Six Bullet-Proof Income Plays for Flatline Markets

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Six Bullet-Proof Income Plays for Flatline Markets

During the high-flying stock market of the '90s, it seemed so easy to make money with your investments.

Pick a technology-laden mutual fund. Shovel money into it. Get rich.

Well, rich on paper perhaps. Because, as events have shown, nothing grows to the sky. The wealth that many people thought they had acquired never landed in their pockets. It disappeared without a trace, a victim of the precipitate decline in stock prices.

Someone once said, in talking about an underperforming baseball team: "Sure, that team is good on paper. That's why they're always folding when it counts."

Well, much of the wealth that accumulated in recent stock markets was on paper. And it folded faster than a paper napkin.

Don't get us wrong. Seeking big gains in the stock market is a key to building wealth.

But it's not the only key. And the older you get, the more essential it is that you focus on an aspect other than intangible capital gains—gains you won't benefit from until you sell the stock.

You need to focus at least some of your attention on income investing.

Discover a hidden world of profit-making wonders

Problem is, otherwise savvy investors often ignore income investing. You remember back in junior high school: the worst possible thing you could be called by your classmates wasn't a delinquent, or dumb, or even ugly.

It was to be called boring. Well, too many investors treat income investing like it's a high-school dweeb.

Not smart, for two reasons.

First, it shouldn't matter if your investments are boring. You're not looking for investments that will win popularity contests. If you're looking for excitement, go pick a fight in a bar full of bikers.

Making investment decisions is serious business. You shouldn't worry about whether your investments will make good fodder for cocktail party conversation. You're looking for assets that will help make your wealth grow… substantially and safely.

But this is all beside the point. Because the truth of the matter—and our second point—is that income investing is *not* boring. There are a wide variety of income investments to choose from. It can get complicated. The options you have will at times be mind-boggling. But they're well worth exploring, as you'll soon find out when you see our six income plays.

You see, income investing opens a broad world of possibilities and provides a wide range of choices that, used properly, can work together with your growth stocks to boost your returns—while reducing the chances that you will wake up one day to find half your wealth gobbled up by a rampaging bear market.

Three reasons why you must own income-producing assets

What's income investing?

It's investing primarily for cash flow, with possible capital gains a distant second in priority. When you invest in income assets, you're looking for interest, dividends, or some predictable payments at regular intervals.

There are several reasons a portion of your portfolio should be devoted to income-producing assets.

First, they diversify your portfolio.

Generally, income-producing assets react differently from stocks that you invest in for capital gains potential. So when the market's heading down, the value of your income assets may go up. Of course, that's not always the case. But over a long period of time, you'll find that any losses from your equities may well be offset by the total return on your income assets.

Second, income assets provide a predictable cash flow.

Particularly in times of troubled stock markets,

those payments you will be receiving—semiannually, quarterly or monthly—will boost both your wealth and your spirits.

Third, income assets are generally safer than stocks.

Suppose you're entering retirement age. You don't want to risk losing a substantial portion of your nest egg in the market. You want a predictable cash flow to rely on for your retirement years.

Or suppose you know you're going to be sending your kid off to college in a year. You don't want to risk that money being halved by an ill-fated stock right at the moment you need it.

In those circumstances, income assets can help you meet your financial goals while assuring your peace of mind.

Income investing no longer means passbook savings and EE Bonds

Trouble is, even when people realize they need a portion of their assets in something other than growth stocks, they don't pay enough attention to the income side of things.

If they think of income investing at all, it's for "asset allocation."

To be sure, asset allocation is quite a significant issue. Normally, the more conservative you are, the older you are, the less you need high-flying gains—the more you'll throw into income producing assets.

But there's a question that goes unanswered in much of the advice on asset allocation.

You see, the raging bulls will tell you to put 80% of your money into stocks. After Alan Greenspan opens his big mouth and roils the equity markets, you'll see various analysts lowering their equity recommendation to 60%. A bear might tell you to keep your stocks to 40% or less of your portfolio.

Whether stocks constitute 80%, 60%, or 40% of your assets, though, the question that gets overlooked is: what the heck are you supposed to do with the rest of your money? Do you put it into U.S. Treasuries… corporate bonds… municipal bonds… bond funds… zero coupon bonds?

The term often used for non-equity assets—another term for income assets—is "fixed income." And too many people assume that fixed income assets are all the same, and it's only the stock part of the portfolio that demands your time and attention.

Not so. Sure, fixed income is supposed to be less risky, its main function being to produce more predictable cash flow. But it's not an area to be pushed aside like that boring kid in seventh grade.

Deciding among fixed-income options can have as much an impact on your wealth as deciding which stocks to buy.

Five keys to determining if an income asset is right for you

As we'll soon see, income assets give you a broader menu of choices than a well-stocked diner. Some are plain vanilla and ultra safe, others are exotic and riskier.

