BAIRD

The Quest for Yield

The Roles of Dividend and Interest Income

By Baird Private Wealth Management

Summary

Investment income has always been an important part of the total return for investments: Total Return = Price Change + Investment Income. Income can come in various forms, including the dividends associated with stocks and the interest associated with bonds. For sake of consistency, we will refer to investment income as yield. Yield is simply the income received stated as a percentage of the security price. Traditionally, investors have sought price appreciation from stocks and income from bond investments, though these delineations are starting to blur.

Yield has become increasingly important to investors. Following the extreme market volatility over the past few years, many investors have allocated away from stocks and other risk assets, either to position themselves more defensively in the face of uncertainty or to correct an over-allocation to risky assets. However, while investors are taking on less risk, it appears they have not ratcheted down their return objectives, increasing the need for yield. Additionally, most would agree that the outlook for the stock market over the decade to come is more muted than the recent past. Whatever the driver, it is clear that yield is top-of-mind for many investors.

As investors search for new and often less-traditional sources of income, we remind our clients to put their decisions into context by answering three important questions. *What is the yield or income that is required on a regular basis? What is the total return necessary to achieve my objectives? What risks and volatility am I willing to tolerate to meet the yield and return objectives?* Investing involves a great deal of trade-offs, many of which we will discuss later in this paper.

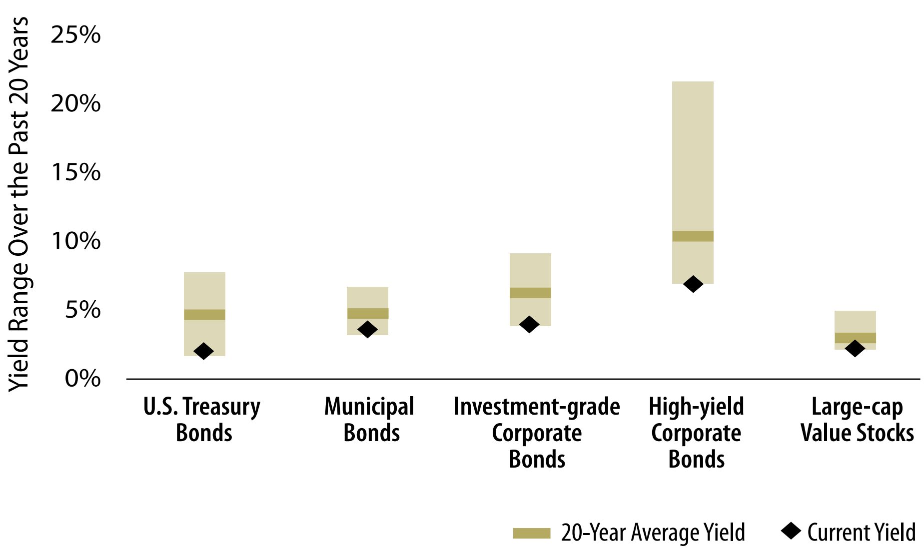
Key Considerations in the Quest for Yield

There are two key considerations to keep in mind when evaluating different yield instruments: 1) how the current market environment impacts the level of yield that can be expected, and 2) the trade-offs necessary to earn higher yields.

Market Environment. The challenge facing yield-seeking investors today is that the rates they have grown accustomed to in the past are no longer attainable using the same investment vehicles. As a result of monetary policy actions taken by the Federal Reserve, coupled with a period of weak economic growth and low inflation, the yields available on different asset classes have been compressed across the board.

CHART 1:

20-Year Historical Yield Range and Current Yield for Common Asset Classes



Source: Morningstar. For the past 20 years ending April 2011.
Refer to the disclosures section for category and index definitions.

