Investing for Yield

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In a volatile market environment with record-low interest rates, many investors today have gravitated toward assets with higher yields to obtain more income from their investments. In this update, three Bessemer investment professionals discuss how Bessemer evaluates yield-related assets and their concomitant risks — and which such investments we find most attractive today.

Q: What exactly do you mean when you talk about an investment's yield?

Langas: Every time you purchase an investment, you have three potential ways of making money on it: capital appreciation, currency appreciation, and yield. Yield is another word for what the investment pays you if you keep holding it. It can come from dividends, coupon payments from a bond, mortgage or rent payments to property owners, preferred stock payments, bank loans, and so forth.

Q: Why are higher-yielding investments getting more focus from investors today?

Langas: There are two main reasons.

First of all, getting returns from yield typically offers more stability or security during difficult market environments such as today's. Ongoing debt problems in Europe and the U.S., high unemployment, and subdued sentiment — not to mention the painful memory of stock market losses — have made investments whose returns come primarily from yield more attractive.

Second, within yield-oriented investments, higher-yielding securities have become more popular because — in an environment of historically low interest rates — it's become much more difficult for investors to receive a considerable steady income from a relatively safe investment such as a government bond. Five years ago, if someone had purchased $10 million in 10-year U.S. Treasury bonds, they could count on an annual income of over $500,000 — regardless of fluctuations in the bond market. Today, someone purchasing the same amount could expect to receive less than $175,000 per year. As a result, many investors are faced with the choice of either accepting a much lower income or investing in riskier securities that yield more.

Q: What are some types of higher-yielding investments that investors can pursue today?

Rossmiller: Some of the more common examples would be high-yield corporate bonds, global government bonds, convertible debt, mortgage-backed securities, bank loans, preferred stock, master limited partnerships (MLPs), real estate investment trusts (REITs), and dividend-paying stocks. Naturally, each instrument carries some corresponding measure of risk.

Q: How does Bessemer assess yield?

Rossmiller: Our philosophy is that yield should be just one of several characteristics to consider when evaluating a potential investment. Equally important to yield is the extra risk you take on to achieve it. Moreover, we look to find investments that offer not only yield, but the potential for capital appreciation as well. In some cases, we can find investments that offer robust yields and good upside at a reasonable level of risk, whereas with other investments our research suggests the higher yields are not worth the added risk.

Q: Is investing in high-yielding investments a good strategy today?

Langas: It can be. We first began emphasizing high-yield investments in 2008 and 2009. Back then, we saw compelling opportunities in high-yield bonds (which yielded more than U.S. Treasuries by historically large margins), mortgage-backed securities, and convertible debt, all of which have performed extremely well over the past several years. We believe it still can be a good strategy, which is why we recently increased our allocation to certain yield-oriented investments. Many of them offer returns competitive with equities but with potentially less volatility over time, giving them a crucial role in portfolio construction.

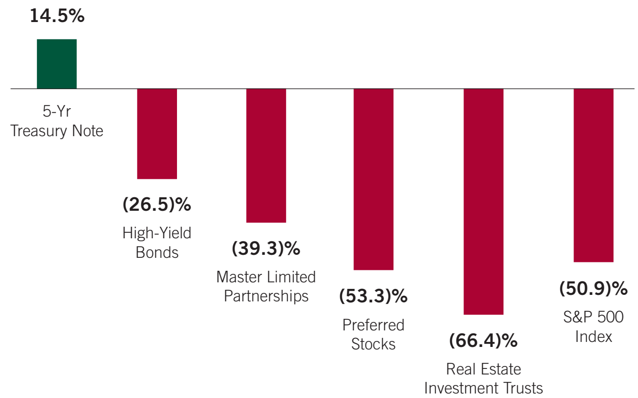
However, it's not quite so cut-and-dried. If you want more yield, you're going to have to sacrifice something, and, in many cases, that's safety. In other words, there are two reasons why a corporate bond yields more than a Treasury bond: It's less liquid and more likely to default. You take on greater risk — the risk, say, that the business struggles or has trouble financing its operations. Generally, that extra yield is there to compensate you for the higher probability that you won't be paid back in full.

