Introduction to the Universe of Non-Stock Market Income Generating Alternatives

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by David Scranton

There are three basic categories of investments: conservative, moderate and aggressive.

CONSERVATIVE	MODERATE	AGGRESSIVE
CERTIFICATE of DEPOSIT	CORPORATE BONDS	COMMON STOCKS
GOVERNMENT BONDS	INDEXED ANNUITIES	STOCK MUTUAL FUNDS
FIXED ANNUITIES	PREFERRED STOCK	COMMODITIES
INSURED MUNICIPAL BONDS	NON-PUBLICLY TRADED R.E.I.T.S	"SPECULATIVE" REAL ESTATE

Aggressive instruments are those primarily invested in for growth. As the chart shows, they include things such as common stock, stock mutual funds, speculative real estate and commodities. Again, these are typically invested in for growth or capital appreciation, not income. They're considered "aggressive" in part because it's a simple fact that sometimes when you invest for gains you get losses instead – or that growth sometimes ends up being shrinkage.

On the left of the chart are things that are considered "conservative" because they, at least in theory, are deemed to have no default risk. These include bank CDs, government bonds, fixed annuities and insured municipal bonds. In the middle are "moderate" instruments that have some default risk but are generally considered to have a much lower risk of loss than "aggressive" investments. These "moderate" options include non-insured municipal bonds, corporate bonds, indexed annuities, preferred stock and Real Estate Investment Trusts, or REITs.

The instruments on the left and in the middle have two things in common: 1) They're considered, to some degree, to have less risk of loss than the things in the aggressive category and 2) They are things that people invest in primarily for income. In other words, they are not things that people typically invest in first and foremost for growth – although they do appreciate in value. The interest and dividends that are typically yielded by the vehicles on the left and the middle represent a way for you to generate reliable income, but also a way for you to grow your money "organically" through the reinvestment of the interest and dividends that you may not need for income. I call this the "bird in the hand" approach to portfolio growth because you're not crossing your fingers and toes hoping for capital gains to provide growth, your building strategically through a level of growth that's guaranteed.

Bond Mutual Funds

If you're considering investing in the things on the left and the middle of the chart and most of your previous experience has been investing in the stock market or mutual funds, then I urge you not to take a do-it-yourself approach. Rather, seek professional guidance from a qualified financial advisor. There are many complex factors to consider when investing in these conservative and moderate options, some of which I will share with you in the next several pages. First, I'd like to talk a bit about a popular investment tool you may have noticed is conspicuously absent from the chart above, and that is bond mutual funds.

Generally, advisors who specialize in income-generating instruments, as opposed to the stock market and growth-oriented instruments, work more with individual bonds and bond-like instruments rather than bond funds. That's because when an investor buys an individual bond, he has two important guarantees: a fixed rate of interest for the life of the bond, and the return of his face value investment upon maturity. Both guarantees obviously assume that there have been no defaults, but with that assumption, an investor knows exactly what he's going to earn on the individual bond if he holds it to maturity.

By comparison, interest rates on bond funds aren't guaranteed but can fluctuate, and bond funds have no fixed maturity date. If they end up not maturing then, obviously, you can't hold them to maturity and therefore can't get your face value investment back. In short, the two guarantees that mitigate your investment risk in individual bonds don't exist with bond funds.

That's important because many factors can cause bonds and bond mutual funds to fluctuate while you hold them. Most people have heard that when interest rates go down, bond values tend to go up, and vise-versa. But that's really an over-simplification, and just one of the many factors that can impact bond prices during their lifetime.

With all that in mind, imagine that you're a client of an advisor who specializes in individual bonds while your friend Joe is with an advisor who's put him in bond mutual funds. If something happens in the bond market to cause bond values to drop, a portfolio of individually held bonds and a bond mutual fund might drop similar amounts in value, but because you're in individual bonds, yours is only a paper loss. If you choose to hold those bonds in your portfolio to maturity, then, as noted, you will get your face value back at that time – again, assuming there have been no defaults. But for Joe, who has the mutual funds, his is an *actual* loss, not a paper loss. In other words, a loss that might have been only a temporary paper loss in individual bonds can turn out to be an actual monetary loss in bond funds.

