Introduction

For decades investors have slowly been trained by Wall Street to focus on the income, or yield, of their investments as the metric for measuring the success of their portfolio. The basic idea may have had noble roots associated with understanding the expected cashflow generated from a portfolio to help with retirement planning, and it may still be applicable today in some very narrow circumstances, such as when a trust is set up to only distribute interest and dividends. Wall Street, however, has taken the idea further than appropriate and created a series of income-oriented products. We believe that these products, not surprisingly, have high fees and poor net total returns. In our view, the advisors who use these products focus the reporting of them on the yield produced by the portfolio because, by definition, the yield is always positive! This has created several issues for investors including:

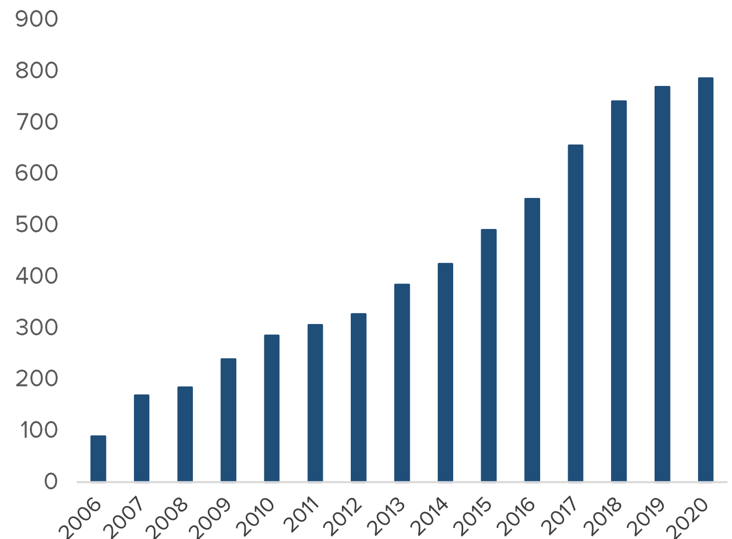
1) An overemphasis on maximizing income generally exposes a portfolio to the risk of loss during a period of rising interest rates, like we just experienced.

2) A focus on forward looking yield often obfuscates the actual return on a portfolio.

3) Higher yielding products are often less tax efficient, which can have negative consequences for clients in higher tax brackets.

Overemphasis on Yield Has Created Riskier Portfolios

Since the Great Financial Crisis, low interest rates have aided in creating a boom in investment products designed to maximize income. This is perhaps most prevalent in the growth of the private, non-bank direct lending to companies, which now totals nearly 1 trillion dollars. You may have encountered some of these products given the number of private credit, private real estate, and other high yield debt products that have been created specifically to target individual investors.



Source: Marquette Associates

While yield is one important metric when evaluating the relative value of certain investments, a strategy that simply aims to maximize yield generally does not result in the best returns. Consider the US Aggregate Bond Index compared with the Emerging Markets (EM) Aggregate Bond Index. Five years ago, in March of 2018, the US Aggregate Bond Index yielded 3.17% compared with the EM Aggregate Bond Index that yielded 5.07%. An investor seeking to maximize yield might have preferred to invest in the EM Aggregate Bond Index because they believed it would generate more income and therefore better investment returns. However, over the past 5 years, the US Aggregate Bond Index outperformed the EM Aggregate Bond Index by over 2% on a total return basis. Yield alone does not tell the whole story and other factors such as duration, credit risk, and interest rates can have a significant impact on both the yield and the total return of fixed income investments. In this case, a combination of interest rate movements and defaults has caused the higher yielding index to deliver lower returns.

To make matters worse, an emphasis on targeting yield naturally forces investors into riskier and riskier products at precisely the worst times. We've seen this firsthand over the last several years. When interest rates remain low for an extended period, investors must take more

