HOUSTON TRUST COMPANY

VIEWPOINTS

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Investing for Income

Introduction

The distinction between investment "income" and "capital" (or "principal") is an ancient one in finance and trust law, perhaps most succinctly encapsulated in "The Goose that Laid the Golden Eggs" fable. For much of modern history, the concept of using income for current consumption and preserving capital for future growth has been fundamental. During the 21st century, however, and especially since the 2008 financial crisis, global central banks have broadly maintained interest rates at very low levels (close to 0% and even negative in some cases). In such an interest rate environment, interest income has been oftentimes inadequate to support individuals (or charitable organizations) relying on financial assets for current uses.

In response to this, a discussion around "investing for income" versus "investing for total return" has become increasingly widespread. We explore the advantages, constraints, and performance of each strategy in this issue of Viewpoints.

Aesop's Fables "The Goose that Laid the Golden Eggs," illustrated by Milo Winter in a 1919 edition.

The Interest Rate Backdrop

Treasury yields have been on a persistent downtrend since the 1980s when yields on the 10-year treasury reached a record high of 15.8%. The chart below outlines the last 60 years of 10-year treasury yields.

In the 1970s through the early 1980s, the nation faced weak economic growth, high unemployment, and volatile markets. During the "Great Society" era of Lyndon B. Johnson's presidency in the 1960s, inflation was persistently high from easy money policies designed to stimulate job growth along with increased government spending in the Vietnam war, and high oil prices caused by oil embargos.

LBJ's Great Society programs. President Lyndon Johnson signing of Public Broadcasting Act of 1967. HEW Sec. John Gardner is standing behind him at right. Nov. 7, 1967. Contributor: Everett Collection Inc / Alamy Stock Photo

Unemployment would reach 7.4% by the time Jimmy Carter was elected in 1977 and the administration responded by encouraging the Federal Reserve to expand the money supply. While the goal was to stimulate job creation, the actions created additional inflationary pressure. Consumers accelerated their purchasing of goods for fear of higher costs in the future. Lower purchasing power led to demands for higher wages, which resulted in increased production costs and higher prices for goods. Throughout the 1970s, a less-transparent Fed faced credibility concerns as central bankers were unwilling to raise rates in fear that it would damage the economy. The Fed pivoted from raising rates to reduce inflation to lowering rates to stimulate job growth. This strategy proved to be ineffective as unemployment and inflation eventually increased simultaneously. It had become clear—a more targeted and consistent effort to combat inflation was needed. By 1979, inflation was spiraling out of control as the Consumer Price Index (CPI) climbed to 13.3%.

Washington, DC 1979/10/01 Paul Volcker, Chairman of the Board of Governors of the Federal Reserve System speaking in the East Room of the White House. Photo by Dennis Brack

Following this sharp rise in inflation, Fed Chairman Volcker was appointed by President Jimmy Carter. Volcker's aggressive monetary policy of targeting the volume of bank reserves in the system and allowing the Fed Funds rate to reach 20% initially led to a deeper economic downturn as unemployment reached double digits. American citizens largely blamed this economic turmoil on Volcker and politicians threatened impeachment. Homebuilders even shipped unused lumber to the Chairman, exclaiming that they had no use for the product if homes were not selling. Car dealerships filled with unsold cars, and farmers blocked the main building of the Federal Reserve with their tractors in protest. 10-year U.S. Treasury yields subsequently reached a high of 15.8% as investors believed central bankers would reverse the tight conditions due to rising unemployment. While the previous Fed might have adjusted their policy and cut rates to stimulate employment and growth, Volcker persisted. Fed Funds rates remained high, signaling that the Fed was finally committed to lowering inflation. While Volcker's policies were considered controversial at the time, his strategy eventually led to a significant drop in inflation as CPI decreased to 2.6% in 1983, remaining under 5% until 1989. With high inflation defeated, an economic expansion occurred, driven by stronger consumer confidence and more stable economic outlooks allowing businesses to plan for future projects without concern of rapid input cost increases.

