Investing for Income in Low Interest Rate Environments:

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Executive Summary
Fixed income investors do not necessarily share the same objectives, however, those seeking to maximize income in this historically low interest rate environment are presented with unique challenges requiring a thoughtful and creative approach. These income investors should identify the types of risk they are comfortable assuming and the pitfalls they are determined to avoid. A basic approach would start with increasing one’s exposure to investment grade corporate bonds and reducing one’s allocation to government bonds, as corporates tend to provide higher yield. These investors may also wish to include in their portfolios floating rate and fixed to floating rate preferred stocks. Such an environment may also compel investors to insist on actually owning the bonds and other securities directly, as opposed to investing via commingled pools and/or mutual funds. This approach can help investors to ensure that they are not investing with others who do not share their goals and objectives.

Total Return vs. Income Investing
Not all fixed income investors utilize the bond markets exactly the same way, and so there are different approaches as to how best to structure portfolios. Some investors primarily attempt to profit from correctly anticipating changes in interest rate levels. This approach, like any speculation, is of course wrought with danger and not generally appealing to most fixed income participants.

Many other investors use bond portfolios as components of much larger asset allocation programs. In this manner, bonds serve as safe havens from other assets classes like equities, commodities and real estate holdings, especially when negative price volatility in those other investments become too onerous to bear. Fixed income portfolios as portions of multi-asset strategies are therefore valued for their ability to protect principal and provide a predictable cash flow. Moreover, multi-asset investors resort to using total rate of return calculations to measure their bond portfolio’s performance just as they do for all other asset class allocations.

There is another major group of investors, however, that do not view fixed income investing in exactly either of these two ways. An increasing number of bond buyers rely on their fixed income portfolios primarily for exactly that - income. When this is the case, the best approach to achieving the highest yields possible, even in the challenging low-rate environment of the past five years, stands unique and apart from the techniques employed by the other two primary users of bond portfolios - speculators and asset allocators. Not only do income investors need to structure their investments in the best possible manner so as to maximize annual cash flows, they need the most appropriate tools to measure their results and - even more importantly - identify and control the associated longer-term risks to their principal value.

Understanding Risk/Reward
No meaningful return can be earned of course without taking some level of risk. But there are limits to which most are confined to respect. By the same notion, many investors can increase yield by simply assuming layer upon layer of additional uncertainty. The challenge for income investors is then to determine to what extent and type of risk their portfolios can comfortably withstand.

For example, investors often receive additional yield for taking on the increased credit risk of moving from government to corporate issues, and then even further yield levels by moving from investment grade to non-investment grade issues, also referred to as junk bonds. Similarly, fixed income investments issued by emerging market entities pay higher yields than the issues of established U. S. corporations. But an expanding risk of default is not acceptable to all investors. In fact, many income investors are not allowed to purchase higher credit risk securities at all.
There are several other forms of risk that investors may take on to improve yields. Longer-dated bonds usually pay higher yields than shorter-dated bonds. Some investment products promising above market yield levels employ leverage, or borrowing against the portfolio’s value, to increase possible returns. And there are many forms of derivative instruments which assume a variety of interest rate, credit and principal pay down risks to tantalize investors with improved yield levels. In some cases, a portfolio of these investments is appropriate for providing enhanced income levels. But again, they may not accomplish the intended results for all investors; especially when the safety of principal, investment liquidity and cash flow predictability are equally important.

The challenge of the current low interest rate environment is therefore a balancing act: how are annual expenses and other liabilities best generated in a historically very low rate environment without exposing investors to the pitfalls of unacceptable combinations of investment risks? A growing list of uncertainties from Federal Reserve Bank policy changes to geopolitical disruptions is complicating income-oriented portfolios. How then can income seekers differentiate their portfolio mix from rate speculation and the total rate of return model?

The first step may be simply defining a portfolio’s goal in terms that actually make sense. Most fixed income products are priced in terms of yield-to-maturities. This calculation is an excellent tool to compare bonds that have different terms to maturity, different coupons and different credit ratings in order to determine if a bond is attractively priced to alternative fixed income alternatives. Yield-to-maturity does not reveal, however, how much money an investment will actually produce quarter over quarter, year over year, or necessarily what the exact annual total rate of return a holding will produce. Several unknown variables, such as yield curve and credit spread changes, will affect fixed income performance prior to maturity. Moreover, yield-to-maturity calculations assume compounding levels which may or may not be obtainable over time.

Income investors also need to evaluate portfolio holdings in terms of current yield calculations. This simple division of a portfolio’s weighted-average coupon by the weighted average price paid for the securities will identify exactly what annual cash flow a portfolio will provide, and then allow an investor to match these expected incomes to expected expenses and/or liabilities.

While current yield calculations also do not take all future portfolio performance variables into account, such as market price changes, reinvestment levels, and compounding variables, they do reveal a fixed income portfolio’s present cash flow expectations in a clear manner. And this analysis allows income portfolio building to begin more appropriately with the least levels of risk and incorporate identifiable steps to achieve cash flow targets as opposed to starting with unnecessary (and unidentified) risk levels and hoping for the best outcomes.