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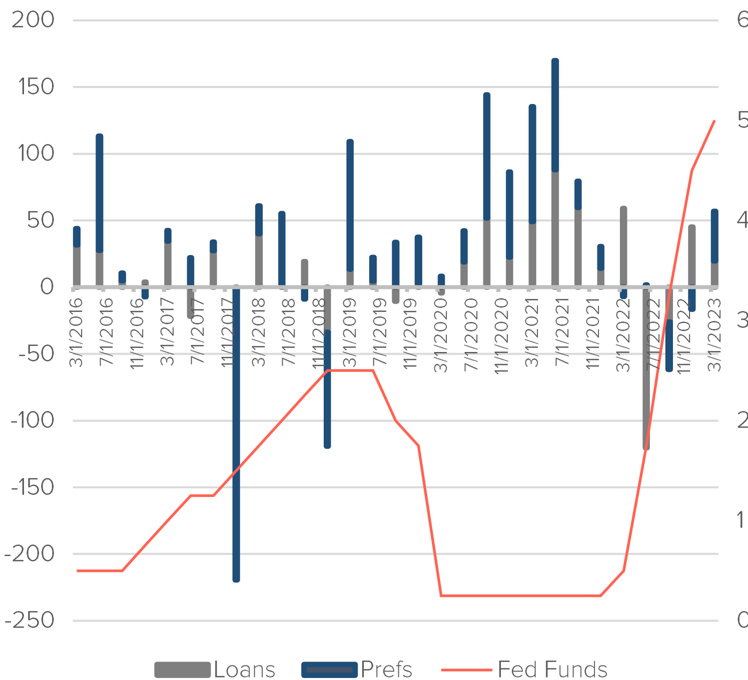
exposure to default risk to achieve their desired yield. For example, in 2020, yields on US Treasury Bonds reached historically low levels, with 10-year Treasury Bonds yielding as low as 0.70%. In response, investors piled money into riskier securities such as bank loans because they yielded close to 5%. While this was considerably more than Treasuries, it was also very low relative to their own history. Low interest rates on government bonds meant that the returns offered on all fixed income instruments going forward were much lower as well. Historically, this is a bad time to take additional exposure to the risk of defaults because companies, like individuals, are likely overborrowing given the low rates they can get when they take out a loan. Now that interest rates have returned to higher levels, investors can instead achieve a 5% yield by buying a risk-free Treasury Bill, and all the other fixed income products have repriced substantially lower as a result. The losses are particularly painful in areas with greater defaults (or "credit risk").



Source: Bloomberg

Total Return, Not Yield, Is What Matters

The performance reports generated by many Wall Street firms often list the income or yield of each asset, rather than the return of that asset. This is because yield is a forward-looking metric. It is the answer to the question "if nothing goes wrong, a bond doesn't default, or the stock prices don't move, what will my return be?" Total return is a backward-looking metric. It answers the question "How have my investments actually done?" In terms of evaluating the performance of your portfolio or your advisor, the focus should be on what has actually taken place in the portfolio, not on what is possible in some idealistic future.

Generally, the higher the yield, the more likely it is that something goes wrong because the extra yield is the price the seller of the security must pay to compensate an investor for the risk of something going wrong. For this reason, investors should always be wary of funds that tout high distribution yields because they typically come with an excessive amount of risk and may underperform expectations.

Yield often times is rarely a good predictor of the actual return you will receive on an investment. Contrasting the stock market vs. a portfolio of high dividend stocks provides a perfect example. Consider SPY, an ETF that tracks the S&P 500 Index, versus SPYD, which tracks an index of high divided stocks within the S&P 500. Over the last five years SPY has outperformed by over 18%, despite having a dividend yield of 1.7% vs 4.02% for SPYD at the start of the period. In other words, an investor that prioritized yield has 18% less money today than an investor who bought the equity market index.

Worse, the yield on a fund is misleading and may not accurately reflect the total return of a given investment. For example, consider the Carlyle Tactical Private Credit Fund, which is a fund designed to produce income to investors through investments in the private credit market. Since inception, their institutional class fund

