



The 2020 Retirees' Dilemma: Low Yields, Low Income

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We live in a world of rock-bottom interest rates.

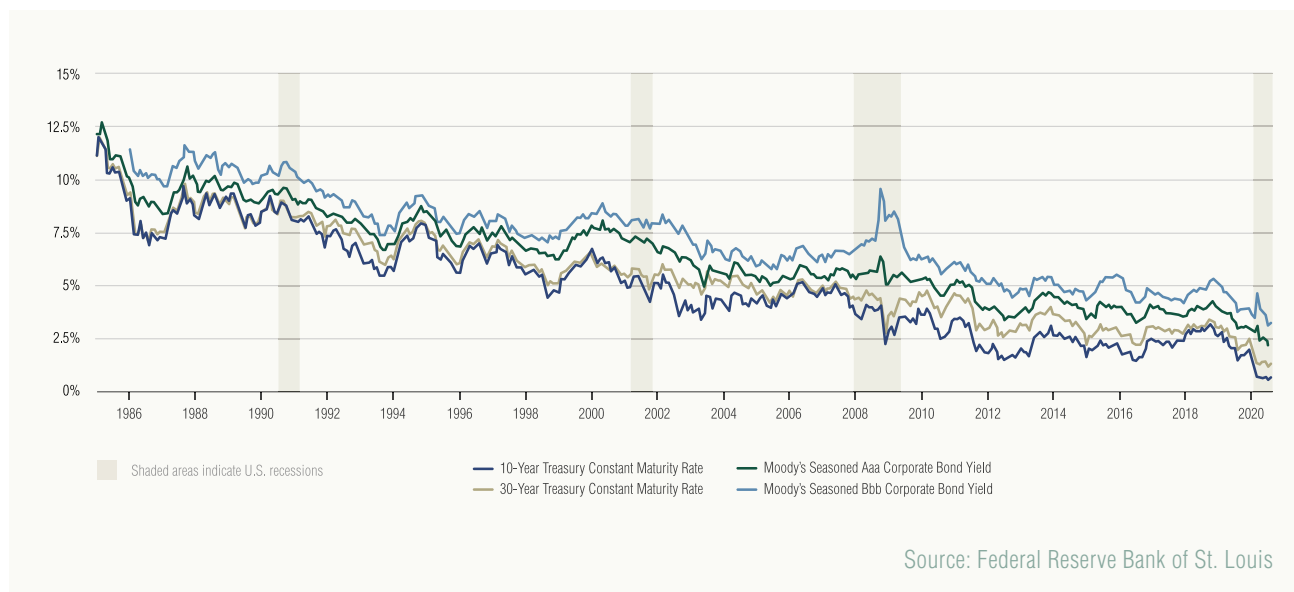
During and after the 2008 Global Financial Crisis, central banks around the world lowered interest rates to the zero bound, in an effort to get the economy moving again. In the decade that followed, the global economy grew, but not at a pace that allowed central banks to push interest rates materially higher. Going into 2020, interest rates were still relatively low compared to the needs of many retirees to generate meaningful, low-risk income.

Then Covid-19 happened.

The pandemic resulted in a near full-stop to economic activity, and developed countries around the world experienced some of the sharpest declines in output seen since the Great Depression. Interest rates fell back to zero.

The downward pressure on interest rates can be felt across U.S. Treasuries, investment-grade corporate bonds, and even municipal bonds—all traditional sources of income for retirement investors.

U.S. TREASURIES AND INVESTMENT-GRADE CORPORATE BONDS: FALLING YIELDS, FALLING INCOME



If the experience after the 2008 Great Recession serves as an indicator—which we believe it does—then it would be reasonable to assume that low interest rates may stick around for years to come. This environment creates income-generating challenges for people in or near retirement.

WHAT OPTIONS DO RETIREES HAVE FOR GENERATING INCOME?

A harsh reality in the current environment is that bonds alone are probably not sufficient for retirees in search of attractive, risk-controlled income. It falls on retirees to get creative, while at the same time avoiding too much risk in the process. It's all about balance.

To be fair, bonds can still very much contribute to an income-generating strategy. Fixed income portfolios as portions of multi-asset strategies are valuable for their ability to protect principal and provide a predictable cash flow—even if it means low levels of cash flow. There are many types of bonds, of course, and investors can increase yield by moving further out onto the risk curve. The challenge for income investors is to determine to what extent and what types of risks 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 high yield or 'junk' bonds. Similarly, fixed income investments issued by emerging market entities typically 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 professional fixed income investors are not allowed to purchase higher credit risk securities.

Preferred securities offer another income-generating alternative, and are often considered 'hybrid securities' because of their bond-like and stock-like properties. With preferred securities, investors are promised fixed income payments over time (in the form of fixed dividends). As with bonds, an investor in preferred securities can expect to receive regular payments over time with the full "par value" – another term for principal – returned when the securities mature or are redeemed by the issuer. In some cases the dividends are 'qualified', meaning they receive special tax treatment that can make their after-tax yield more attractive.

Dividend-paying common stocks can also be a useful resource for generating cash in an investment portfolio. In some cases, the yield on common stocks can reach 4-5%, which is quite competitive in a low interest rate environment. Many of the most consistent dividend payers are large-cap or even mega-cap stocks, and those stocks often operate in global markets. Owning these multinational companies can mean giving your portfolio some international exposure, without having to buy companies domiciled in other countries—a diversification perk. Of course, owning common stocks can expose an investor to the risk of a declining stock market.

Finally, annuities may be another option for retirees, as some types of annuities can guarantee income payments for life. Options are limited here, however, and most annuities require very close scrutiny. There are liquidity issues to consider, and many annuities come with highly complex contracts and structures that are difficult to understand. High fees are also the norm.

THE BOTTOM LINE

In today's low interest rate environment, income-seeking investors must evaluate a variety of income-generating securities, ultimately building a diversified portfolio that may include Treasuries, investment-grade corporate bonds of various maturities, high-quality floating rate and fixed-to-floating rate preferred securities, and perhaps dividend-paying stocks. The end portfolio's allocation will almost entirely depend on an investor's income needs and tolerance for risk and volatility. Working with a financial advisor may be the most beneficial solution to assist in solving the retirement dilemma.



Need Help Generating Income?

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