THE INCOME ILLUSION

By Dan Bortolotti
Illustrations by Harry Campbell

With interest rates at all-time lows, investors are desperate for yield. But focusing only on income can often lead to a bad outcome

Investors have a lot to worry about these days but if you're trying to live off the proceeds of your portfolio, one concern trumps all others: low interest rates. As of mid-August, 10-year Government of Canada bonds were paying about 1.8%, not even enough to outpace inflation.

"I feel for people," says Alan Fustey, portfolio manager at Index Wealth Management in Winnipeg. "Fifteen or 20 years ago, you could always find a coupon around 10%. Then it went down to 8%, then 5%, and now if your portfolio is largely fixed income, you just can't get that yield anymore."

The appetite for yield has spurred many Canadians—especially those in retirement—to modify their investment strategy. That's understandable: after all, a retirement portfolio is supposed to generate cash flow to meet your expenses. The problem is many have lost sight of the big picture, and that can lead to poor decisions. "People are blindly looking for yield and not really understanding the consequences," says Fustey.

Most investments deliver some combination of yield (income from interest or dividends) and price appreciation. Both are equally important and together add up to an investment's *total return*. What's often forgotten is that one usually comes at the expense of the other: bonds with higher coupons can bring a capital loss, stocks with higher dividends may experience slower growth, and so on. Investors run into trouble when they look at only one side of the equation.

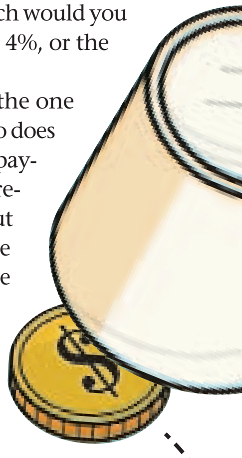
"Right now the flavour of the month is yield, yield, yield," Fustey says. "But at the end of the day there is always a price. You are always giving something up." Here are four common examples that can help you avoid eating tomorrow's lunch today.

BONDS

Say you're comparing bond funds and notice the iShares 1-5 Year Laddered Government Bond Index Fund (CLF) pays a distribution of 4.5%. That sounds awfully tempting when you consider that a ladder of one- to five-year GICs (which has the same level of risk) yields about 2%. Indeed, this difference is what prompted one well-known financial writer to recommend CLF because it offers "better returns than GICs." But this simply isn't true.

Bond math is tricky, but the most important idea is that when interest rates fall, bond prices go up. To understand why, imagine a five-year bond with a face value of $1,000 that pays a 4% rate of interest (or *coupon*), which is $40 annually. Now imagine a year later rates have fallen one percentage point. Our original bond now has four years left to maturity and is still paying $40 in interest, while new four-year bonds are paying just 3%, or $30. If you want to buy a four-year bond today, which would you choose: the old one paying 4%, or the new one paying 3%?

Obviously, you'd want the one paying more interest—but so does everyone else. So the bond paying 4% will now carry a premium: it would sell for about $1,037. When it matures, the investor will get back only the face value of $1,000, so he suffers a capital loss of $37. That will offset some of the higher income he'll receive over the four years. Overall, the bond's total return will work out to 3% annually—exactly the same as if he'd bought a new bond at current rates and paid face value.



OK, back to our government bond fund from iShares. The reason it pays that hefty 4.5% distribution is that all the bonds in the fund were issued several years ago, when interest rates were higher. They were purchased at a premium, and when they are eventually sold the fund will incur a series of capital losses that will offset most of that 4.5% coupon.

That's why investors need to make decisions based on a bond fund's *yield to maturity*. This figure—which should appear on a bond fund's website—estimates the fund's total return based on interest income minus any capital losses. In the case of CLF, the yield to maturity today is about 1.5%—and that's before subtracting management fees. An investor who puts $100,000 into this fund might collect $4,500 in income from the 4.5% yield, but he will also lose more than $3,000 of capital.

You'll notice CLF's yield to maturity is significantly *less* than the yield on a five-year

"With all
that can't be

GIC ladder. That's what you should expect, since GICs usually pay more interest than government bonds. Bottom line: an investor who considered only the income component of these two investments would have chosen the one with the lower total return.

DIVIDENDS

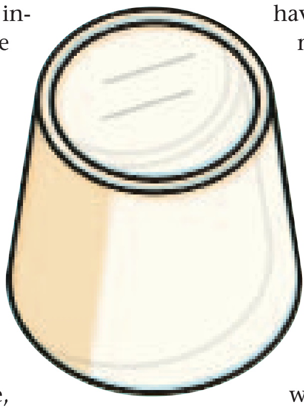
Many investors take for granted that they need to focus on dividend-paying stocks in retirement, as opposed to using a more diversified strategy that also includes growth stocks with little or no yield. There's nothing wrong with focusing on dividends, especially if you're investing outside an RRSP or RRIF, since the tax advantage of Canadian dividends can be enormous. However, just like bond buyers, dividend investors sometimes forget there's a trade-off.

