Income Investing Strategies for an Uncertain Market

At Kiplinger, we are forgiving when an otherwise triumphant stock, fund or sector goes into a tailspin. Investing hath no guarantees, and any company or money manager (or team) can have a slump. So we aren’t embarrassed that every member of the Kiplinger 25 for Income got slammed in March’s trading panic and liquidity crunch. The subsequent sharp recovery by the 25 (and others) brims now with righteous concern that the indexes and averages have already pilfered gains from the steady bounce-back we anticipated for late 2020 and into 2021. As the pandemic lingers and worsens, we thus predict heavy profit-taking (or loss-cutting) in the months ahead, as investors of all ages, sizes, sentiments and political persuasions hedge and exhale. Once again, if you have enough savings for life, or you do not expect to earn new money to replace your losses, we advise continued de-risking and a cautious approach to the reinvestment of interest and dividends.

But 2020 has been so freaky that we also offer this comfort: We presume any investment that escaped the collapse with only slight damage did so on merit. And, given all of the unforeseen and second-order business perils the crisis brought, these stalwarts are not always the outfits you might have expected (Boeing, Disney, Exxon and Wells Fargo, we’re pointing at you). Good and bad performance and dividend stability or instability are widely dispersed within categories ranging from banking and real estate to tech, transportation and utilities. The flat yield curve even affects credit and financial companies differently. It helps beneficiaries of cheap short-term funding, such as credit card banks. But it harms others, such as business development companies and mortgage real estate investment trusts, as the spread (the profit margin) between their cost of funds and the yields they earn on their assets shrinks.

That said, our purpose here is to spotlight—and praise—income ideas well-placed to hold value and maintain distributions if the economic outlook and market action regress from cautiously positive back to ugly. This is possible. There is no fundamental reason why a stock index such as the Nasdaq keeps hitting all-time highs. Too much exuberant money is chasing neon rainbows like Tesla and Zoom.

Let us now review what has stood up well to the year’s challenges and offers opportunity.

We could extend this discussion, but let us now review what has stood up well to the year’s challenges and will likely offer opportunities and stability even in a longer or deeper disruption.

**FULL FAITH AND CREDIT.** The sense that mortgage and rent delinquencies will soar encourages investment in government-guaranteed real estate loans—specifically, Ginnie Mae pools. In the GNMA world, if a borrower skips a payment, the Treasury ensures that investors collect “timely payment of principal and interest.” And although the yields on new mortgages are low, seasoned fixed-rate mortgages, like long-term Treasury bonds, are gaining value. Representative GNMA funds from Fidelity, Pimco, continued on next page ...
Lockdowns and business failures stress—but cannot cripple—sales of food, medical supplies and other essential goods.

Risks Versus Values in Tax-Exempt Bonds

This odd year’s predominant trading pattern: A security’s price typically moseyed or rose gently through January and February, then peaked, retreated and plunged into a ravine in March. As April arrived, the stock, fund, index or whatever clambered out of the hole—hoisted by sellers’ remorse, risk-seeking buyers and the trillion-dollar Federal Reserve rescue—and rapidly reclaimed half its loss. Then, starting in May, the excitement ended as bosses publicly, if reluctantly, nixed expectations for a fast return to previous growth and profits. The price retreated and resumed moseying, the disappointment palpable.

As a result, the price chart for many securities forms the shape of a square root symbol. It falls between the cockeyed optimists’ V-shaped visions and the defeatists’ L-shaped foreboding. And, unexpectedly, the square root shape appears in the prices for municipal bonds. Despite its usual calm and stability, the muni market is thick with issues whose values are banging around as rarely before. Muni trading volume is at its highest since 2008. Active bond-fund managers and traders obviously relish opportunities to buy and sell “mispriced” bonds. But to you and me, this volatility underscores the fragility of what seemed to be rock-solid investments pre-COVID, as well as the return of fear and caution as the U.S. fails to vanquish the coronavirus and state, local and other public-sector revenues suffer.

An illustration: The New York Metropolitan Transit Authority, a state agency that Moody’s just downgraded to A2 and Standard & Poor’s to BBB+, owns the New York City subways, suburban commuter railroads, and bus service. Let’s randomly pick one of its bonds—CUSIP 59259YTT6, issued in 2012 with a 5% coupon and maturing in November 2024. Its initial offering price was 118. It opened this year at 112, but since the crisis began, the bond has changed hands at 97, rallied to more than 110, and now trades at 104, for a “yield to worst” of 3.2%. A Treasury note due the same month yields 0.23% to maturity. For a mere four-year term, that is a massive spread. A four-year triple-A-rated municipal is unlikely to offer more than 0.5% to maturity.

Trouble is, the MTA’s revenue base—its ridership—has disappeared. Whether the authority can retain its investment-grade rating or avoid default is out of its control and instead in the hands of Congress and the vaccine scientists. Some
watchers, like Matt Fabian of Municipal Market Analytics, are unconcerned. "The MTA, like New York water, is essential and too big to fail," Fabian says. Federal assistance is possible. And if New York resorts to creative budgeting, he says, "the market has become more tolerant of state budget gimmicks."