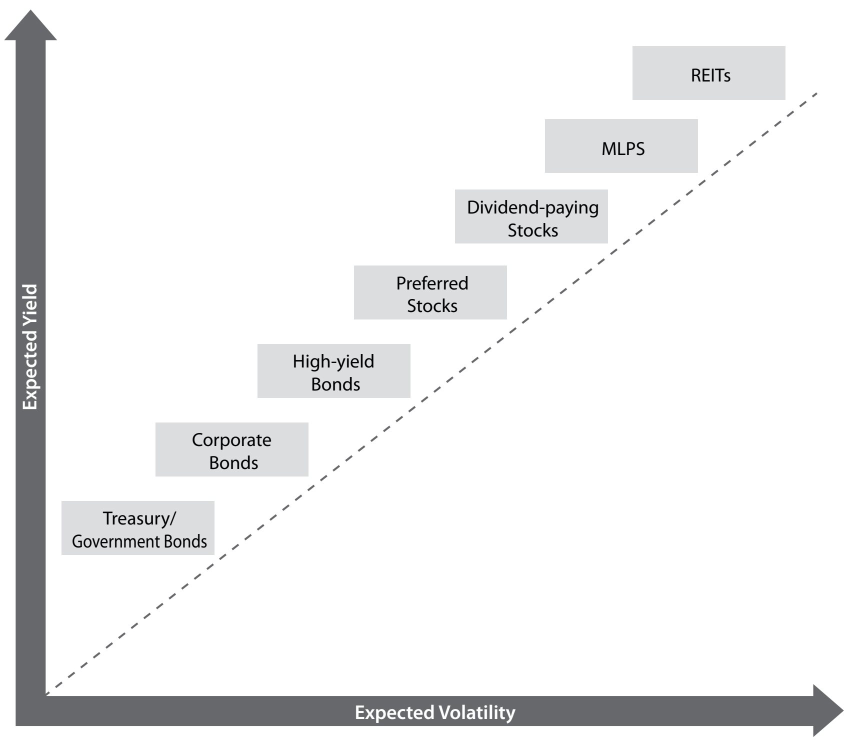
Chart 1 illustrates how the yields available on traditional income-oriented investments now stand at or near historic lows. The bellwether 10-year U.S. Treasury Bond, which has averaged a 5.2% yield over the past 20 years, today stands at a yield under 3.2%. Riskier high-yield bonds, which have historically averaged a yield of over 10%, today offer less than 7%.

Investors commonly assess yield based on expectations they have formed from past experience. However, investors must recognize that the current environment is different from what they have experienced in the past, and that their yield expectations may need to be adjusted accordingly. Achieving the yields investors have obtained in the past might require utilizing different asset classes, which will likely entail increased risks, as discussed in the remainder of this paper.

Risk/Return Trade-Off. As investors pursue yield opportunities, it is paramount to factor in the risk/return trade-offs associated with various investments. Whether the search for increased yield is driven by a desire to offset lower expected price appreciation or by unrealistic expectations, investors must be aware that higher-yielding investments are often characterized by higher volatility and risk of loss. Though investors may be hesitant to accept lower returns, we caution not to chase higher-yield opportunities without full consideration of the risk/return trade-offs, as they may be taking on more risk than they are aware.

Chart 2 details the relationship between yield, risk and total return. Traditional bonds (government, corporate, and high-yield) have historically provided average to above-average yields, lower volatility and moderate total return. Less traditional yield options (REITs, MLPs, preferreds) generally have above-average yields and total return potential, but they also have higher volatility and are susceptible to periods of pronounced negative performance.

CHART 2:



For illustrative purposes only. Chart not drawn to scale.

Yield Opportunities

There are several investment vehicles that offer the potential for income instead of, or in addition to, the potential for price appreciation. These include more traditional investment vehicles such as bonds and dividend-paying stocks, as well as less traditional vehicles such as preferred stocks, real estate investment trusts (REITs) and master limited partnerships (MLPs).

Each of these vehicles has a unique structure and a unique risk/return trade-off, described below. As such, investors can benefit from having a diversified portfolio of yield-focused investments across several of these categories.