But the basics are roughly the same.

When deciding if an income asset is appropriate for your portfolio, you should look at the following factors:

YIELD. This is what makes an income asset an income asset… the payments it'll send your way. Now, with a savings account or money market fund, yield is simple. It's basically the interest rate on the account.

With a bond, the yield is the so-called coupon rate divided by the price you paid for the bond. In other words, the yield is the annual income payments you receive divided by the principal you paid for the investment.

LIQUIDITY. Fearful that you may have to skip town one step ahead of the sheriff? You'll want ready cash. Okay, liquidity's important for reasons other than an expectation that you will soon be on the lam. It's simply a measure of how easily, cheaply and quickly you can get your principal back when you need it. A savings account and a money market fund are both ultra-liquid. A trip to the bank or a call to the brokerage firm and you have your dough. With a 30-year bond, however, if you wish to take your money and go home before the maturity date, you have to sell on the secondary market. You don't know how much you'll get; you may get more than the principal you put in, or less. But there's some risk to liquidating such investments before the maturity date.

That leads us to the third factor: **potential for capital appreciation or decline.**

Like stocks, the value of most income investments can rise or fall depending on various influences, such as interest rate trends, economic conditions, profitability, and creditworthiness of the issuer.

Next is **MATURITY**, or how long the investment is to be held. A money market fund is day-to-day. A ten-year bond matures at a "date certain." Overall, the interest rate you receive for a longer-term investment should be greater than for a shorter term. But that's not always the case. In any event, you have to balance two competing factors. If you put your money in a shorter-term investment, that means you will have that principal available sooner to reinvest. But if interest rates go down in the interim, you will miss out on the higher yields.

Similarly, if you buy and hold a ten-year bond, interest rates may drop within that ten-year period, but you will have locked in that rate. On the other hand, if rates go up, the value of your income investment declines. Sure, you can sell, but the price of the bond will go down because of the increased rates.

Finally, there's **CREDIT RISK**. That is, how safe is the investment?

The money you stash in a savings account is backed by the federal government, as is the Treasury bill you just purchased. But corporate bonds come in varying levels of safety. Junk bonds are even more questionable.

But the more solid the credit rating, the less the yield. The shakier the credit rating, the higher the yield, because that's how you are compensated for taking the greater risk.

From plain vanilla to chili pepper fudge, your income choices are endless

The point is, just as with your equities, you should select a cross section of income investments: some for safe, solid cash flow, others for a bit more flair and higher returns. Just remember, the sooner you need the money, the more you should be concerned with safety and liquidity.

With this advice in mind, let's review some of the variety out there. And we'll point to six specific income-producing opportunities that you can use to bolster your cash flow.

Here are some of the choices you have.

Your liquid stash

There's always a need for some ready money, accounts you can write checks against, or use to pay the repairman when your water heater blows up. Or get you through three months of unexpected unemployment, or for the moment when you find the courage to get back into stocks.

Ready or not, your money should be earning more money for you wherever it's sitting. So for your liquid accounts, shop around to find the highest yields. As for safety, look for respected institutions you trust. Sure, bank accounts are backed by the FDIC (up to US$100,000 per account) and money market funds at brokerage institutions aren't. Practically speaking, that doesn't matter much. No one has ever lost a penny in a money market fund.

Money market funds, in effect, are fancy savings accounts with higher yields. They invest in short-term debt instruments. The advantage is liquidity. The disadvantage is that interest rates can fluctuate.

If you really want to be on the safe side, you can split up your separate funds among various institutions. Along with avoiding the "all your eggs in one basket" problem, you also avoid binding yourself to one institution. And trying out several institutions gives you a feel for whether you want to invest more money in some of their other assets.

For aggressive income plays, you would like a yield of about 8%. You're not going to find money markets that do that for you. Yields will vary along with interest rates. One way to boost the returns you get from money markets is to find funds that pay you higher rates for amounts over a certain minimum.

For example, in March 2001, T. Rowe Price's simplest money market fund, the Prime Reserve Fund, paid about 5.24%, but Summit Cash Reserves, which imposes a minimum account of US$25,000, paid 5.41%. (To contact T. Rowe Price, call 800-225-5132, or visit their website at www.troweprice.com.)

CDs that make money, not music

Certificates of deposit differ from money market funds mainly in that they lock up your money for a specified term, whether it's three months, one year, or two years. If you need your money before the end of the term, you usually have to pay a penalty.

But you get the advantage of locking in a fixed rate of return in case interest rates fall during the life of the CD. In most cases, CDs are quite straightforward. While yields can be competitive with short-term instruments, you should compare what you can get with a CD to other options, such as U.S. Treasuries, which have the added benefit of being exempt from state income taxes.

While most CDs are rather bland, there are some that offer very interesting opportunities and higher yields, though with a bit more risk.