A common strategy for building the most efficient income portfolio is to avoid over-allocation in government securities and very long-dated maturities. Most total rate of return fixed income products are evaluated on a relative performance basis to a specific market benchmark. This approach allows investors in these products to compare their portfolio’s performance over arbitrary time periods to other similarly strategically positioned portfolios.
But therein lays a problem. In the first place, the most common fixed income benchmarks are dominated largely by U. S. Treasury and other government-backed bonds. Since the government sector is also the lowest yielding fixed income investment given a specific maturity range, income investors may not be so prone to concentrate their portfolios in these least productive investment choices. And so performance measurements to broad market indices may also not be all that revealing of the actual income levels that a portfolio is providing. In the second place, the wide potential price swings of longer-dated issues that may provide much of a broad market's price volatility may have little to do with the income investor's longer-term needs of steadier portfolio valuations and more predictable income flows.

Income investors may be better served by diversifying a fixed income portfolio more conservatively, while still meeting current income objectives. In today's low interest rate environment this may be achieved through a fully sector diversified collection of intermediate and shorter-term maturities of investment grade corporate bonds and perhaps the incorporation of higher quality floating rate and fixed to floating rate preferred stocks. This sort of portfolio has the advantage today of avoiding the market price volatility associated with dramatic swings to higher interest rate levels in the near future, while still achieving the necessary annual income generation.

A Final Note of Caution

Income investors with asset balances large enough to open separate accounts can avoid the potential risks of co-mingling their assets with large numbers of other investors who may not share their underlying investment objectives. If and when interest rates rise rapidly, total rate of return investors will seek other asset classes to avoid the declining prices of fixed income investments. This selling pressure may further force bond prices down. An income investor who has properly constructed a portfolio to match identified expenses may NOT want to sell parts of the existing mix of fixed income investments - satisfied with things as is.

Moreover, higher rates actually provide income investors with golden future opportunities to improve their annual income levels by re-investing proceeds from maturing bonds and sales of short-term issues for more attractively priced high yielding alternatives. But these opportunities may not be available to pooled income investors if the bonds have been sold to meet the redemption demands of other investors.

Going forward, the most powerful tool in an income investor's arsenal may in fact be the simple, outright ownership of the bonds producing predictable coupon flows.
About the Authors

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Howard Potter joined Roosevelt in 2011 as a Senior Fixed Income Portfolio Manager. Prior to Roosevelt, Mr. Potter was an Executive Vice President and Senior Fixed Income Portfolio Manager at Capstone Asset Management Company. Before joining Capstone, Mr. Potter founded New Castle Advisers, Inc. managing two sub-advised fixed income mutual funds. New Castle merged with Capstone in 1995. Mr. Potter earned his BA from the University of Wisconsin and an MA from Northwestern University.

About the Domestic Fixed Income Team

Howard Potter, a Senior Fixed Income Portfolio Manager with over 30 years of experience, joined Roosevelt Investments in October 2011 to lead Roosevelt’s domestic investment-grade fixed income team. Howard manages three fixed income styles at Roosevelt that he has managed for the past 10+ years, and his decision making process for the portfolios remains intact and independent. Roosevelt’s domestic investment-grade fixed income team was subsequently formed in March 2012 under Howard’s leadership, and also includes Robert Meyer, CFA and John Roscoe, CFA, who have a combined 24 years of fixed income portfolio management experience, as well as Dr. Gongwen Peng, Roosevelt’s Director of Quantitative Research. This combination of personnel demonstrates Roosevelt Investments’ commitment, depth and succession planning for our domestic investment-grade fixed income clients.

About Roosevelt Investments

In 1971 P. James Roosevelt of Oyster Bay, NY, a cousin of Theodore Roosevelt, founded the investment advisory firm P. James Roosevelt, Inc. The firm managed investment assets of individuals and endowments including several members of the Roosevelt family as well as the assets of the Theodore Roosevelt Association. The firm’s name was changed in 1993 to The Roosevelt Investment Group, Inc.

In 2002, The Roosevelt Investment Group, Inc. merged into Sheer Asset Management, Inc., an investment advisory firm founded by Arthur Sheer in 1990, retaining The Roosevelt Investment Group, Inc. as the name of the combined firm.

To this day, The Roosevelt Investment Group, Inc. manages investment assets of the Theodore Roosevelt Association in addition to several members of the Roosevelt family.*
GLOSSARY

**Coupon** - Interest rate on a bond that the issuer commits to pay to the holder until the security has reached maturity, expressed as an annual percentage of face value.

**Credit Ratings/Quality** - A measure of the chances that a bond issuer will default on its obligations. Credit quality is determined by credit rating agencies that provide bond ratings and may change these ratings at their discretion. These bond ratings form a scale - the lower the rating, the higher the probability of default, as perceived by the rating agency.

**Credit Risk** - The risk that a bond issuer will not meet its obligation and thus, a loss or default will result.

**Current Yield** - The annual interest of a bond divided by its current market price. Current Yield is the actual income rate of return, as opposed to the yield-to-maturity or the coupon rate (the coupon rate and current yield would be equal if the bond were bought at par value).

**Interest Rate** - The amount charged by a lender to a borrower. A bond's interest rate is usually expressed as an annual percentage of the principal.

**Investment-Grade** - A bond with a credit quality rating of AAA/Aaa to BBB-/Baa3. These types of bonds are perceived by credit rating agencies as having a lower probability of default than bonds that are designated as "high yield" or "junk".

**Maturity** - The date at which a bond's principal is due to the bondholder.

**Yield Curve** - A line graph of interest rates of bonds that have the same credit quality but different maturities, ranging from the shortest to the longest dates available. The graph illustrates whether short-term interest rates are higher or lower than long-term interest rates.

**Yield-to-Maturity** - The concept used to measure the rate of return on a security, such as a bond, if it is held to its maturity date.

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