Indeed, yield doesn't necessarily mean protection. For instance, during the financial crisis, U.S. stocks suffered a peak-to-trough loss of more than 50% over 15 months. But during that same period, preferred stocks and REITs actually lost more than the S&P 500 (Exhibit 1). And despite their yields, even high-yield bonds and MLPs fell 26% and 40%, respectively.

There's another risk to higher-yielding investments: They're likely to struggle during a period of rising interest rates, because their fixed payments become less and less attractive as investors can get higher yields from newer bonds elsewhere. If five-year Treasury bonds went back to yielding 5%, the 5% yield of a bond from a mid cap company would no longer seem to be enough to compensate for the extra risk, so many investors would sell it to reinvest in a better opportunity. Moreover, if inflation rears its head, an investment's stream of fixed payments — such as the interest on a bank loan — becomes less valuable as its purchasing power dwindles.

Exhibit 1: Yield Doesn't Necessarily Mean Protection

Financial Crisis: Peak-to-Trough Return



Data from October 31, 2007 to February 28, 2009.
"High-Yield Bonds" represents BofA Merrill Lynch U.S. High Yield — Master II Index; "Master Limited Partnerships" represents Alerian MLP Index; "Preferred Stocks" represents "BofA Merrill Lynch Preferred Stock Fixed Rate Index; "Real Estate Investment Trusts" represents FTSE/EPRA NAREIT USA Index.
Source: Alerian, Bank of America Merrill Lynch, Financial Times, Global Financial Data, London Stock Exchange, National Association of Real Estate Investment Trusts, Standard & Poor's

Q: What are some examples of higher-yielding investments that you find particularly attractive today?

Rossmiller: Within the fixed income category, we would highlight four:

High-yield bonds are corporate bonds that offer investors higher yields than government agencies or blue-chip companies. Today, we've found that the extra risk many of these bonds present — such as the potential for bankruptcy or default — is more than offset by their significantly higher yields than Treasuries. In fact, spreads (the measure of how much greater bond yields are than those of U.S. Treasuries) for BB- and B-rated bonds are currently about one-third above their historical average, which suggests investors are vastly overvaluing the safety of Treasuries compared to these bonds. When we consider that many BB- and B-rated companies have respectable finances and debt levels today, we like this opportunity. That said, high-yield bond spreads have already come down from their highs and many companies are scheduled to issue new debt in 2014.

This could increase the supply, potentially causing spreads to widen. For these reasons, we'll be monitoring this space more closely over the coming quarters.

Global government bonds are those issued by non-U.S. governments. Today, bonds of many financially sound governments — particularly those in emerging markets such as South Korea, Malaysia, and Mexico — offer significantly higher yields than U.S. bonds because their economies are growing faster than the U.S. and their central banks have kept interest rates higher to curtail inflation. Additionally, these countries' strong fiscal positions and economic fundamentals offer the potential not only for yield but also currency appreciation against the U.S. dollar.

Mortgage-backed securities are bonds backed by pools of mortgages. As such, their yields are closely tied to two factors: the number of homeowners defaulting on mortgage payments, and the general health of the housing market (since rising home values boost homeowners' wealth). During the financial crisis, these securities were hardest hit because of fears that borrowers wouldn't be able to repay their loans. However, with consumers continuing to reduce their debt levels and the housing market improving considerably, we see compelling opportunities in this area today. Additionally, the housing downturn caused mortgage issuance to drop significantly, which has lowered the supply of these investments amid greater demand. That in turn provides potential for capital appreciation. Particularly attractive to us are residential bonds that are 1) not backed by federal agencies (such as Fannie Mae and Freddie Mac) and 2) in the senior portion of the capital structure.

