The Challenge to Income Investing

January 25, 2021

For many years, fixed income investing was a major component of developing a viable investment strategy for long-long investors. Up until the financial crash of 2008, investors could get a positive i.e., real, rate of return from holding money market securities that yielded 5%. Long-term government bonds could be counted on to return an even higher 6-10% during the Eighties and Nineties depending on how long an investor wanted to hold the security. After the peak in bond yields in October of 1981 when a long-term government bond yielded over 15%, there has been a general decline in bond yields to where that same 10-year government bond yields 1.1% today as you can see in the chart below.

10-Year U.S. Government Bond Yield

Source: Macrotrends

For investors willing to take on some additional business risk for current income, there was always the high yield (junk) sector of the bond market. During the heyday of this market in the 1980s, a diversified portfolio of high yield bonds could produce a current yield well into the double digits with a low risk of default. In 1989, we owned a McCaw Cellular high yield bond with a current coupon of 16% at a price of 72! Up until recently, high yield bonds offered some comfort to investors seeking to receive some reasonable income from their portfolio.

While nobody seemed to notice, the yield on high yield bonds and high yield bond funds have collapsed. Not too long ago, diversified fixed income high yield funds yielded at or above 6%. Recently some of those fund yields have fallen below 4% unless leverage is being used by the fund manager. (Note that these estimated yields are quoted on a 30-day SEC yield basis). The definition of this calculation according to Wikipedia is: “In the United States, 30-day yield is a standardized yield calculation for bond funds. The formula for calculating 30-day yield is specified by the U.S. Securities and Exchange Commission (SEC). The formula translates the bond fund's current

portfolio income into a standardized yield for reporting and comparison purposes. A bond fund's 30-day yield may appear in the fund's "Statement of Additional Information (SAI)" in its prospectus." When you step back and look at the entire spectrum of fixed income security returns, the picture is that of a catastrophe for fixed income investors.

Since 1980, there has been a 40-year decline in government bond yields. As a result, the government bond market appreciation has been hyped by a rise in bond prices due to falling yields. However, it is the current yield that determines where the bond market goes in the future. The crisis is that bond returns cannot approximate the historical return of bonds simply because, in a rising interest rate environment, outstanding bond prices will fall offsetting the higher yields of new bonds in a rising interest rate environment. If interest rates do not rise, then bond yields will remain at record lows.

The whole notion of asset allocation, the mix between bonds and stocks, is turned on its head as bond returns collapse and stock returns accelerate. To achieve higher long-term returns, asset allocation may have to skew toward more stocks and less bonds. While a portfolio more heavily weighted in stocks may suffer from greater short term market volatility, the long-term outlook for a higher return from such a portfolio is likely to increase given historical returns on stock market indices.