These Steady Income Generators Provide Protection

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By Scott Chan (see bio at end)
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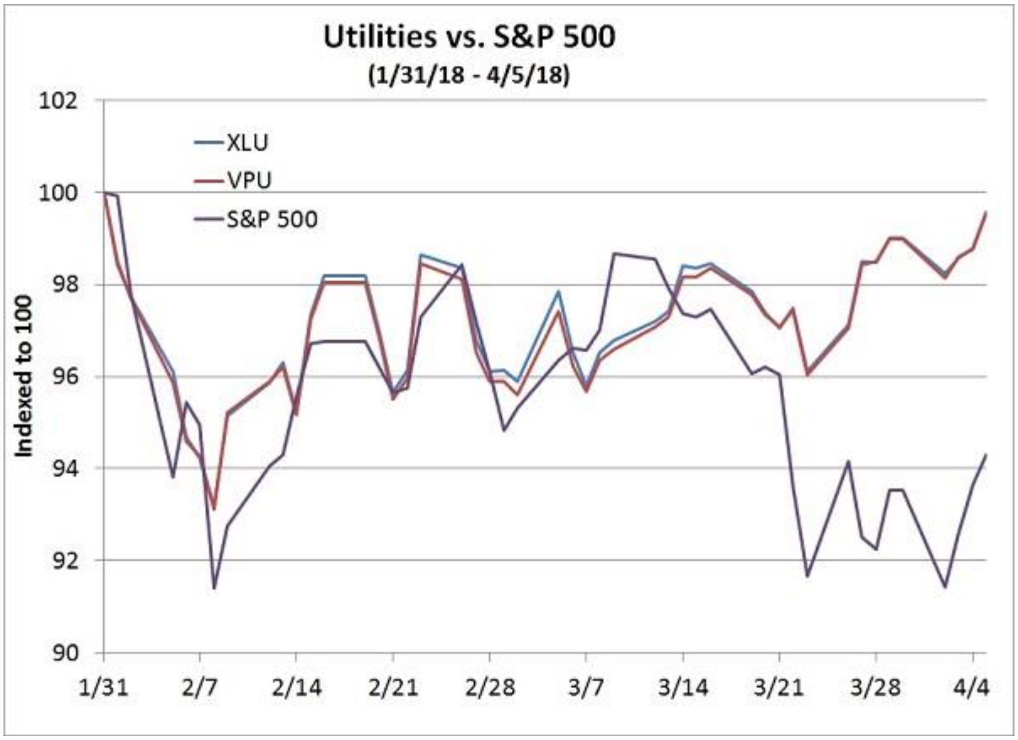
When market conditions become rocky, investors often switch to investments regarded as less risky. This is known as a "risk-off" trade. For example, the chart below shows how two U.S. utility ETFs have performed relative to the S&P 500 Index since the end of January, when market volatility significantly increased.



As you can see, the two ETFs have essentially mirrored one another and have easily outperformed the S&P 500.

Note that the chart simply shows the price movements of the two utility ETFs. If dividend received during the period was included, the total return for both XLU and VPU would have been slightly positive. To compare, the total return of the S&P 500 over this same nine-week period was negative 6%.

Good Investing is Boring?

George Soros once said: "If investing is entertaining, if you are having fun, you are probably not making any money. Good investing is boring."

Is he right? Well, it depends.

If you owned utility stocks throughout 2017, you would have under-performed the broader market. This is because the market was consistently rising and volatility was very low. Everyone was feeling good and investors preferred growth stocks. But, as the chart above illustrates, as market volatility has now increased, the traditionally "boring" utilities have regained favor.

Slow but Steady Growth

Utilities are considered boring because their revenue and earnings growth are slow. They are not the kind of stocks people look to when they want to make a lot of money in a short amount of time.

Utility companies provide essential services, such as water and electricity. Their line of business ensures steady consumer demand. But the government regulates the industry. It keeps a sharp eye over their business practices, including controlling how much they can charge customers. In return, the government allow these companies to operate as monopolies and earn a modest profit.

In recent years, some utility companies have also added unregulated businesses. These new endeavors add some growth potential, but unregulated business remains a relatively small portion of these companies' revenue and profit.

Overall, earnings per share for most utilities tend to fall in the 3%-to-5% range. Their dividend growth rates are usually in the same ballpark. When the stock market is flying, these slow growers will not attract a lot of buyers. But, when investors want to reduce risk, utilities provide a haven. Not only do they have dependable earnings growth rates, but they also provide a steady source of income when stock prices behave like a roller coaster.

Watch Treasury Yields

Investors who buy utility stocks (and other types of income stocks) should keep an eye on Treasury yields. Besides market volatility, the fall in Treasury yields in recent days has also helped utilities.

The yield on government bonds act as the benchmark for many interest rates in the real economy. When Treasury yields rise, so will borrowing costs. This is viewed as a negative for utilities because they tend to need to borrow to finance capital projects—for example, building a new power plant.

Secondly, U.S. government debt is considered to be "riskless.” Therefore, when Treasury yields rise, by comparison utility stocks' dividend yield look less appealing.

Investors want a higher yield to compensate them for taking a higher risk (relative to treasuries) by buying utility stocks. The way a stock's yield can rise, without actually increasing the dividend pay-out, is for the price to fall. Put another way, when Treasury yields are high, people demand to pay a lower price for the same amount of dividend.

If and when the market stabilizes, expect utility stocks to revert back to what they have always been: dependable income-generating investments for conservative investors. And that is perfectly fine. Especially for people in retirement, having a steady stream of dividend income to help cover living expenses is important.

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ABOUT THE ANALYST

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Bio | Archive

Scott Chan moved from China to the U.S.A. with his family at the age of ten. He passed the rigorous entrance exam and attended the merit-based Stuyvesant High School, widely held to be the best public school in New York City. He earned undergraduate degrees from New York University followed by an MBA degree from the Zicklin School of Business at Baruch College.