These comments suggest that you ought to snap up this and other A-list transportation bonds, like those from the Atlanta and Dallas–Fort Worth airports and our longtime favorites, toll roads. If you can be patient while waiting for the bonds to recover, we’d advise you act. The S&P index of toll-road bonds is having a rare bad year, with a year-to-date return of 2.6%, compared with 4% for local general obligations and 4.2% for water and sewer issues. We found a Central Texas Turnpike bond (88283KBJ6) with a 3% coupon due in 2040 whose price plowed from 110 to 85 in March, sending the yield briefly above 4%. Now, it’s back to 107 and a 2.3% yield, but that’s still not bad. Toll-road bonds still retain their healthy three- and five-year total return edge over airport, hospital and general obligation bonds.

Our general feeling remains that tax-exempt bonds are essential to everyday life and commerce in the U.S. Unless you get greedy or confused and buy a bond backed by a vanity project, your odds of getting stiffed are minimal. Even bonds backed by stadiums and convention centers aren’t cratering because most share state or local sales taxes. A few lacking stable permanent funding face downgrades, but “the devil is in the details,” says David Dowden, of MacKay Municipal Managers, whose skill is to determine which debtors can last two or three years regardless of the overriding economic situation and which ones are already desperate. Dowden is wary of certain housing and health care projects for seniors and of private colleges with falling enrollments. But those make up a tiny slice of the $4 trillion municipal bond universe.

None of this gainsays our conviction that the best ways to invest in tax-frees are directly (with emphasis on critical sectors like water and sewer systems and, yes, toll roads) and with actively managed, research-intensive mutual funds—and never with exchange-traded funds or index funds. The coronavirus and pop-up recession have not spared all municals. But there’s still more-than-adequate security in this vast and successful category.

Timely Tactic
We give high marks to the fixed-income offerings from PGIM, whose strategists and managers are steadfast in their (and our) view that interest rates will stay even lower for even longer. PGIM has also been adept at turning this trend into good returns—even when the firm dips into lower-rated corporate debt—with its research prowess and commitment to active management. So it’s no surprise that the PGIM Floating Rate Income Fund (FRFZX, $8.88, yield 5.6%) is on fire, with an 8% total return over the past three months. That’s near the tip-top of the bank-loan fund category. This will not be an easy ride if the U.S. economy collapses again, but even if it does, we trust PGIM to stay out of trouble better than most anyone else.

The Aristocrats Lose Some Luster
Here’s a stunner: Despite puny and falling interest rates that promote the appeal of dividends, the 66 stocks known as Standard & Poor’s Dividend Aristocrats show a collective total loss of 5.5% so far this year, including dividends. The Vanguard Dividend Growth fund is down 3%. By comparison, the full S&P 500 is up 2%, and corporate and municipal bond indexes are in positive territory. So are investment-grade preferred stocks. Because it is gospel that high and growing dividends retard volatility and provide up to 75% of stocks’ long-term return, is this just another upside-down aspect of a strange year? Or is it a changing of attitudes? We remain committed to dividend-growth strategies and high-yielding stock sectors. We do not quit on a successful investment idea or strategy because of an occasional and inevitable downturn. But these numbers deserve explanation.

Aristocrats are S&P 500 members that have raised dividends 25 consecutive years. Entering this year, the largest cohort was (and still is) big traditional industrials, such as Caterpillar, Chevron, General Dynamics, 3M and PPG Industries. There are a bunch of banks and financial companies, several real estate investment trusts, and familiar consumer-products and retail names such as Procter & Gamble and Sherwin-Williams. The pandemic has been rough on several of these sectors; for example, regulators just banned U.S. banks from raising dividends until further notice. In May, we even saw the extremely rare case of an Aristocrat, Ross Stores, suspending dividends knowing that doing so would earn it swift excommunication, which S&P imposed starting July 1. Ross investors have lost more than 25% for the year to date, and that markdown counts in the Aristocrats’ overall first-half performance.

At the same time, many pillars of 2020’s resilient market, including Amazon, Netflix and some small pharmaceutical companies, either pay no dividend or disburse only a token amount. Among 2020’s unconventional gainers, the farm and home retailer Tractor Supply has returned 55%. It is an eventual candidate for aristocracy, but it started dividends only in 2011.

Some entire sectors, such as airlines and hotels, have chopped or suspended dividends. Boeing and Wells Fargo are blue-chip dividend casualties. Big and small oil companies either have cut pay-outs or are denying or delaying the deed. In total, second-quarter 2020 dividend cuts came to $49 billion, compared with $6.7 billion of increases. Enormous numbers of healthy dividend-payers are doling out paltry one- or two-cent raises. That’s either out of an abundance of caution or, as is always left unsaid, because the optics of generous dividend boosts amid continued on next page ...
mass layoffs and emergency government largesse are … well, choose your epithet. And yet our interpretation is that this situation could be worse. If dividends are a keystone of your income plan, do not jump ship. Nothing remotely suggests dividends are doomed. Utilities, REITs and partnerships are legally or morally obligated to maintain and usually raise them (otherwise, few investors would stand by). Companies save as much or more cash by reducing stock repurchases—a dangerous tactic anyway during a rocky market. The relatively fine recent performance of preferred shares, REITs (outside of lodging and retail) and taxable municipal bonds shows the quest for yield is unabated. We also expect large firms, including the Aristocrats, to try to make their dividend investors whole (as they did after the previous recession) because these payouts go not only to executives and mutual funds but also to thousands of their own employees. To mangle a cliché, dividends are too vital to fail.