Since that time, investors have enjoyed the greatest fixed income bull market in history as interest rates have steadily declined over the last 40 years, with the 10-year treasury reaching as low as 50bps in August of 2020. Those that have historically relied on income generated from their fixed income portfolio have been penalized during the low yield environment and tasked with finding a replacement for the reduction in income.

Total Return versus Equity Income Investing

In response to the chronic low interest rates of recent decades, two primary strategies have emerged: total return investing and equity income (dividend-based) investing. There are two primary components of expected future returns from an equity investment: 1) capital gains realized from the underlying appreciation of stock shares that comes from a company with growing revenues and increasing profitability; and 2) income return in the form of dividends issued by a company to its shareholders. The "equity income" approach focuses on income return from dividends paid by companies to their equity owners. "Total return" investing incorporates investment in a combination of companies that provide both capital gains appreciation and income in the form of dividends and interest. In this approach, capital gains are harvested for cash flow to supplement the dividend income earned by the portfolio.

When a company is positioned for above-average and profitable growth in its respective industry, that company will often pay little-to-no dividend in order to invest profits back into the business for the promise of higher returns on capital in the future. Therefore, lower dividend yields have been offered in sectors like technology since the beginning of the century. These companies prefer to use profits to grow their high-margin, cash flow generating businesses in order to maximize total shareholder return.

RETURNING CAPITAL

LONG TERM VERSUS SHORT TERM

Alternatively, a public company positioned in a more mature, lower-growth industry might place more focus on returning capital to shareholders today versus in the future in order to attract an adequate level of investor interest. A company in the tobacco industry, for example, will not have the type of high growth prospects of an innovative software company. Since more mature companies do not have the promise of higher-returning capital investments down the road, management is incentivized to return cash to shareholders currently in the form of a quarterly dividend. The view is that excess cash from company operations is better suited in the hands of shareholders for investment in alternative endeavors instead of being allocated to limited and lower-returning projects by company management.

Investing for total return is the process of seeking return in the form of both income generation and capital appreciation of an underlying investment, rather than focusing on one return outcome or the other.

Concerning distributions from a trust, many older trusts restrict distributions to current beneficiaries to trust income (defined as interest or dividends). In these instances, the remainder beneficiaries ultimately receive the principal of the trust upon the termination of the trust. This is a scenario where two sets of beneficiaries have mutually exclusive return objectives with the remainder beneficiary hoping to maximize capital appreciation. In this instance, the income beneficiaries might look to maximize income at the expense of capital appreciation during their lifetime.

A solution to this issue of caring for both sets of beneficiaries was created in the 1970s in the form of the "Unitrust" or "Total Return Trust." A Unitrust provides that instead of the income beneficiaries receiving just the income from the trust, they receive a set percentage of the net asset value of the trust annually. A commonly used percentage is 4%. Establishment of this type of trust allows the trustee to better follow the Prudent Investor Rule, investing for income and/or capital appreciation in a diversified manner. This approach also aligns the interests of both the current and remainder beneficiaries behind a total return approach.

UNITRUST

A WAY FOR EVERYBODY TO HAVE THEIR CAKE AND EAT IT TOO.

The Uniform Prudent Investor Act

The most comprehensive response to these issues was ultimately the adoption of the "two UPIAs": The Uniform Prudent Investor Act and the Uniform Principal and Income Act (adopted and incorporated into the Texas Trust Code in 2003). These legislative acts explicitly permit fiduciaries (even those operating under older trust instruments) to manage portfolios on a total return basis while providing trustees with the flexibility to re-classify principal and income in certain circumstances.

