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COROMANDEL WEALTH MANAGEMENT

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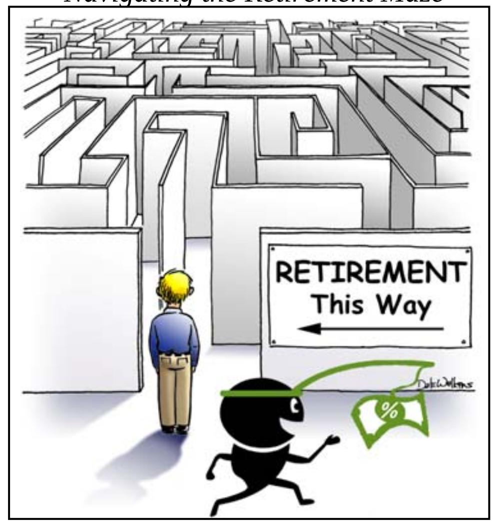
Chasing Yield? Do So Cautiously

Navigating the Retirement Maze



The next time you visit your local bank, make sure they thank you for the subsidy that you are indirectly providing to them. The Federal Reserve's "zero interest rate" policy that is intended to stimulate the housing market and provide low-cost capital to banks, has the unfortunate effect of penalizing retirees who are mostly invested in fixed income securities.

Holding bonds and CDs that previously paid 4% to 5%, and now yield under 1%, require that you now either deplete your retirement savings at a faster rate, or substantially reduce your standard of living. There are a number of other income-generating investments, but you need to choose them carefully so that they match your tolerance for risk. Plus, the types of risk vary, so make sure you understand them before adding these investments to your portfolio.

Hidden Dangers in Higher Bond Yields

The average investor tends to classify stocks as "risky" and bonds as "safe." However, raising bond yield by increasing the number of years to maturity can prove disastrous when rates increase, particularly on long maturity bonds. For example, a 30-year Treasury bond yielding 3.1% today would lose over one-third (36%) of its value if long-term rates rose to 5%. Long-term rates are at historic lows, and it isn't realistic to expect them to remain this low for more than another year or two. Even Warren Buffett recently warned about the dangers of owning Treasury bonds.

Rising inflation can also punish bond holders. If the nascent recovery takes hold and inflation rises, bonds would have negative real returns (i.e., [bond %] – [inflation %]), and thus decreased buying power while still being at considerable risk from rising rates.

Better Ways to Boost Yield

Mutual funds and exchange traded funds (ETFs) offer the average investor convenient ways to diversify their income. Here are some that I find appealing, though with varying degrees and types of risk, so all of them aren't appropriate for every investor:

- High yield bond funds – Also called "junk bond" funds, they offer higher yields because of the weaker financial condition of the entities issuing the bonds they hold. Except for recessions, bond default rates are typically low (1-2% a year), and a fund mitigates the default risk of any one bond. The current rate premium over Treasuries of similar maturity (e.g., 6-7% vs. 1% for 5-year) makes them an attractive option.
- Dividend growth stocks – There are ETFs that hold so-called "dividend achievers," companies that have increased their dividends like clockwork year after year. These funds currently yield between 2% and 4%. The dividends should grow each year, along with the possibility of equity appreciation.

- Master limited partnerships (MLPs) – Most MLPs are energy-based, and the ones that generate income from pipelines are the least volatile, as their income is not tied to energy prices. MLPs currently yield between 5% and 8%. They are not appropriate for IRAs because of their tax treatment.
- Utilities – Who ever thought that boring utilities would look attractive? The ETFs are paying around 4%, and are less volatile than the overall market.
- Agency bonds – Mortgage bonds backed by the U.S. Government. ETFs are yielding 2 to 3% for shorter maturities (less than 5 years).

Not Worth the Risk

Yield boosters that I would advise the typical investor avoid:

- Non-traded REITS – Illiquid, and carry high up-front commissions.
- Life settlements – Promises of high returns, but with substantial risks, and not liquid.
- Variable annuities – Complex products that tie up your capital and typically have high fees.
- Structured products – Require a PhD to understand them, and have many associated risks plus high fees.

Mix 'Em Up

Diversification reduces the risk that any one investment will tank your portfolio. Choose a range of income generating vehicles, make sure that you know what the risks are, and keep cash that you will need over the next year or two in ultra-safe accounts: money markets, short-term CDs, short-term Treasuries. Don't stretch for yield when doing so will stretch your peace of mind.

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