Any investors focus on the yield or income generated from their investments as the foundation for what they have available to spend. The higher the portfolio’s yield, the more the investor potentially can spend. The challenge over the past few years is that yields for most investments have been at or near historical lows, and both yields and returns for traditional income investments are forecasted to remain low for the foreseeable future. As a result, income-oriented investors have three options: (1) spend less, (2) reallocate their portfolios to higher-yielding investments, or (3) spend from total returns instead of income alone. Given that spending less is generally not a desirable option for most investors, we focus instead on the second and third options and conclude that moving from an income or yield focus to a total-return approach may be the better solution.

Over the past 30-plus years, investors were able to spend from a portfolio’s income while maintaining a conservative asset allocation. Investors with a spending target of 4 percent of portfolio assets (a reasonable starting point for broadly diversified portfolios) enjoyed a yield that met or exceeded 4 percent simply by allocating part of their portfolios to broadly diversified fixed-income investments. In this environment, investors or their financial advisors worried little about maintaining sufficient levels of income. In many cases, they had income leftover and remained net accumulators. However, since the early 2000s, many balanced portfolios have consistently provided yields below 4 percent, and since 2010, even 100-percent bond portfolios have failed to meet that target. As a result, we have seen a significant shift in cash flows toward corporate bonds and other riskier segments of the fixed-income market (see figure 1).

**Risks of Chasing Yield**

This article focuses on three ways investors have been trying to increase the income return or yield of their portfolios:

- Extending the bond portfolio’s duration
- Increasing the bond portfolio’s credit risk
- Increasing the portfolio’s exposure to dividend-paying equities

**Extending the Bond Portfolio’s Duration**

The first move investors often make when they seek to increase portfolio yield is to raise the allocation to bonds of longer maturity. This approach increases risk because the longer the duration, the greater the loss in prices when interest rates rise (and the greater the price gain when interest rates fall). You can see this in the hypothetical example in figure 2 in which long-term U.S. bonds could potentially experience much more significant losses than the broad U.S. bond market in an acute rising-rate scenario. Moreover, risks of duration-extension strategies are magnified today: Current yields are so low that they provide little cushion from even a marginal increase in interest rates and the resulting decline in prices. Even given the opportunity cost of accepting minimal yields in cash securities, investors for whom principal security is important may not find duration extension a solution.

**Increasing the Bond Portfolio’s Credit Risk**

Perhaps as a result of negative press surrounding the perceived risks of government securities in the current environment, many investors
have turned to higher-yielding bonds that are exposed to marginal or even significant credit risk. These include longer-durate
ion investment-grade corporate bonds, high-yield (i.e., junk) corporate bonds, and emerging-market bonds. Yet, credit
risk tends to be correlated with equity risk, as demonstrated during the global financial crisis (see figure 3)—a risk that tends
to increase when investors lose the proven diversification benefits of Treasury bonds.³

Further, our research has shown that replacing fixed income holdings with high-
yield bonds historically has increased the volatility of a balanced portfolio by an average of 78 basis points annually
(100 basis points equal 1 percent). This is because high-yield bonds are both more highly correlated with the equity markets
and more volatile than investment-grade bonds.⁴

Increasing the Exposure to Dividend-Paying Equities
An often-advocated equity approach to increase income is to shift some or all of a fixed-income allocation into higher-
yielding dividend-paying stocks. But, stocks are not bonds. As demonstrated in figure 4, stocks will perform like stocks—
that is, they carry the risks of high volatility and significant potential for loss. Moreover, dividend stocks are correlated with stocks in general, whereas bonds show little to no correlation to either stocks in general or dividend-paying stocks.

A second approach investors may take is to shift from broad-market equity to dividend- or income-focused equity. However, these investors may be inadvertently changing the risk profile of their portfolios because dividend-focused indexes display a persistent and significant bias toward value stocks. Although value stocks generally are considered to be a less-risky subset of the broader equity market,⁵ the risks nevertheless can be substantial because portfolios focused on dividend-paying stocks tend to be overly concentrated in certain individual stocks and sectors such as consumer goods or utilities. As a result, the significant focus on dividend stocks since 2002 has driven

![Figure 2: Hypothetical Impact of One-Time 3-Percentage-Point Increase in Interest Rates on $100 Investment in Two Bond Portfolios](image)

![Figure 3: Cumulative Performance of Selected Market Segments, October 9, 2007–March 9, 2009](image)
Figure 4: Dividend-Paying Stocks Are Not Bonds, December 1997–September 30, 2013

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<tr>
<td></td>
<td>Std Dev</td>
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<tr>
<td>Dividend stocks</td>
<td>15%</td>
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<tr>
<td>U.S. bonds</td>
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Notes: U.S. stocks are represented by Dow Jones Wilshire 5000 Index through April 2005 and MSCI US Broad Market Index thereafter. Dividend stocks are represented by S&P 500 Dividend Aristocrats Index through December 2003 and FTSE High Dividend Yield Index thereafter. U.S. bonds are represented by Barclays Capital US Aggregate Bond Index. Sources: Vanguard, Dow Jones, MSCI, S&P, FTSE, and Barclays Capital.

relative price/earnings valuations to levels well above their average for the decade ended September 30, 2013.

A final point to keep in mind in reference to the dividend discussion is that a dividend has no inherent economic value. This is because a stock's price is immediately reduced by the dollar amount of the dividend on the ex-dividend date. In fact, for a taxable investor, dividends could potentially be of negative value when taking taxes into account.

The Total-Return Approach to Investing

In contrast to income-only strategies that could damage a portfolio's overall health, we recommend the total-return investing approach because it looks at both components of total return: income return and capital return.