Equity Income Investing

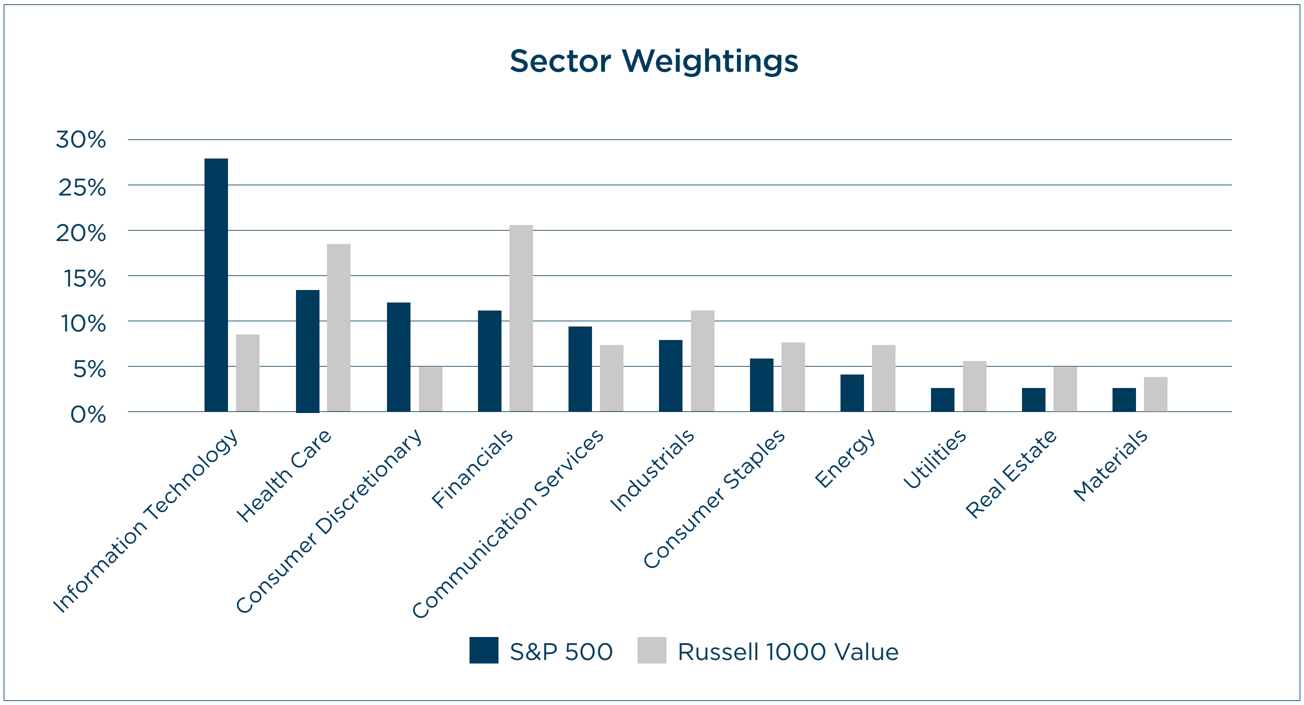
Advantages

There are numerous advantages to investing in income-producing equities. The types of companies with higher dividend payouts are typically categorized as conforming to the "value" style of equity investing. They are often well-established companies with strong balance sheets and consistent earnings and cash flow. These companies are often less volatile than the overall market, providing a measure of downside protection by way of the income stream during periods of market correction through either economic recession, or fear in some other form.

In the persistently low interest rate environment of the last decade, income-producing equities have also been a provider of higher yields relative to high-quality fixed income issues and money market funds, while also providing a higher level of underlying appreciation relative to investment-grade fixed income and cash asset classes. At the same time, there is risk to an equity income style of investing if interest rates substantially rise and investors find it prudent to rotate out of higher yielding equities into better yielding safe-haven asset classes such as high-grade bonds.

Constraints

One of the primary risks associated with equity income investing is the direct exposure to interest rates. At a time of upward-moving interest rates, income-generating equities could become less attractive to income-seeking investors as other means of income generation become available in the form of securities (investment grade bonds or government treasuries). In this scenario of rising supply of income alternatives to stocks, overall demand for income-producing equities may decline, with returns declining in tandem.



Additionally, income-generating equities tend to center around more mature sectors such as regulated utilities, tobacco producers, and energy, with less exposure to above-average growth industries like technology. Reducing the number of sectors available to invest in will increase portfolio concentration and overall portfolio risk. The above graph displays this sector disparity between the S&P 500 and the Russell 1000 Value, a benchmark for an equity income strategy.

