What Is The Right Price To Pay For Income?

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What Is The Right Price To Pay For Income?

By Jim Pearce (bio at end)
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The stock market is up more than 10% over the past 12 months, despite struggling to break even in 2018. Higher interest rates are to blame for this year's flattish start. Recently, the yield on the 10-year Treasury note rose above 3%. That is considered a red flag that inflation is on the rise, cheapening the value of future profits. Rising interest rates are also bad for bonds that pay a fixed amount of income. Since newly issued bonds must pay higher interest rates to attract investor capital, existing bonds are marked down in price to keep their yields competitive.

The same dynamic also is applied to high-yield "pass-through" securities such as real estate investment trusts (REITs), master limited partnerships (MLPs), and business development companies (BDCs). Since they compete with bonds for investors looking for steady income, higher bond yields tend to pull money away from these riskier asset classes.

Pass-Throughs Passed Over

So far, reality has followed theory. To gain a sense of magnitude, I tracked results for these three exchange-traded funds (ETFs) over the past 12 months:

- **VanEck Vectors Mortgage REIT ETF** (MORT)
- **VanEck Vectors BDC Income ETF** (BIZD)
- **Alerian MLP ETF** (AMLP)

On average, the share price for these three funds declined by 9.1%. The REIT fund performed the best, falling only 2%. Our BDC fund dropped 9%, while the MLP energy fund gave up 16% of its value despite rising oil prices (see chart below):

At the same time, the income paid out by these funds barely changed at all. The most recent combined quarterly dividend payment from these three funds was only 3% lower than its year-ago total (see next chart). Over the past year, the average quarterly payment was actually 4% higher than what it was a year ago.

Asset Values on the Rise

I believe high-income investments such as these are undervalued and likely to out-perform bonds over the next several years. That is because there is not anything a fixed-rate bond can do to improve its cash flow. Assuming no default, it will continue to pay the same amount of interest every year until it matures, but it will not pay more than that.

However, there are many measures an operating company can adopt to improve its cash flow to enable it to pay higher dividends in the future. As I mentioned earlier, the price of oil is 50% higher than it was a year ago. That should translate into more fee income for midstream MLPs that facilitate distribution and storage.

Thanks to low employment and higher wages, real estate prices are being bid up. That means most equity REITs should be able to raise rents at a pace to offset higher borrowing costs. The same principle holds true for BDCs, since a healthy economy means the companies to which they lend are growing profits faster than their borrowing costs.

Bond Prices in Decline

For the past 35 years, interest rates have been in decline. For that reason, bond investors had the best of both worlds. The bonds they owned appreciated enough in value to offset the decreased income they received from newly issued bonds with lower yields.

Those days are over.

As rates rise, income investors will see the value of their fixed-rate bonds fall steadily. It has been so long since that has happened, very few investors can remember what that feels like. For that reason, it is difficult to predict how most investors will react to this new world order.

My guess is they will hang in there for a while, hoping it will soon end. Slowly, they will start to realize that their bond portfolios may never recover during their lifetimes. When that happens, they will start looking for other high-yield income investments that stand a better chance of retaining their value.

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Jim Pearce is the Chief Investment Strategist of *Personal Finance*, our flagship publication. He is also the Director of Research at Investing Daily, overseeing the work of our entire analyst team. He began his career as a stockbroker in 1983 and over the years has managed client investment portfolios for major banks, brokerage firms and investment advisors. Jim has a BA in Business Management from The College of William & Mary, and a CFP from the College for Financial Planning.