Convertible bonds are corporate bonds that offer investors the option of converting them to stock at a predetermined price. Because they share characteristics of both equities and bonds, they often offer "asymmetrical" return potential — that is, meaningful upside if the stock soars despite offering even more downside protection if the stock doesn't. Driving this protection is the coupon the investor receives and the knowledge that — unless the company defaults — he or she will be paid back the original (or par) value of the bond when it matures. Although yields for many convertibles have come down from their highs, we still see many convertibles well positioned for capital appreciation, but with a better risk-reward profile than pure stocks.

Langas: We're also finding value today in certain **dividend stocks**, which — as their name suggests — are equities that pay dividends. These investments offer a stock's potential for capital appreciation while also delivering yield through dividend payments. Companies that pay steady dividends tend to be more mature and don't have as much potential for rapid growth as, say, a start-up technology stock, but their dividends give them greater stability during more volatile periods.

A key aspect of evaluating the attractiveness of a stock's dividend yield is analyzing the company's balance sheet. A high dividend yield can sometimes suggest poor financial health and the likelihood of a future dividend cut. As a result, it's important to focus not only on dividend yield but also the prospects for dividend *growth*. Currently, many blue-chip companies such as Pfizer, ConocoPhillips, and Microsoft offer greater yields on their stocks than on their bonds — a scenario that favors stockholders (who can benefit not only from dividend payments but a rising stock price, too).

Q: What about MLPs, REITs, and preferred stock?

Healy: Let's take them one by one:

Master limited partnerships (MLPs) are publicly traded entities — the vast majority of which are in the energy sector — whose distributions aren't subject to corporate taxes. These investments offer relatively high yields (because of the favorable tax status of distributions) and exposure to the energy sector, which could benefit from greater spending on infrastructure such as natural gas pipelines and oil storage. However, MLPs are almost entirely in the energy industry, which creates concentration risk. Furthermore, many MLPs rely heavily on debt to finance their operations, which leaves them especially vulnerable to higher costs when interest rates rise. Because interest rates are already near record lows, the likelihood of rising rates going forward bodes poorly for MLPs. These risks lead us to believe we can find assets with better risk-reward profiles elsewhere, whether accessing energy commodities directly or targeting yield-oriented investments through high-yield bonds.

A **real estate investment trust (REIT)** is a real estate company that owns, operates, and manages real estate assets ranging from an apartment complex to a self-storage space. REITs offer investors access to the traditionally illiquid real estate market along with many tax advantages, since REIT distributions are taxed only once: as income for the shareholders to whom they're paid. However, many REITs are structured so that all or most of the company's earnings must be distributed in dividends, which makes growth very difficult unless the trust takes on more debt or sells additional shares. As a result, many of them, like MLPs, rely heavily on leverage. Moreover, while real estate does show some promising signs today, we believe REITs are currently very expensive; valuations are highest when interest rates are lowest. This, combined with REITs' traditionally steep management fees and historical volatility, suggests that we can find better opportunities elsewhere.

Preferred stock is essentially a cross between a bond and stock, with bond-like payouts but a stock's position in the capital structure. Holders of preferred stock, which is issued primarily by financial firms, stand in front of common stockholders in the event of a bankruptcy and are paid dividends before them as well. Despite their attractive yields, preferred securities have several risks: 1) many are callable (that is, the issuer can buy it back at a predetermined price), which limits upside; 2) dividends are not guaranteed; 3) the investments are heavily exposed to the fortunes of the financial industry; and 4) preferred shares have historically been volatile during times of turmoil.

Q: How do yield-oriented assets fit into a broader asset allocation strategy?

Langas: They are an important component of a balanced portfolio, playing a key role in a market environment such as today's with so many risks and the potential for greater market volatility. However, investors can't just blindly buy high-yield assets but instead have to carefully weigh the unique risks and return potential associated with each. As such, it's critical to have yield come from diverse sources — whether from high-quality fixed income, corporate credit, equities, or real estate. It's also important to realize that yield-oriented assets aren't immune to losses and are just one part of a well-diversified portfolio of complementary assets.

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