EMERALD ASSET ADVISORS, LLC

Investment Strategists for **Successful Families**

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Thank you for reading GreenThought$. It is our privilege to provide you with our insight on current financial market events and our outlook on topics relevant to you.

The Hunt for (Sustainable) Yield

Federal Reserve Chairman Ben Bernanke has made it clear that he wants to keep today's low interest rates in place through the middle of 2013. While that may be great news for anyone fortunate enough to qualify for a mortgage or a car loan, the Fed's easy money policy is bad news for savers, retirees, or anyone trying to generate income off their investment portfolio.

Most money market funds are currently yielding close to zero. So-called "high-yield" savings accounts are yielding a puny 1% or less. Those who are willing to venture out a little further on the yield curve will find five-year CDs paying a whopping 1.75%. Thinking of taking the plunge on a 10-year Treasury? Good luck keeping pace with inflation with yields hovering around 2%. Taking inflation into consideration, these low nominal rates are actually negative in real terms.

Today's low interest rates have prompted some income-oriented investors to seek more creative ways to earn higher yields. While we are strong proponents of alternative investment strategies, we believe there is a right way and a wrong way to earn higher yields. We also believe that investors need to focus on total return and risk, and not view yield in isolation. An investment that sports a 10% yield may seem attractive at first glance, but that attraction will quickly fade if the value of your principal investment drops 20%.

In today's low interest rate environment, many investors are looking for yield in all the wrong places. Here are three common missteps we have seen:

Investing in Risky, Lower Quality Bonds

High yield bonds are one of the first places investors turn to when fixed income yields are low.

The companies that issue high-yield bonds are often financially weak; therefore, they carry an elevated risk of default. The higher coupon rates on these bonds compensate for this risk. Recently, junk bond "spreads" (the difference between yields of high yield bonds over U.S. Treasuries) have widened significantly, signaling a weakening of high-yield bond prices. This decline underscores the risks involved in high yield bonds and the importance of solid credit analysis and diversification. That's why we recommend investors spread their bets across a wide variety of issuers via a high yield bond fund, rather than concentrating their bets on a few individual companies.

Getting Seduced By Unsustainably High Yields

Investors are sometimes seduced by an investment's yield, with no consideration as to whether that yield is sustainable. This occurs when a stock offers an abnormally high dividend yield. In many cases, the yield is high because the stock price has recently tumbled due to some financial challenges facing the company. Soon after buying, investors may be caught off guard when the company reduces or eliminates its dividend to preserve cash. Disappointed investors then dump the stock, driving the price down further.

Mortgage REITs offer another example of a high-yielding investment that can turn out to be a mirage. Unlike equity REITs, which invest in income-producing properties, mortgage REITs make money on the interest they earn from mortgages, as well as fees from buying and selling mortgages. They invest in pools of home loans and then use these mortgage-backed securities as collateral to borrow in the hope of boosting returns. This is a highly leveraged business model that is subject to pre-payment, interest rate, and default risks. As a result, dividend yields fluctuate, sometimes drastically, when interest rates or mortgage defaults rise. Investors are sometimes seduced by an investment's yield, with no consideration as to whether that yield is sustainable. This occurs when a stock offers an abnormally high dividend yield. In many cases, the yield is high because the stock price has recently tumbled due to some financial challenges facing the company. Soon after buying, investors may be caught off guard when the company reduces or eliminates its dividend to preserve cash. Disappointed investors then dump the stock, driving the price down further.

Mortgage REITs are also subject to regulatory risk. Currently, they are pass-through entities that are not taxed as corporations, which allows them to pass on their income to investors. But on August 31, the SEC sought comment on whether mortgage REITs should lose their tax exemption or their ability to use leverage. If this occurs, those tempting high yields could disappear quickly.

Managed Payout

This class of funds targets a certain level of monthly or quarterly distributions, not to be confused with true yield or income. Each distribution is expected to be paid from some or all of the following sources: net investment income, realized gains, unrealized gains or return of capital. In some cases, the return of capital – money that investors put in – can be a significant portion of the periodic distribution, while the income generated by the portfolio and distributed to investors can be small. Taken together, these components can overstate the true yield of the investment, unless carefully scrutinized. Thus, these should be examined very closely for anyone considering these types of funds.

A Focus on Risk, Consistency, and Growth

At Emerald, we believe it's important to focus on total return, rather than viewing yield in isolation. In today's challenging economic and market environment, capital appreciation has been difficult to achieve, so we have been giving more weight to the income side of the total return equation. When seeking yield, however, we believe it's important to invest in vehicles that can deliver attractive, sustainable yields that have the potential to grow. Currently, we are finding attractive opportunities in:

- **Funds That Invest in Dividend-Paying Stocks.** Dividends accounted for 20% of the S&P 500 Index's 9.8% average annual return between 1930 and July 2011[1]. In the last decade the contribution from dividends has been even greater. The S&P 500 actually declined 1.1% from 2000 to 2011, but dividend income of 1.8% helped the index log a total return, albeit tiny, of 0.7%. As of September 21, 89 companies in the S&P 500 Index had dividend yields that were higher than the yield on the 10-year Treasury, with 49 yielding 4% or higher. Many of highest, most dependable yields can be found in non-cyclical industries, such as consumer staples.

- **Higher Quality High-Yield Bond Funds.** We prefer funds that focus their investments on bonds rated BB or better, while avoiding lower-quality issues. These issues deliver attractive yields with significantly lower default risk.

- **Emerging Markets Bond Funds.** In a bit of role reversal, many emerging markets economies today enjoy healthy balance sheets and robust economic growth. At the same time, emerging markets bonds still deliver higher yields than those from most developed nations. We favor funds that are well diversified across countries, industries, issuers, and credit ratings.

- **Real Estate Oriented Investments.** Equity REITs and other real estate investments generally provide attractive yields, as cash flows generated from their properties are passed through to shareholders. Additionally, many real estate securities (mortgage REITs excepted) have demonstrated the ability to grow their distributions over time, which helps offset the impact of inflation.

- **Master Limited Partnerships (MLPs).** MLPs represent interests in fixed assets such as energy pipelines and terminals that throw off predictable cash flows that are passed through to investors. Operating like toll roads, MLPs collect fees to transport or store natural resources, most commonly oil and natural gas. Historically, MLPs have been able to increase their cash flows and their distribution rates over time. For more on MLPs, see last month's issue of Greenthought$: 09/16/2011: Bleak Outlook? MLPs May Help Cushion Against Market Volatility

In sum, in any low-rate environment, it is easy to be seduced by any investment that can deliver high yields. This is especially so given today's historically low market rates. But to achieve a consistent total return, you need to carefully weigh the risks and focus on investments that can deliver attractive yields that are sustainable, while also providing the potential for higher income in the future. There are numerous "yield" plays out there that sound enticing, but the available options that fulfill these objectives may not be as plentiful as you might like. Our answer thus far has been a combination of sources from the investment categories described above. Given the current miniscule yield environment, we expect these higher-quality asset classes to move the income-generation meter at least a little for client portfolios without exposing them to inordinate risk.

1. Generating Income From Stocks, Fidelity Investments, September 21, 2011

Disclosure
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