Take the idea that spending $1,000 of dividends is "living off income," while selling $1,000 worth of shares is "depleting capital." Academics have spent decades arguing that these two actions are essentially the same, but the message hasn't sunk in. "That's a hard one, because it's totally behavioural," says Steve Lowrie, portfolio manager at Lowrie Financial in Toronto. "People think that dividends are found money: they don't realize it's just money coming out of the company that could have been used to buy back shares or expand the business."

Think of it this way: if a company pays you a $1,000 cash dividend, it must be worth $1,000 less than it was before. That's why you'll often see a company's share price decline a few days before an announced dividend is paid. That confuses many investors. As one finance professor wrote: "I once heard a fellow say, 'I don't understand it; every time this stupid stock pays a dividend, it goes down. You would think it would go up.'" That's a classic example of the income illusion at work.

Investors who gobbled up income trusts fell into a similar trap several years ago. Thanks to a tax loophole the government has since closed, these companies paid out generous distributions, often 8% to 10% or more. But often more was going out than coming in. "Generally these were depreciating assets, so you were getting some return, plus a piece of your principal back," says Alan Fustey. "People would call it yield, but that makes no sense, because you're depleting your original capital."

Another common misunderstanding arises when investors measure their "yield on cost." Say you bought a stock 10 years ago for $20, when it was paying a dividend of 4%, or $0.80 per share. The dividend increased 8% annually, so a decade later it's grown to $1.73 per share. Some investors will divide the current dividend by their *original* cost and say their investment is yielding 8.6% (1.73 ÷ 20 = 0.086). But a stock's true yield is its dividend divided by its *current* price, not the price you paid for it. Yield on cost is an almost meaningless figure that can lead investors to badly overestimate their total return.



None of this means dividends are irrelevant. "With all of the accounting shenanigans that have gone on, dividends are something that can't be masked—at least not entirely," says Dan Hallett, director of asset management at HighView Financial Group in Oakville, Ont. He argues dividends can signal management's confidence in the business and its earnings outlook, and there is evidence to suggest that companies with strict dividend policies are less likely to squander their profits on ill-advised acquisitions. "But I would agree it is largely a psychological love affair with dividend strategies in general."

RETURN OF CAPITAL

Some of the most popular mutual funds around are those that pay unitholders a fixed distribution each month. The BMO Monthly Income Fund, for example, pays out $0.06 per unit every month, which currently works out to about 10% per year. That juicy yield helps explain why the fund has attracted some $5 billion in assets.

The thing is, this distribution far exceeds what the fund can produce in bond interest and dividends. So in order to maintain its monthly payout, the fund has to sell some of its assets and pass along the proceeds to investors in the form of "return of capital." This is essentially giving you back your own money and calling it income.

There's nothing wrong with generating cash flow from a combination of interest, dividends and dipping into capital. (In fact, that's exactly the approach we recommend in "A better way to generate cash flow," p. 32.) "In the same way that there's no difference between receiving a dividend and selling a few shares to generate cash flow, there is no difference between having your mutual fund automatically pay a distribution and you selling a few units," says Hallett. "The problem is with investors' perceptions of what's really happening, and with how these funds are sold."

The fact sheet for the BMO Monthly Income Fund says the fund is appropriate if "you want regular monthly cash flow with the potential for capital gains." But as Hallett points out, "With that level of distribution, there's no way you can get capital growth." This is a fund of half stocks and half bonds, paying almost 10% and charging 1.57% in fees. It would only enjoy capital growth if the stocks appreciated by about 20% a year.

In fact, the price of the BMO fund has fallen from $9.30 in mid-2003 to about $7.30 as of mid-August, a decline of more than 20% over 10 years. Its total return over this period was much lower than its payout: 5.3% annually, which is about what you'd expect from a balanced portfolio ➤

the accounting shenanigans, dividends are something masked. They can signal management's confidence in the business and its earnings outlook."

of bonds and dividend stocks. It's a perfectly good balanced mutual fund, so long as investors understand that about half the "income" is just their own money being returned to them.

Return of capital isn't just a feature of monthly income mutual funds: even dividend ETFs use the technique to smooth out their payouts. From 2009 through 2011, for example, about one-sixth of the cash distributions from the iShares Canadian Dow Jones Canada Select Dividend Index Fund (XDV) were return of capital. To see whether this applies to your own ETFs, visit their web pages and click the "Distributions" tab for details.

COVERED CALLS

If you need proof that many Canadian investors are blinded by their search for yield, look no further than the extraordinary popularity of ETFs that use covered calls to generate income. There are now 19 of these trading on the TSX, and in about 18 months they've gathered about $2 billion. Given that these ETFs boast yields in the range of 9% to more than 18%, it's easy to see the appeal. But once again, investors may be setting themselves up for disappointment.