Bonds. Bonds are among the most common way that investors can add yield to a portfolio. This yield comes in the form of income that bonds are required to pay on a periodic basis. Generally, these income payments constitute a large percentage of an investor's total return from bonds because price appreciation is not a main driver. The stability of income payments makes bonds less volatile than other yield-oriented options that have higher potential for price appreciation.

It is important to note that all bonds are not created equal. A bond offering higher yields is a sign that investors expect to be compensated for taking on additional risk. That risk may stem from concerns about the financial health of the issuer or from the structure of the bond itself. For example, bonds with longer maturities are more susceptible to changes in interest rates and have greater uncertainty that all future interest payments can be made. Thus, these bonds will often have a higher yield.

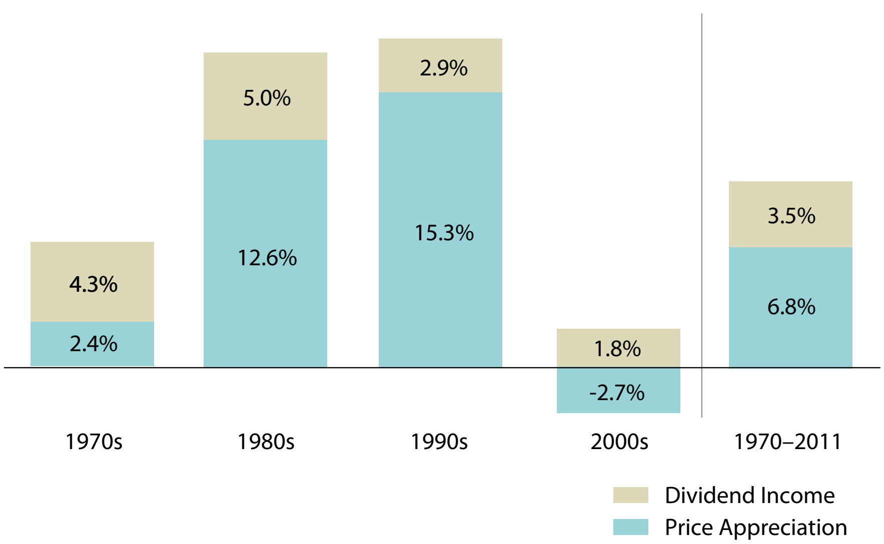
The bond market is very diverse and offers bonds with many different types of characteristics. Common classes of bonds include government bonds, corporate bonds and high-yield (or junk) bonds, among others.

Dividend-paying Stocks. Companies have choices on how to best utilize earnings: paying down debt, reinvesting in the company, buying back shares and returning earnings to shareholders through dividend payments are all available options. More mature companies that produce cash earnings in excess of growth needs often choose to pay cash dividends. An attractive feature of investing in dividend-paying stocks is that investors are able to share in a portion of the earnings and are not reliant solely on price appreciation for returns.

Historically, dividends have made a meaningful contribution to the total return of the stock market, at least in the United States. Chart 3 breaks down the S&P 500 return by decade into price appreciation and dividend income. Since 1970, dividend income has provided approximately one-third of the total stock return. Note that dividend income can only be positive. In periods where stock market performance is negative to moderately positive, like the 1970s and 2000s, dividends provide a valuable source of return.

CHART 3:

S&P 500 Return by Decade



Source: Standard & Poor's; Morningstar Direct; Baird analysis.

Hybrids: Preferred Stocks and Convertible Bonds. Preferred stocks and convertible bonds are hybrid securities that have characteristics of both bonds and stocks. Similar to a bond, a preferred stock is issued with a fixed value, and payments are made based on a percentage of that value. Preferred shareholders have priority claim over stockholders on a company's earnings. In this sense, a preferred stock's income stream is more dependable than a dividend payment. Although the yield premium for preferred stocks over Treasury bonds has fallen from the peak, the asset class still provides an above-average yield relative to Treasuries.