For example, take so-called "currency CDs."

With a currency CD, the issuing bank buys futures contracts on the currencies of one or more countries. This means they have a right to buy the currency at a given price and time.

But you don't have to worry about the mechanics. What is important is that you have a chance to boost your returns by taking advantage of rising currencies while hedging your bets in case the dollar falls. You also get to take advantage of high interest rates in other countries.

Plus, if the dollar weakens during the term of the CD, you get a little more return once you convert back to dollars.

Sure, if the dollar strengthens, your return is reduced and you're exposed to currency risk. But if all your other money is in dollars, placing a small percentage of your investment portfolio in other foreign currencies for purposes of diversification is generally a shrewd maneuver.

Let's face it, if the dollar tanks, most of us have no protection.

And CDs offered by banks, even currency CDs, are insured by the FDIC. This insurance does not protect you from currency fluctuations. But it does protect you from bank failures and the like.

Not many banks offer this type of CD. One that does an online bank called everbank (yes, small "e"). It's a division of Wilmington Savings Fund Society.

Income Play Number 1: If you're looking for a currency CD with some extra pizzazz, take a look at everbank's Currency Opportunity CD.

When we checked with them recently, this CD was offering an annual rate of 7.5% percent for a six-month term. Even the higher-rate domestic CDs won't give much more than 6%. (Whatever you do, when you buy a CD, confirm the rate at the time of purchase. These rates change daily. Of course, once you buy the CD, the rate is locked for the full term.)

When you buy the Currency Opportunity CD, you in effect buy CDs in four currencies: the euro, the Mexican peso, and the Australian dollar and the New Zealand dollar.

Don't worry. You don't have to hop planes to destinations across the globe. The bank does it for you.

The high yield comes from the relatively high interest rates in the countries involved, particularly Mexico, where interest rates hover around 14%. In 2000, the peso was one of the best-performing currencies against the dollar.

The minimum investment for a Currency Opportunity CD is US$20,000.

For more information about this CD, and other currency CDs, contact everbank at 800-926-4922, ext. 1, or by e-mail at worldmarkets@everbank.com.

Let the government pay YOU for a change

The supply of U.S. Treasuries is being depleted. Due to the huge estimated budget surpluses, the government has announced that it will no longer offer a 52-week bill, and it may get rid of the 30-year bond as well. The lower supply will help keep a lid on Treasury yields.

Of course, Treasuries are worth a place in your portfolio, particularly because they're exempt from state income tax. But to beat inflation with the fixed-income side of your portfolio, you need more.

That's why this might be the time to buy government securities from other countries, which may give you higher yields.

Income Play Number 2: First Australia Prime Income Fund (AMEX, FAX)

This is a closed-end fund that invests mainly in Australian debt securities. More than two thirds of its holdings are Australian government and government-related securities. The rest are in corporate bonds in other countries. This is a vehicle to ride the beaten down Australian dollar on the way up, and hedge

against the dollar plummeting south.

The 30% of its assets not being kept Down Under goes mostly to Asian counties.

As of this writing, it's trading at a discount. But with people getting more skittish about American stocks now that the Internet is boom over, interest in other currencies will grow.

As of January 31, 2001, the annual cash distribution rate based on a price of US$4.18 was 13.6%.

If you're looking for exposure to bonds in a wider variety of countries, try:

Income Play Number 3: Templeton Global Income Funds

Try this closed-end fund for a more diversified play on international bonds. Through March 2001, the fund enjoyed a 12-month total return of 16.22%, not too shabby considering the fact that domestic stock market sank like a rock in that period. And the fund was selling at a double-digit discount, leaving room for upside capital gain potential.

You can call Templeton at: 800-354-9191

Junk bonds

Now's a good time for junk.

We don't mean you should prowl the landfills for old tires. Or take up dumpster diving. Rather, we mean that with low-grade bonds having gone through some awfully tough times in recent years, they're due for an upsurge as stocks are continue to tumble.

In 2000, many high yield bonds (so-called "junk bonds") floundered, losing more than 9%. At the same time, yields on these things were soaring, particularly relative to Treasuries. At one point, some were yielding more than 8 percentage points more than Treasuries. That spread is shrinking, and the value of these bonds is rising.

Of course, the biggest downside to junk bonds is the high credit risk. Indeed, that's precisely why their yields are so much higher. But as investors began to see the economy slipping late last year, and figured the default rate would rise, junk bond prices slipped.

Thus, the bad news is already factored into the price of junk bonds. They're as depressed as they're going to get.

We don't recommend that you buy individual junk bonds, unless you have US$50,000 or more to invest solely in these types of investments. That's because, due to the credit risk, you need to diversify in a big way.

Instead, we suggest you buy a junk bond mutual fund. That way you get to enjoy high yields, diversify among many bonds, and stay liquid—that is, you get to cash out when you want to, and don't have to worry about selling the bond or waiting until maturity.