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which trade like bonds, have done better than the common shares. The 5% preferreds traded in mid June at $25.13, and the 4.75% preferreds at $23.50. That gap is curious, given the slight difference in the coupon, but preferreds and $25 bonds are notorious for inefficient pricing. Over the same interval, AT&T’s common shares fell from nearly $40 to the present trading range of $28 to $32, for a current yield between 6.5% and 7.25%. (For reference, Standard & Poor’s energy-free junk bond index has a yield to maturity of 5.1%.)

There is no visible threat to AT&T’s common dividend, but the 4.75% preferreds at 6% below par value look sweeter. The yield to the first call date in 2025 is 6.4%, nearly equal to the common stock’s yield but with more assurance of price stability. Yes, AT&T can defer paying its preferred dividends, but that’s unlikely because it would first have to suspend its regular dividend, which it has increased for 35 consecutive years. We went prospecting for similar situations and, as usual, one can see a lot just by looking. (We use and recommend the site www.cdx3investor.com, which charges for monthly subscriptions but generally allows a free short-term trial.)

Note that although income from most preferreds is qualified, which means it is lightly taxed, real estate investment trust and partnership preferred dividends are taxed as ordinary income. That includes Annaly Capital Management’s popular 6.5% to 7.5% preferreds, whose prices tend to be less unpredictable than Annaly’s common shares. So—and this is unusual—Annaly’s preferreds yield less. They are available now, however, for about $20, a reasonable entry point because you will get paid in full, whereas the common NLY shares are subject to dividend cuts, including a small one last month.

Plenty of bank and insurance company preferreds with qualified dividends now trade between $23 and $25 and with coupons from the high 5s up to 7%. Bank common stocks can yield 5%, but the dividend growth prospects are dimmed by the Fed’s proclamation of a flatter-for-longer yield curve because that constrains the profit margin on many loans. (That will not affect the fixed dividend rate on the banks’ preferred securities.)

Looking at late 2019 and 2020 offerings, which have four to five years of call protection, we saw issues from banking giants like Truist (the merged BB&T and SunTrust), Northern Trust and JP Morgan priced to yield in the 5s, while well-established regional banks’ preferreds normally offer a percentage point or so more. The 118-year-old Virginia concern Atlantic Union Bankshares, as well as United Community Banks (Atlanta through the western Carolinas) and First Midwest Bank (Chicago and into Iowa and Wisconsin), all have newish preferreds trading in the $24s or at $25 for yields to call from 6.8% to 7.2%.

Turning to exchange-traded debt—remember, bond interest is taxable as ordinary income—utilities like Southern Company and several insurance companies are well represented at current yields of 5% and up. The trick here is to scour for issues discounted to $20 or less and hope that improved business and credit conditions will push the price closer to par. Much of what fits that price point now, however, are issues backed by dicey propositions like tanker leases and consumer finance companies. Bank preferreds strike us as much safer and well priced for today’s low-yield world.

**Anything Overlooked Out There?**

Preferred stocks and investment-grade corporate bonds have held their value much better than you might expect during a panicky market and a sudden and sharp recession. In part, this is a reflection of the uninterrupted hunger for high income, a force that is nowhere near spent and looks to accelerate, given the Federal Reserve’s intention to repress interest rates for years.

We believe seniority in the payment order is another key to this fine showing. Bondholders must get their interest before shareholders see any dividends, and preferred dividends must precede payments to common stockholders. The Fed says it will buy corporate bonds directly if it chooses, another reason to expect bond shoppers to stay confident and compete vigorously. Our favorite ways to participate include $25 par value bond snippets, formally called exchange-traded debt, as well as traditional preferred shares. Many preferreds are issued by outfits you know and are rated BB or BBB, yet you can often find them priced to yield as much as or more than a high-yield (junk) bond mutual fund or ETF.

Case in point: In December 2019, AT&T issued a whopping $1.2 billion of 5% preferred stock (symbol T-A). The company followed up in February with T-C, another $1.75 billion at 4.75%. Both originated at $25. Because interest rates are down, but also because AT&T is creditworthy, the preferred shares, which trade like bonds, have done better than the common shares. The 5% preferreds traded in mid June at $25.13, and the 4.75% preferreds at $23.50. That gap is curious, given the slight difference in the coupon, but preferreds and $25 bonds are notorious for inefficient pricing. Over the same interval, AT&T’s common shares fell from nearly $40 to the present trading range of $28 to $32, for a current yield between 6.5% and 7.25%. (For reference, Standard & Poor’s energy-free junk bond index has a yield to maturity of 5.1%.)

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