On the downside, preferred shareholders give up voting rights and generally have less of an opportunity for price appreciation. Additionally, issuing preferred stock is a less common form of financing, and not all companies will have that option.

Convertible bonds are unique in that they can be converted to a fixed amount of equity. Whether or not a bond will be converted is at the discretion of the issuer. Issuers are most likely to force a conversion if interest rates decline significantly; note that forced conversions are generally detrimental to the holders of the security. Given the conversion potential, these bonds present greater upside potential than most bonds, which can be important for those seeking higher total return.

However, in order to gain this upside potential, convertible bonds typically offer a lower yield than traditional bonds, albeit generally still higher than dividend-paying stocks.

REITs and MLPs. What makes REITs and MLPs attractive to income-seeking investors is the legal structure of these securities. REITs and MLPs are required to pay out 90% of their taxable income to investors. As such, above-average yields can be earned. Additionally, both can add diversification benefits to a portfolio, as they are often less correlated with the stock market.

REITs provide investors with access to a pool of real estate assets. These pools may be specialized (commercial property, apartments, health care facilities, etc.) or diversified. MLPs are commonly associated with the natural gas and oil industries, though other non-energy industries are slowly beginning to adopt the MLP structure. The goal is to assemble a portfolio of assets and revenue sources that provide a steady income stream that can be paid to investors.

Along with the unique benefits of REITs and MLPs, some unique considerations also exist. These securities have stock-like volatility and are often concentrated in narrow industry segments that may be subject to periodic shocks. Also, any income derived is subject to ordinary tax rates. Due to these complexities, we recommend consulting your Financial Advisor before making an investment in these areas.

Tax Considerations

As always, the level of income earned after taxes is the most relevant figure to most clients. There are too many nuances to the tax code to list here, so we recommend evaluating the merits of each option with your tax advisor.

Conclusion

Yield has historically accounted for a meaningful portion of total return, especially in lower-return environments. As such, adding different instruments to access yield opportunities may enhance a portfolio. The differences in yield between investments are a result of the risks that are associated with an investment. Balancing the risk and return trade-offs is an important step in constructing a suitable portfolio.

For more information, please contact your Financial Advisor.

Disclaimers

This is not a complete analysis of every material fact regarding any investment. The information has been obtained from sources we consider to be reliable, but we cannot guarantee its accuracy. Past performance is not a guarantee of future results. Diversification does not insure against loss.

Category and Index Definitions

U.S. Treasury Bonds: Based on the Barclays Capital U.S. Treasury index, which measures the performance of the U.S. Treasury bond market across all maturities.

Municipal Bonds: Based on the Barclays Capital Municipal index, which measures the performance of non-taxable municipal bonds rated investment-grade (Baa3/BBB- or higher) by at least two rating agencies.

Investment-grade Corporate Bonds: Based on the Barclays Capital U.S. Corporate Investment Grade index, which measures the performance of corporate bonds rated investment-grade (Baa3/BBB- or higher) by at least two rating agencies.

High-yield Corporate Bonds: Based on the Barclays Capital U.S. Corporate High-Yield index, which measures the performance of corporate bonds rated below investment-grade (BB+/Ba1 or lower) by at least two rating agencies.

Large-cap Value Stocks: Based on the Russell 1000® Value index, which measures the performance of Russell 1000® companies with lower price-to-book ratios and lower expected growth values. The Russell 1000® index measures the performance of the 1,000 largest U.S. companies based on total market capitalization.

S&P 500: A representative sample of 500 leading U.S. companies in leading industries of the economy. Considered a large-cap index.

The Russell Indices are a trademark of the Frank Russell Company. Russell® is a trademark of the Frank Russell Company.

All investments or investment strategies involve risk. Investors should consider the investment objectives, risks, charges and expenses of an investment carefully before investing. This and other information can be obtained by contacting your Baird Financial Advisor.

Baird does not offer tax or legal advice.

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