The Search for Higher Yielding Assets

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One of the most important aspects in achieving long term success in your portfolio is to adhere to your targeted equity and fixed income allocations. Your personal time horizon, risk tolerance and financial goals should determine your asset allocation; the outlook for the market should not. Within this framework, however, you can also look for ways to increase the income your assets generate. Income will help to offset the volatility in your portfolio you will experience from time to time.

Interest rates have risen from record lows, but it is still difficult to find ways to boost yield in your portfolio. With baby boomers moving into retirement, there is huge demand for income producing securities; therefore they are not cheap. Your only choice is to look at the best relative value offered. As always your time horizon and risk tolerance need to be considered first and foremost. All investment instruments can have a place in your portfolio, but should be included as part of the bigger picture without allocating too much to any one of them.

High dividend paying stocks offer the combination of dividend income and potential for capital appreciation. There are many large, mature companies paying dividends greater than 2.5% to 3%. Today we also see more and more growth oriented companies paying steady dividends, including technology firms. Dividend payout ratios on the whole are at historic lows. After seeing numerous companies cutting their dividend in 2008 and 2009, we can reasonably look for this to turn in the coming years. Look for companies with stable earnings growth over the last five years, low debt, and a consistent track record of increasing dividends. Work with your advisor to develop a portfolio that includes value oriented companies with above average dividends or good potential for dividend growth. If you are managing on your own, there are a number of dividend oriented mutual funds and ETFs to choose from, such as **IShares Dow Jones Select Dividend Index (DVY).**

Real Estate Investments Trust or REITs are companies that own income producing real estate. They are required to derive at least 75% of their income from real estate and distribute 90% of their taxable net income as dividends. They payout average dividends around 4%. Depending on your risk profile, you could invest in an investment grade REIT bond yielding around 3.5% for a 10 year maturity or invest in the stocks. Rising interest rates are a major concern for REITs, and as a result they underperformed last year. However, after this sell-off they are now trading at the cheapest levels in five years. Some to consider are office REITs, which should perform well with economic recovery, and senior housing REITs, which can be expected to see growth with the aging population.

Utility stocks also pay higher than average dividends. They offer diversification as they are often less volatile during a market downturn. Many investors view them as a hybrid between stocks and bonds due to their more stable nature. Names like **Southern Company (SO)** and **Duke Energy Corp (DUK)** are large regulated companies paying dividends over 4%. If you prefer a fund, the largest ETF in the Utilities sector is the **Utilities Sector Select (XLU)**, which is yielding 3.6%. Utility stock dividends are also projected to increase over the next 12 months.

Preferred stocks are hybrid investments with qualities of both stocks and bonds. They are considered equity securities but they are higher in the capital structure than common stock. They tend to pay fixed, higher dividends than common stock. On the other hand, you are less likely to see the capital appreciation as a holder of preferred stock that you might see if you held the common stock. The average dividend on preferred stock is around 6.5%. Like bonds however, preferred stock declines in value when interest rates rise. This does not mean they should be ignored entirely, as the high income offered helps to offset some of the price decline that would come with small moves in interest rates. If you stick with large liquid issues, the markets are quite liquid should you decide you want to exit your position.

High Yield Bonds are typically a place to turn for more yield if you are willing to take on a bit more credit risk. Right now the high yield market does not look appealing. After very strong performance since the financial crisis, the spread versus investment grade bonds has narrowed; you are not paid that much to take on the extra credit risk. Another negative is that most high yield bonds are benchmarked off the 5 year Treasury bond and will be sensitive to short term interest rate increases. Also note that although they are bonds and considered a fixed income investment, they are highly correlated with the equity markets and therefore do not provide as much diversity in a portfolio with a high allocation to stocks.

Municipal bonds are generally exempt from federal taxes. If you live in the state where they are issued they can also be free from state tax. Municipals are an attractive choice right now. Credit on the whole will be improving with increased revenues from taxes and increases in property values. Demand for municipals is increasing with baby boomers moving into retirement, and subject to generally higher tax rates overall.

Treasury bonds. These still don't offer much in the way of income, but the yields are higher than they have been. Treasuries are still an important component of your portfolio. They offer high quality and they are often negatively correlated with stocks. This provides diversification, which allows you to take on more risk in other parts of your portfolio. A 10 year Treasury now pays about 2.7% for US government risk. If you hold the bond to maturity you won't lose principal. In a rising rate environment, Treasuries are best included as part of a laddered portfolio to allow you to reinvest at presumed higher interest rates as bonds mature.

It is challenging to find yield, but you can't avoid all income producing assets that are sensitive to increases in interest rates. Be selective in your choices, -- diversification should be the overriding principle to ensure you protect your downside risk.