In times of prolonged low interest rates as we have seen the past decade, some investors tend to "chase" yield—investing in lower quality securities or companies to maintain a desired level of income. Chasing higher yields will significantly increase the overall risk of a portfolio, as higher income yields are a necessary offering to attract investors to a lower quality stock. Single company dividend yields typically range from 1% to 5%. Anything above an 8% yield should be reviewed carefully for company-specific risks, as the market could be signaling that such a yield is unsustainable in the long term.

Performance

As discussed above, higher dividend paying equities are typically categorized within a "value" equity investing framework. In terms of total historic returns, this value style of investing has significantly lagged growth-oriented equity performance over the last decade. Growth stocks are those companies that are considered to have the potential to outperform the market over time because of their future revenue and earnings growth potential. Value stocks are classified as companies that are currently trading below what they are perceived to be worth, depending on the financial ratio or benchmark the stock is being compared to, and will thus provide a superior return.

VIEWPOINTS

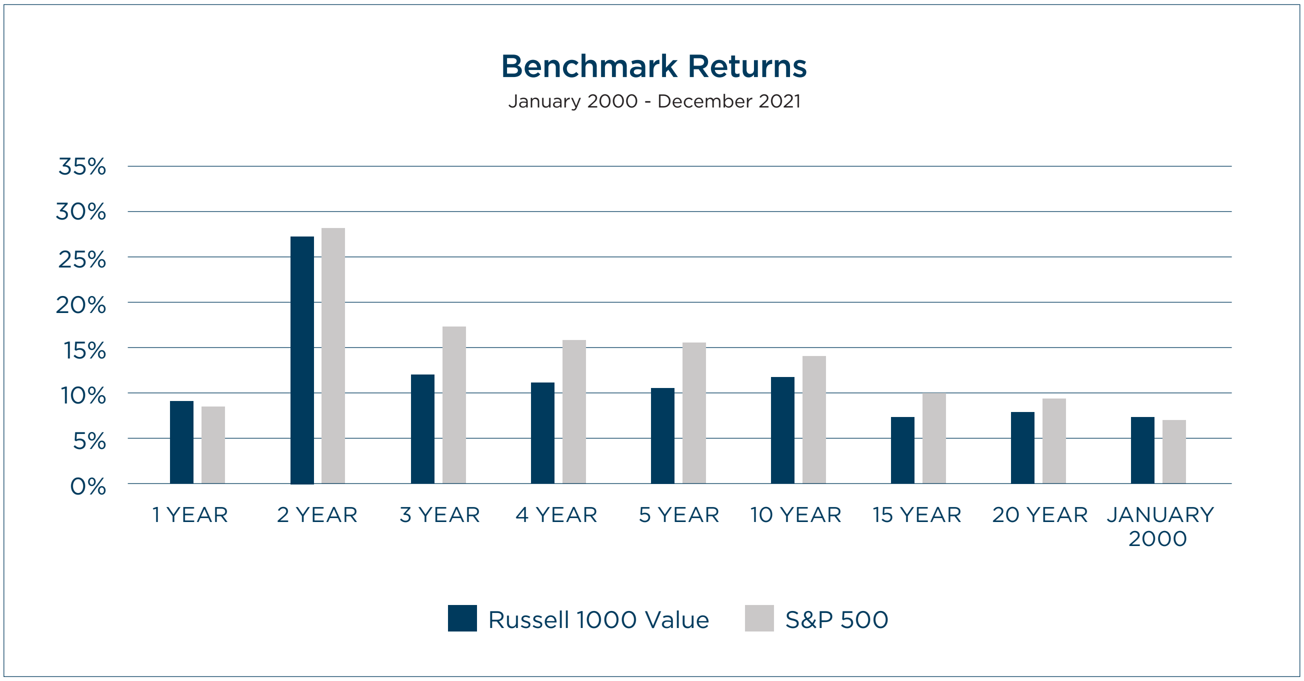
TOP TEN HOLDINGS ACROSS INDICES

Russell 1000 Value		
1	Berkshire Hathaway Inc. Class B	3.1
2	Johnson & Johnson	2.3
3	UnitedHealth Group Inc	2.3
4	JPMorgan Chase & Co	1.9
5	Proctor & Gamble Co	1.9
6	Exxon Mobil Corp	1.7
7	Chevron Corp	1.5
8	Pfizer Inc	1.5
9	Bank of America Corp	1.4
10	Verizon Communications Inc	1.1
Top 10 as % of Total Net Assets		**18.7%**

