retained earnings to reinvest and the market price should adjust to reflect reduced growth expectations. Non-dividend paying companies, the theory goes, will invest 100% of retained earnings and thus should be able to offer higher growth. These arguments make intuitive sense, but they are not supported by historical data. There is evidence, for example, that dividend-paying companies may have higher rates of earnings growth than non-payers.[2] The earnings from dividend-paying stocks will differ in other ways as well. Dividend-paying companies tend to have more consistent earnings streams over time (often referred to as higher-quality earnings) and are less likely to report losses.[3]

Dividend-paying stocks have also historically provided investors with higher returns as compared to non-payers. Total return advocates may submit that these higher returns are not causally related to the income paid by these stocks but rather by the fact that dividend stocks also tend to be value stocks. Value stocks have historically earned higher returns than the market as a whole. Portfolios formed on the basis of value and those formed on the basis of dividends may be related and have historically out-performed the broad market.

Bonds, in a total return approach, reduce portfolio risk and provide more income in typical environments. Stocks and higher-quality bonds have low correlation to one another, so that bonds generally offer positive returns when stocks are falling and broad bond indexes have fairly low volatility. It is well documented that current yield on high-quality bonds is an excellent predictor of future expected return.[4] When yields are low, the expected return of any given stock-bond allocation tends to be lower than the historical average. In order to maintain a portfolio that can support a long-term income stream, the total return investor's solution is to increase the equity exposure of the portfolio to provide higher potential price appreciation.[5] This is where financial theory and individual investor behavior begin to diverge. Many are simply not willing to accept the higher volatility associated with owning more stocks, and it is counter-intuitive to increase the weight of equities in a portfolio that is intended to produce a sustainable level of income. This can lead to an income orientation and investment in yield-oriented securities.

Income Approach

The goal of income investors is to maintain portfolios with a balance between current yield, income quality (consistency), income growth, interest rate exposure, and risk. Income to fund expenditures is often the primary concern and price appreciation is a secondary goal. Given the choice of two portfolios with similar expected return, the income investor will choose the one with higher yield.[6] Today, to access an acceptable level of income may require moving beyond portfolios that contain only traditional common stocks and bonds. There are a range of other securities that provide a large fraction of their total returns in the form of income. REITs and preferred shares are two of the more well known, and each income-generating asset has different investment characteristics.

The Challenge

In general, higher yield comes with higher risk. High-yield bonds are riskier, for example. This is not always the case, but by comparing risk and yield in a consistent framework across asset classes, investors can construct portfolios which provide much higher income than traditional stock and bond blended portfolios.

Perhaps the greatest challenge for income investors is managing the different types of risk in income portfolios, as compared to traditional total return portfolios. In general, income portfolios are more sensitive to changes in interest rates, for example. Depending on market conditions, preferred shares may look especially attractive as income generators, but replacing some part of a traditional stock-bond allocation with preferreds requires careful due diligence of the terms and analysis of the issuer of the security. Equity REITs and mortgage REITs also provide high levels of income, but these have unique exposures that must be taken into consideration. In summary, income portfolios can have very different sector exposures than traditional total return portfolios, leading to different risks which must be evaluated.

Our analysis suggests that, even in the current low interest rate environment, income portfolios can provide as much as 6% in yield with risk levels within the range of an 80% equity/ 20% fixed income portfolio. With the current yield on the S&P500 at about 1.9% and the yield of an aggregate bond index at 2.2%,[7] a wide range of stock / bond allocations will have total yields around 2%. The price appreciation potential for income portfolios tend to be lower than that of traditional stock/ bond portfolios, but estimates of expected price appreciation are highly uncertain.

Conclusions

There are two components of portfolio return: income and price appreciation. An ongoing debate rages as to whether investors are best served by a total return approach to investing or whether there are good reasons investors may prefer high-income portfolios that are not as reliant on price appreciation. For those who specifically favor income-oriented portfolios, we believe it is worth considering measured allocations to higher income-producing sectors of the market, as a complement to a blend of traditional common stocks and bonds. Even with low yields on Treasury bonds and major equity indexes, there are asset allocations that can provide appreciable levels of income.

** This analysis and research was prepared and written by Geoff Considine, in conjunction with Crawford Investment Counsel, Inc. Geoff is the founder of Quantext, which was an early contributor to SeekingAlpha and now writes regularly for Advisor Perspectives and Financial Planning. He has been working in asset management analytics and research for more than ten years. Before entering finance, Geoff was a research scientist for NASA. Geoff holds a PhD in Atmospheric Science and a BS in Physics.*

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