Which fund should you buy?

Bond funds vary. They vary by the industries they focus on, by the credit risk they're willing to handle, and by the maturity of the bonds.

We don't suggest going with funds where most of the bonds are rated B or lower. Look for ones that stick to B plus and higher.

Also, look for funds with relatively low expenses. That way, your yields won't get eaten up by costs.

Income Play Number 4: our pick is the Strong High-Yield Bond Fund.

The total expense ratio is a relatively low 0.80%. This fund has recorded a five-year return of 9.38% (annualized). At the beginning of 2001, when most stocks were tanking, it was recording a return of 10.57%.

For the past five years, while the average high-yield fund was returning 3.87%, Strong High-Yield was giving you 8.72%.

Strong Investments can be contacted at 800-359-3379, or through their website at www.estrong.com.

Get yield and gains with preferred stocks and convertibles

Scientists keep discovering new subatomic particles in our universe, giving them crazy-sounding names like "quarks." Well, imaginative brokerage firms keep inventing new types of income securities with a mixture of equity and income qualities, giving them weird-sounding acronyms like MIPs, QUIPs, and TOPrS. As a group, these instruments are sometimes referred to as fixed-rate capital securities.

These income-producing securities, cousins of preferred stock, are worth a look.

Preferred stock is a hybrid between common stock and debt. While it gives you no voting rights, you

get a steady stream of dividend income. And preferred stock dividends must be paid before dividends to common stock holders.

Companies issue preferred stock when they need more capital, do not want to dilute their equity shares, and don't want to burden their financial statements with too much debt.

Generally, preferred stock gives the investor a high yield and predictable cash flow.

But issuing companies have a tax problem with preferred stocks: the issuing company cannot deduct the dividends for tax purposes. That reduces the amount of dividends they can issue.

The hybrids mentioned above generally offer higher yields because, unlike preferred stocks, they are not eligible for the 70% intercorporate dividend tax deduction (because these quirky inventions are treated by the tax gods more like debt than equity). To compensate corporations for the absence of the special tax treatment, issuers offer a higher yield. Since individuals wouldn't be eligible for the 70% deduction anyway, they get higher yield with no extra downside.

These investments are generally sold on stock markets like the New York Stock Exchange.

Like bonds, these fixed-rate capital securities generally mature by a certain time, usually 20 years or longer.

Most of these securities are issued at a US$25 par value. This makes it much easier to buy these investments than your typical bond.

And like bonds, they are often rated for credit risk. For example, the highest credit rating issued by Moody's is Aaa.

There are some caveats. Dividend payments can be deferred if the issuer faces financial difficulties. But the investor will still incur a tax obligation. Also, the issuer can call the investment before the maturity date.

You may want to familiarize yourself with these arcane financial instruments by first investing in a mutual fund that specializes in these things. For example, the no-load Fidelity Convertible Securities Fund (800-544-6666), which returned 7.21% in 2000 and has had an annualized return of 18.65% over the past ten years, invests in convertible securities, preferred stocks, and other income securities.

If you're ready to dive into one of these stocks, try the following:

Income Play Number 5: CMS Energy PIES (NYSE, CMP)

The utility industry is a prime source for dividend stocks, and for these preferred hybrids as well.

CMS Energy is a Michigan-based electric and gas utility.

A convertible preferred hybrid, PIES stands for participating equity income securities.

The CMS Energy PIES yields about 10.5%. Each one is exchangeable for more than 0.783 shares of CMS common stock on July 1, 2002.

The price of the PIES is currently 5% below conversion value. In addition, earnings growth is solid, with profits projected from its global power production along with oil and gas production.

High-rise office buildings produce high yields

How can you benefit from the selloff in dot-com stocks? One way is by investing in retail real estate, which for a while there was getting clobbered by the Internet threat. If everyone and their pet poodle was buying off the Internet, who needed malls?

Turns out, reports of the mall's demise may have been a bit premature. When the economy picks up, retail real estate is primed to benefit.

Income Play Number 6: Vornado Realty Trust (NYSE, VNO)

A REIT based in Paramus, NJ, Vornado owns more than 11 million square feet of commercial real estate, most of it in the Northeast. It owns about 20 office buildings in Manhattan alone, and 60 shopping centers across seven states and Puerto Rico.

The company just negotiated a lease with the Port Authority of New York for the World Trade Center complex in New York, for US$3.25 billion, the largest deal of its kind.

For the fiscal year ended December 31, 2000, this REIT's revenues grew 19% to 826.5 million. The dividend yield as of this writing is a relatively low 6%, but look for it to rise to 10% before the year is out.

As of March, it was selling for around US$38, with a 52-week high of US$40.75 and a low of US$29.87.

For more information, you can contact Vornado at 201-587-1000.