Keep in mind that the income-only and total-return approaches are identical to a point: Under each method, investors spend the income generated by their portfolios; it is only when investors need additional monies from their portfolios that the approaches may diverge. The income gap can be filled either by turning to income-producing assets or by spending from the other piece of total return, namely, capital appreciation.

By focusing on the entire return rather than only the income component, the total-return approach offers the investor three potential advantages:

- Maintains portfolio diversification (risk exposure)
- Allows portfolio to be more tax-efficient
- Increases portfolio's longevity

Maintains Portfolio Diversification

Diversification can be a powerful strategy for managing the risk of return volatility, allowing investors to establish portfolios with risk profiles that are consistent with their goals and preferences. Although every portfolio is subject to market risk, investors can potentially largely avoid firm-, sector-, and style-specific risks (idiosyncratic risks) by investing in funds that seek to track broad-market indexes.

Allows Portfolio to be More Tax-Efficient

Minimizing investment costs is critical to long-term investing success. Contrary to the typical economic relationship between price and value, higher costs do not lead to higher returns. Every dollar paid for management fees, trading commissions, or taxes is a dollar less of potential return. Research repeatedly has shown a powerful relationship between low costs and long-term performance (e.g., Wallick et al. 2011). However, unlike market returns and the other elements that determine performance, costs are predictable and controllable.

Taxes are one of the most significant costs. They are incurred when an investor either sells shares that have appreciated in value, earns interest or dividends, or receives capital gains distributions on assets held in taxable accounts. (Taxes are not due on assets held in tax-advantaged accounts for these items and are not due on assets held in Roth accounts if certain conditions are met.) Therefore, when constructing a portfolio, it is important to consider which assets to purchase as well as (1) whether to purchase them in a taxable or tax-advantaged account, a concept known as asset location, and (2) whether to withdraw assets from taxable or tax-advantaged accounts.

When the goal is to maximize after-tax returns, the strong preference is to hold tax-efficient (i.e., tax-minimizing) investments such as broad-market equity index funds and exchange-traded funds (ETFs) in taxable accounts and to hold tax-inefficient (i.e., more-highly taxed) investments such as active equity or taxable bonds in tax-advantaged accounts.

For total-return investors, asset location is driven by tax-efficiency, not by accessing income. Conversely, for investors following the income-only approach, asset location is driven by accessing the income at the expense of tax-efficiency.
Income-only investors are more likely to purchase taxable bond funds and/or income-oriented stock funds in taxable accounts so that they can gain access to the income from these investments. For assets held in taxable accounts, the investor will be subject to the following:

1. Paying a federal marginal income tax rate on taxable bond income. This could be as high as 39.6 percent and, depending on income level, 43.4 percent because of the Medicare surcharge that took effect on January 1, 2013. The investor could purchase municipal bonds but would forgo the taxable municipal yield spread.

2. Paying a long-term capital gains tax rate as high as 15 percent or 20 percent, depending on income, long-term capital gains/distributions, and the investor’s marginal income tax rate on short-term gains. (To the extent the investor uses actively managed equity funds, capital gains distributions are more likely.)

3. Paying a tax on qualified dividend income at a rate of 15 percent or 20 percent from equities, depending on income.

By contrast, total-return investors are likely to purchase tax-efficient equity funds and ETFs for taxable accounts. Although they will still be subject to points 2 and 3 above, the amount of income or capital gains distributions likely will be significantly lower.

When it comes to withdrawals, investors can maximize the long-term growth of their portfolios by depleting balances in taxable accounts before withdrawing from tax-deferred accounts. Switching the order of withdrawals would accelerate the payment of income taxes, which likely would be higher, for the following two reasons:

- The investor will pay ordinary income taxes on the entire withdrawal (assuming pre-tax contributions), not capital gains taxes on just the capital appreciation.
- Ordinary income tax rates are currently higher than the respective capital gains tax rates. Over time, the result would be lower terminal wealth values and lower success rates (portfolio longevity) compared with spending first from taxable accounts.

Spending from tax-free accounts before taxable accounts would reduce final wealth values and lower investment success rates as assets with growth potential exit the portfolio.

Increases Portfolio’s Longevity

Minimizing the impact of taxes and other portfolio costs can increase portfolio longevity—the length of time over which a portfolio can meet an investor’s spending needs. Put another way, minimizing taxes results in keeping more of the returns earned, which increases the portfolio’s longevity.

Conclusion

The current low-yield environment is leading many investors to focus on only one piece of their portfolios’ total return, namely, the income component. This focus may be encouraging investors to consider strategies such as extending the duration of bond portfolios, tilting bond holdings toward high-yield bonds, or shifting equity holdings toward stocks that pay higher dividends. In their hopes for a more certain return, these investors may not realize that they are moving away from broadly diversified to more concentrated portfolios, potentially reducing diversification and increasing risk, decreasing tax-efficiency (for taxable investors), and/or increasing the chance of falling short of long-term financial goals. On the other hand, the potential benefits of a total-return approach include maintaining diversification, enhancing the portfolio’s tax-efficiency, and increasing the portfolio’s longevity.

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Endnotes

1. Unless otherwise noted, the term “bonds” refers to broadly diversified portfolios of investment-grade bonds of intermediate-term duration.
2. For certain clients, such as those in defined benefit pension plans that engage in asset-liability matching, extending duration is likely to be more beneficial as part of a long-term strategy.
3. For more on the role of U.S. Treasury bonds during market environments characterized by a flight to quality, see Philips et al. (2012).
4. Note that REITs, commodities, and hedge funds are also more highly correlated with the equity markets than investment-grade bonds; see Philips (2012).
5. “Less risky” should not be taken to mean “better.” Going forward, value stocks should have a risk-adjusted return similar to that of the broad equity market, unless there are risks that are not recognized in traditional volatility metrics.

References


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