Since that's the case, you might wonder why so many financial advisors utilize bond mutual funds instead of individual bonds. One possibility is that the majority of advisors today specialize in growth-oriented, stock market-based strategies: those things in the "aggressive" column. And advisors who specialize in the stock market or the growth side are often not very proficient at fixed income analysis – which is very different. Therefore, it's easier for those advisors to recommend a bond mutual fund than a portfolio of individual bonds because, in so doing, they are leaning on the fund manager to pick the individual bonds. Bond funds really are a simpler way for stock market based advisors, or even do-it-yourselfers, to invest in the bond market. But like most things in life, simplicity comes at a cost, and in this case that cost exposing yourself to significantly more risk with bond mutual funds than you would with a portfolio of individual bonds.

Variables to Consider

Returning to the chart, understand that if you are investing in the different categories of individual bonds or even preferred stocks, there are many variables to consider. First is the credit worthiness of the issuer. The higher the issuer's credit rating, the less interest or dividend gets paid, and the lower the credit rating, the higher the interest or dividend that gets paid. In the case of municipal bonds, you also need to understand how your marginal tax bracket has an effect on your decision. The next thing you need to consider is the maturity date, but at the same time you also want to look at the yield curve to see where you get the most bang for your buck.

You also need to consider the yields offered on various types of fixed income securities. There are at least four different types of quoted interest rates that all mean different things, which means you need to understand such things as an individual security's coupon rate, current yield, yield-to-maturity and yield to call – as well as whether a bond is callable or non-callable, or convertible or non-convertible.

This is all just an overview, but I hope it gives you a sense of why I strongly suggest working with a qualified advisor who specializes in fixed income instruments if you have no, or even limited, real world experience with them, yourself. (You can probably also understand better why many stock market-based advisors prefer to "keep it simple" by working with bond funds.)

You may also be wondering about the wisdom of buying bonds in today's market with interest rates so low, thinking that when interest rates go back up, bonds will invariably drop in value. Your concerns are probably based to a large extent on the fact that many stock market-based advisors and Wall Street firms have been actively promoting that very message. But I believe this focus on a "bond bubble" is primarily a scare tactic being used in an effort to keep you investors from moving out of the stock market and into bonds. As explained, if you plan to hold bonds to maturity then interest rates become largely a moot point, in addition to which – as I've also explained – there are many factors that impact bond values besides interest rates.

To elaborate, one such factor is premium. When interest rates go up, it's because the economy is doing well and investors are becoming more confident. At that time, they typically require a lower risk premium, which means less additional interest to go from government bonds to corporate bonds. What that does is to partially offset the negative effects to bond values of increasing interest rates.

Returning to the chart, I want to look briefly at annuities. Odds are you already know these can be extremely complicated investment tools. Some have embedded fees and some have no fees at all. Some are subject to market volatility, and some have zero volatility risk. Some are irrevocable and others more flexible. In fact, there are so many factors to consider with annuities that unless you have real world experience with the various types of annuities, you certainly shouldn't pursue this option without the help of a qualified specialist in income-generating investment strategies.

Regarding REITs, the options are also extremely varied. When choosing REITs, one needs to look at the type of real estate that the REIT is invested in, the average length of the leases within the REIT and the profile of the major tenants, as well many other factors. Simply put, REITs are every bit as varied and complex in their own way as annuities.

Educational Process

More than 30 years ago, conservative financial investment alternatives such as these were extremely popular with retirees and those approaching retirement. Since the last bull market of the 80s and 90s, however, when investors became addicted to the stock market, they have gotten labeled as "dull, boring or old-fashioned." As a result, most investors today have, at best, a basic understanding of these investment strategies without any real world experience. But a good, experienced advisor who specializes in these income-generating alternatives can guide you through an educational process to help you understand the pros and cons of each, their risks, expected returns, and how they may or may not fit in with your personal situation and objectives.

With the exception of bank certificates of deposit (CDs), all of the "conservative"-to-"moderate" investment vehicles I've discussed are designed to generate reasonable returns in today's low-interest rate environment. All are generally considered to have less risk of loss than common stocks or stock mutual funds. Again, building your wealth by receiving predictable interest and dividends from your investments can is what I call a "bird in the hand" approach, and a smart alternative in today's environment than crossing your fingers and toes and hoping for capital gains – which, as noted, can quickly become losses.

And just remember, at the end of the day, the single most important factor when choosing a financial advisor is that you feel comfortable with that advisor's philosophies and that they match yours when it comes to savings and investing.