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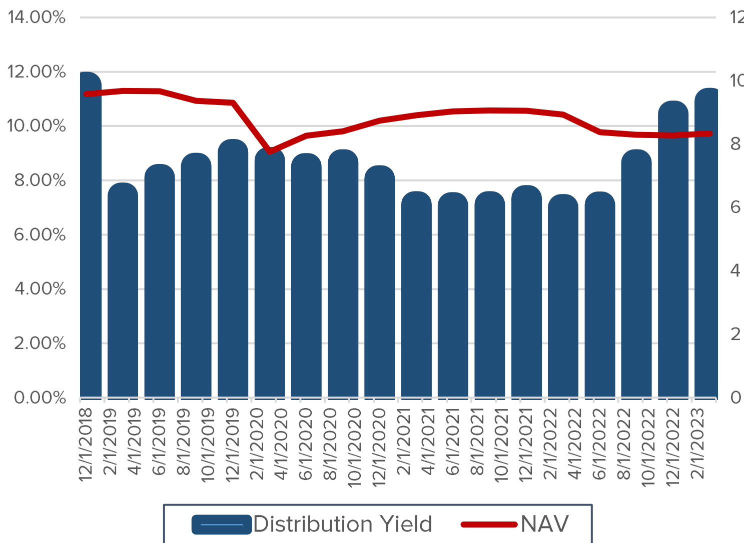
(TAKIX), has maintained an annualized distribution yield above 7%, which is calculated as the quarterly dividend divided by the fund's net asset value (NAV), multiplied by 4 to create an annualized figure. However, the fund's NAV has also declined over this time period, which has caused the overall return of the fund to be much less than the 7% distribution yield that the fund has maintained over time. In reality, TAKIX has returned only 4.27% annualized since inception through Q1 of 2023, despite reporting a yield above 7% every quarter.

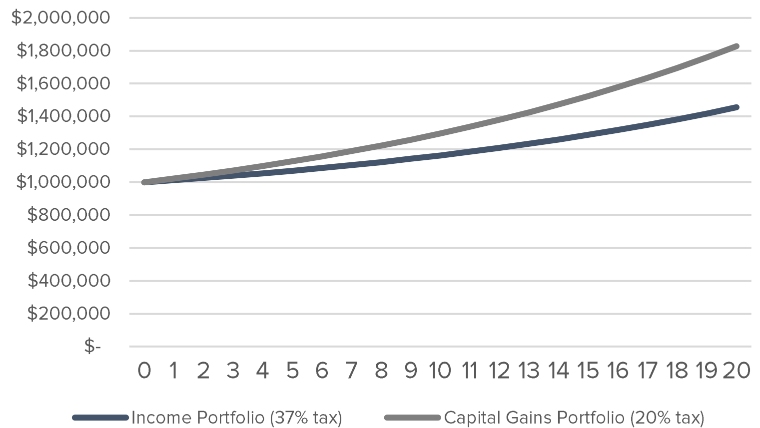


Source: Bloomberg- – the above chart represents the Net Asset Value of Carlyle Tactical Private Credit Fund (TAKIX) vs the annualized distribution yield

Tax Efficiency and Yields

In the United States, many income generating investments are taxed as ordinary income as opposed to long term capital gains, which can lead to significantly different after-tax returns for investors. Investors in the top marginal tax rate will pay a 37% tax on many income generating investments, including bond funds, preferreds, non-qualified equity dividends, and REITS, compared with a 20% tax rate for long term capital gains. Imagine that you start with $1,000,000 and you need to withdraw 5% annually, or $50,000/year. If you are in a high tax bracket, it is significantly better to achieve a 5% return through long term capital gains rather than income. In the case of an income generating investment, if your marginal tax rate is 37%, you will pay $18,500/year in taxes on your $50,000 gain, compared with just $10,000 if you are taxed at the long-term capital gains rate. Stated differently, if you are looking to generate 5%/year in after tax returns, you would only need to return 6.25% through long term capital gains, vs. almost 8% for income generating investments.

To show this graphically, imagine an investor starts out with $1,000,000, and earns a return of 6% annualized. Let's also assume that our investor needs to withdraw $30,000, or 3% of the starting principal, every year **after taxes** to cover expenses. Over a 20 year period, the difference in account value is over $370,000 depending on if the distributions are taxed at a 37% ordinary income rate, vs. the 20% capital gains tax rate.



*The above table represents a starting value of $1,000,000 portfolio with assumptions of a 6% assumed growth rate of portfolio year over year for 20 years. Additional considerations include withdrawing $30,000 each year for the payment of taxes considering a 37% tax rate in the blue axis line and 20% tax rate in the grey axis line.

Conclusion

In closing, generating income in your portfolio through dividends, coupon payments, or alternative income generating investments can be an important component of an investor's portfolio, but focusing strictly on income leads to serious pitfalls. At GenTrust, we're guided by our core principles which include an emphasis on risk, low costs, and tax efficiency, which we believe are much more important considerations than income.

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