Investing for **Income**

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Though selecting stocks for "home run" capital gains is our raison d'être, we do not ignore other investment vehicles that are primarily for income. Investors should have at minimum a passing understanding of the notion of asset allocation. This is usually defined as the proportion of an individual's liquid assets that are put into three main classes: stocks, bonds and cash. Another way to define this further is to evaluate the split in terms of money invested for capital gains, for income, and for the sidelines. Just how much to put into each of these is a complex affair. In this article we will focus on investing for income.

Bonds are certainly a material component of investing for income, but that does not cover the whole territory. Some stocks clearly bridge the two camps – allowing for potential capital gains, but primarily held for their steady dividend income. On the other end of the scale, some long-term GIC's, though nominally considered to be in the third category due to their liquidity, are also essentially income investments.

Bonds are debt instruments issued by institutions for a period of at least one year. When you buy a bond, you are really loaning money to the issuer in exchange for interest to be paid to you. While the rate of interest is fixed, the prices of the bonds fluctuate, so there is both a capital appreciation and risk downside component. Of course, this is primarily of consequence if you want to sell your bond before the term expires.

The main advantage of bonds is the dependable cash flow – you get the cash you need on a regular payment basis (usually semi-annually). This income tends to be more stable than dividends, as bondholders are closer to the "front of the line". In tough times, a company might cut its dividend on common stock, but the bondholders will continue to be paid unless the situation becomes desperate.

The main drawbacks of bonds are that income is taxed at a higher rate than capital gains, and over the long haul, bonds have historically underperformed stocks. They can, however, outperform stocks for long periods of time, and this often coincides with bear markets for stocks. Therefore, bonds act as a hedge for equity investments.

Though long-term bonds, those with terms over 10 years, usually have a slightly better yield than medium-term bonds, we don't favour them. By our way of thinking, a term in the five to ten year range is the "sweet spot" - long enough to get a relatively good yield, but still permitting some manoeuvering room. You are more likely to be able to take advantage of a period with high interest rates, because long-term bonds don't tend to move as much. Paradoxically, long-term bonds are actually more volatile in price, because small changes in their expected yield can make a big difference over their term. That means if you need to sell the bond before the term finishes, you might be in for a nasty surprise.

Quality corporate bonds are an excellent alternative to government issues. They pay a little more interest, and the additional risk can be quite small. Though the fortunes of even the bluest of blue-chip corporations will wax and wane over time, they are remarkably resilient institutions. There is also an opportunity for a bit of a contrarian play here. When companies are out of favour, and their common stock has been hit hard, their bond prices also falter. When an entire sector is in the doghouse, it's worth taking a look at the bonds of the strongest players within that field. Chances are, these companies will survive and prosper, as the industry recovers, and weaker competitors are weeded out. For example, bonds for retail leaders are attractive now, and though the outlook for retail is clouded in the short-term, it will bounce back with time, and the top companies in the field will fulfil their obligations.

One thing to be aware of is that corporate bonds may be "callable". This means the issuer can pay them off at their discretion. This might happen if the organization can obtain cheaper financing elsewhere, or if there is a surplus of cash due to asset sales. This can throw a wrench into your schedule of expected income, and may require that you reinvest at an opportune time, when interest rates are less favourable.

Royalty and income trusts are also worth a look. These vehicles made quite a splash when they became popular several years ago. They offered high yields, steady income, a chance for capital gains, and tax advantages. It all sounded a bit too good to be true, and in many cases, it was. These investments, like all initial public offerings, tend to get floated when the associated businesses are doing well. Given the way that earnings are supposed to flow through to the holders, this means that when the inevitable downturn occurs, there is very little margin available before dividend payments are cut. When that happens, the investor is stuck with a low or no yield asset, a paper loss, and the tax advantages suddenly don't seem so advantageous anymore.

With many of these fund units now trading below their issue price, once again yields are high. After being burned, investors are wary. But in many cases, the current dividend rates are more sustainable than before, or funds have merged and consolidated to create entities that have greater resources and more earnings power. As with stocks, the key is to look for firms with strong management, economies of scale, and a product that might be out of favour now, but is indispensable to the economy and likely to regain its lustre.

A major caveat though applies specifically to time periods when interest rates are changing. When rates are falling, as they have recently, royalty and income trusts tend to appreciate in value. But if and when rates rise in the future, and interest rate returns on alternatives like bonds and GICs correspondingly increase, there will likely be a downturn on the valuations of these trusts.

Another primary consideration is the nature of boom and bust. A year and a half ago, energy trusts could be purchased exceedingly cheaply. Now, they are hot. If you like it that way, then this is the time to buy. Given our tendency to adore stone-cold sectors, we were buying 15 months ago when the payouts were attractive and the unit prices were low. This has provided us with both an income stream and rapid stock appreciation.

Utilities are a classic way to invest for income, and with good reason. Over the years they have shown themselves to be steady performers. They are in an extremely capital intensive business, so borrowing is high, yet due to limited competition and regulation, they have a "captive audience". Corporations chaff under government rules, but these very restrictions also create the conditions which assure a decent return for the companies that provide the infrastructure of our industrialized society.

We are keen on some of the smaller hydroelectric power providers, and that sentiment goes back a lot further than the recent electricity shortages in California. It's tough to go wrong investing in a good source of renewable energy on a planet that is steadily gobbling up resources as the population grows both in numbers and affluence.

Though yield usually determines what helps rank the desirability of income generating assets, we also take a careful look at how the current price compares with historical prices, just as we would do with a stock. This isn't only because we are looking for capital appreciation – though that is a welcome bonus, but by applying our contrarian philosophy and buying into good businesses cheap, we reduce risk and increase the probability of a good yield. Not just for today, but far into the future.

Questions and comments can be directed to the authors through their website at www.contratheheard.com.

The recommendations and opinions expressed herein are those of Benj Gallander and Ben Stadelmann, co-editors of Contra the Heard Investment Letter and do not necessarily reflect those of TD Waterhouse and are not specifically endorsed by TD Waterhouse. Benj is also author of *The Uncommon Investor*.