S&P 500		
1	Apple Inc	7.0
2	Microsoft Corp	5.7
3	Amazon.com Inc	3.5
4	Tesla Inc	2.2
5	Alphabet Inc	4.0
6	Berkshire Hathaway Inc	1.7
7	NVIDIA Corp	1.4
8	UnitedHealth Group Inc	1.4
9	Meta Platforms	1.3
10	Johnson & Johnson	1.3
Top 10 as % of Total Net Assets		**29.5%**

Growth stocks tend to outperform a value style when interest rates are falling and company earnings are rising, which mirrors the economic environment we have witnessed for much of the last decade. The lower cost of capital over this period has spurred innovation and consumer spending, both of which benefit above-average growth companies. When combined with an elevated appetite for risk across the general investor base, growth equities have witnessed positive investor sentiment since the great financial crisis of 2008. The rise of the FAANG stocks (Facebook, Apple, Amazon, Netflix, and Google) illustrates the significant appreciation of this style of investment during this period.

With an accommodative U.S. economic and monetary environment during the last decade, we have seen equity income (as measured by the Russell 1000 Value Index) as an investment style underperform a growth-oriented portfolio of U.S. stocks across all critical measurement periods going back 20 years. The value-oriented approach has also underperformed the broader S&P 500 U.S. equity benchmark during this period.



During a market correction, or in times of heightened market volatility, investors will many times rotate into equities tied to more defensive, mature sectors with consistent cash flow streams and dividend payments as a means of equity risk reduction. An equity income strategy would likely outperform growth in this type of market environment.

Total Return Investing

Advantages

One key advantage of investing for total return versus income-oriented return is the benefit of diversification. If investors do not require concentration in income-producing assets, they can focus on a combination of income and capital appreciation, which could incorporate a broad array of investments, whether that be in bonds, dividend paying stocks, growth stocks, or alternative investments. Diversification away from a limited number of sectors or a particular style of investment can lead to higher expected returns while also reducing overall portfolio risk.

Investing for total return instead of just income will also reduce taxes over time. The tax rate on interest or dividend income is tied to ordinary income rates which can potentially rise to 37% based on the amount of income generated. Alternatively, return in the form of underlying capital appreciation is taxed much lower today (23.8%) if the asset is held over a year. Focusing a portion of your portfolio on capital appreciation will lower the overall amount of taxes paid, increasing after-tax returns. This is the primary measurement of a portfolio's growth for taxable investors.

Constraints

The overall yield on a total return portfolio is generally lower than that of an equity income portfolio. The tradeoff for lower risk is slightly lower yields. This is a constraint of the total return portfolio that is important to take into consideration, and should be coupled with a prudent spending rule to preserve the income generating capability of the account.

In addition, to adequately create a total return portfolio, a holistic approach must be taken with regard to not only income needs, but also risk tolerance and investment goals. This can be a difficult process because although the client may be fully aware of his/her income needs, risk tolerance and investment goals can oftentimes be much more difficult to convey.

	CONSTRAINTS	ADVANTAGES
Total Return	Lower yield	Lower risk through diversification
	Requires more client input at onset	More tax efficient - capital gain versus income
	Higher volatility	Broader sector exposure in an equity portfolio
Income-Oriented	Direct exposure to interest rates	Tilts toward a value style of equity management
	More concentrated portfolio	More consistent yield
	Higher allocation to lower quality securities	Higher expected return versus purely fixed income
	Less tax efficient - income versus capital gain	Lower volatility

Performance

As displayed in the chart above, an advantage of investing for total return is the benefit of diversification. With diversification and a focus away from only income-producing assets, an equity portfolio with broad sector diversification will not only reduce risk, but lead to higher expected returns since including growth stocks provides the potential to outperform the market over time due to their future revenue and earnings growth potential.