A call option is a contract that gives the holder the right to buy a stock at a certain price within a specified period. Imagine you own 1,000 shares of BigBank, currently trading at $50. You might sell (or *write*) call options on those shares with a *strike price* of $52 and an expiry date six months from today. The person buying the call will pay you a premium of, say, $1.20 per share. Over the next sixth months, if the stock never increases to $52, the call options will expire worthless: you get to keep your shares in BigBank, any dividends the company paid, and the $1,200 premium.

However, if the stock rises above the strike price, the holder of the call option will buy the shares from you for $52. You will still get to keep the $1,200 premium, but if you still want 1,000 shares of BigBank you'll have to buy them back at the higher price. That's the trade-off with this strategy: if markets move upward quickly—and they do that all the time—you could forfeit a big gain.

"What you're doing is trading some potential return for some certainty," says Alan Fustey, who regularly writes covered calls for his clients. (A call is said to be "covered" if you actually own the underlying stock. If you don't, it's a "naked call.") "Many of them are looking for consistent levels of income in retirement and if we're not able to generate enough through bond interest and dividends, we can write calls to get them closer to what they need." But he's careful to ensure his clients understand they're giving up some upside. "There's no free lunch. We know if the market goes up 10%, we might only get 6%."

In theory, call-writing strategies should lag in strong bull markets but outperform when markets go sideways, rise gradually, or decline. But as the past year has shown, covered call ETFs can lag during falling markets if there is a lot of volatility. The Horizons Enhanced Income Equity ETF (HEX), for example, currently sports a yield of over 10%, yet its total return over the 12 months ending in June was –11.8%, worse than the overall Canadian market. Over that same period, the BMO Covered Call Canadian Banks ETF (ZWB), boasting a yield of 7%, returned –3.3%. That's 0.5% less than if you had simply held those same bank stocks and not engaged in any call writing.

Fustey is concerned investors flocking to covered call ETFs may simply be chasing yield. "There has to be some degree of misunderstanding about how these work." They may not realize some of these ETFs write calls on 100% of the stocks in the portfolio, something he rarely does. (Others do so on only 25% to 50% of a portfolio, reducing income but giving investors upside if the stock rises in price.)

He worries some ETFs hold a relatively small number of companies in just a single sector. "Look at the ones focused exclusively on Canadian banks—you're buying a narrow segment of an already narrow market." Fustey prefers to write calls on broad-based index ETFs tracking the entire Canadian and U.S. markets, which provides more diversification and less volatility.

Hallett doesn't recommend call-writing strategies. "You're saying you will take the cash now and give up some upside but in the fullness of time, on a total-return basis, I don't see how that works in your favour. If history is any indication—admittedly, it might not be for your investment horizon—you're probably giving up more than you're getting." M

A Better Way to Generate Cash Flow

The idea that retirees should live off the income from their portfolios without dipping into principal goes back a long way. It made sense in the 1980s and 1990s, when 10-year government bonds yielded 9% or 10%, and inflation was less than half that rate. Today, only the wealthiest Canadians can hope to pull this off. "For most people it's an unrealistic expectation that you can live purely off income over a long period," says Dan Hallett of HighView Financial Group. "I just don't think that most people will have saved enough to do that."

A more realistic approach is to use a strategy that generates cash flow using a combination of bond interest, dividends and a dollop or two of principal. After all, that's exactly what you do when you buy an annuity: you turn a lump sum into a regular stream of income that will last throughout your lifetime, but isn't expected to last for eternity. Depending on the risk you're willing to take, the size of your nest egg, and how long you live, this approach should allow a withdrawal rate of about 4% to 6% for 30 years or more. If you keep to the lower end of that range, you should be able to increase your withdrawals each year to keep pace with inflation. (For more, see "Make your nest egg last" on page 20.)

But how do you manage the process? Portfolio manager Steve Lowrie sets aside a cash reserve covering three years' worth of expenses, and clients use this account for their regular cash flow. The rest of the portfolio is invested in a globally diversified blend of stocks and bonds. When it's gone up in value, he takes some profits and replenishes the cash reserve. The three-year buffer usually gives him enough time to ride out market volatility. "This was really helpful during 2008–09," he says, "because my clients could meet their cash flow needs and ignore the rest of the portfolio. Then when things rebounded, I rebalanced by selling stocks. It gives you a lot of flexibility."

Hallett likes that approach too, but warns investors it can be difficult to manage without an adviser. "This total-return approach is a bit more high-maintenance, but realistically it's the best way to address cash-flow needs. There's a little bit of timing involved, because you want to replenish that short-term account when your other assets are on a bit of a high. Just don't get hung up on the timing: it doesn't need to be perfect."