Other Income-Oriented Securities

Other types of securities often relied upon for additional income are master limited partnerships (MLPs), high yield bonds, and real estate investment trusts (REITs). Each of these comes with its own set of advantages and constraints. MLPs, created in 1981, are companies organized as publicly traded partnerships and have been most successfully utilized in two sectors: natural resources (especially pipelines) and real estate. The slow, steady income generated by the underlying companies and assets provides an investment with dependable cash flows and consistent distributions to investors. Given the tax nature of distributions, the yields are often significantly higher than the dividend yield of equities. Although MLPs are tax efficient for investors, the limited partnership tax treatment can create complex filing requirements and delays.

Another income-oriented asset class is high yield bonds (also known as junk bonds). These are corporate debt securities that pay a higher yield because of a lower credit rating and higher risk of default. The disadvantage of this type of investment is greater volatility, like the stock market, and the possibility of default followed by loss of income and principal.

Another income-oriented investment option is real estate investment trusts. REITs are companies that own, operate, or finance income-generating properties. This type of investment provides a steady stream of income, and unlike traditional real estate, is highly liquid and trades similar to an equity. REITs help to diversify a portfolio and often provide returns that outpace that of the S&P 500. A primary constraint of REITs is the tax inefficiency of the asset, as the underlying companies must pay 90% of income back to investors. Consequentially, this makes REITs fully taxable at ordinary income rates versus lower capital gains rates. This high required pay-out also limits long-term growth via re-investment.

Although the income provided by each security discussed above is appealing, the risks of potential default, limited appreciation, and negative tax impacts should be carefully considered before deciding to make an investment.

Conclusion

The current low-yield environment has left investors struggling to replicate the income that they traditionally received from their bond portfolios. Equity income and/or total return strategies have evolved to address this issue; and each has advantages and drawbacks. High-quality bonds do remain an important tool for dampening volatility in portfolios.

Regardless of any current environment for interest rates and asset yields, at Houston Trust Company, our investment approach is always based first and foremost on a clear understanding of client investment objectives—particularly one's investment time horizon and liquidity needs—and our ability to provide customization and flexibility to client portfolios as life and market dynamics intersect.

ABOUT THE AUTHORS

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Adriane Schultea joined Houston Trust Company in 2021. As Senior Vice President of Investments, she is responsible for investment operations, ensuring proper execution of investment strategies in client accounts, and compliance with fiduciary and regulatory issues. In addition, she serves on the Investment Advisory Committee and is a member of the marketing and business development team. Adriane previously served as Vice President, Client Service with Stifel, Nicolaus & Company managing the wealth of high-net worth families and foundations. Prior to that, she served as Vice President at Barclays and Vice President at Goldman Sachs & Co. Adriane began her career in commodities trading at Enron in 2000.

Adriane holds a Bachelor of Arts in English with a minor in Business from The University of Texas.

Taylor Scott
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Taylor Scott joined Houston Trust Company in 2020. As Senior Vice President of Investments, he is responsible for performing equity manager due diligence, constructing the asset allocation for client accounts, and delivering regular reviews to clients to assess changing needs and market conditions. Taylor previously was a Senior Investment Advisor with Sentinel Trust Company, where he advised on $3.5 billion in assets for high-net-worth families. Prior to that, he was an analyst with Goldman Sachs & Co's Special Situations Group, evaluating opportunities in distressed and performing debt.

Taylor holds a Bachelor of Business Administration in Finance from Texas A&M University. He is also a Chartered Financial Analyst (CFA) charterholder.

Kevin Woodworth
Vice President, Investments

Kevin Woodworth joined Houston Trust Company in 2021. As Vice President of Investments, Kevin is responsible for constructing and maintaining client fixed income portfolios, analyzing, and trading fixed income products, and delivering market updates to clients. Kevin was previously a Fixed Income Portfolio Manager at Arvest Wealth Management, where he managed individual trust and fixed income portfolios, and acted as the head fixed income trader for the firm. Prior to Arvest, Kevin was a Senior Vice President at a regional broker-dealer in Houston where he participated in the management and trading of fixed income portfolios for banks, insurance companies, municipalities, and high net worth individuals.

Kevin holds a Bachelor of Business Administration in Management and a Bachelor of Business Administration in Marketing from The University of Arkansas.