MuhlenkampMethods
For the Intelligent Investor
Answers to questions you may not even know you have.

Yield = Income = Caution!

This essay gives examples of why you should completely understand what you are buying before you buy it. Be sure to read the fine print—check the numbers and check the underlying assumptions!

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As the Federal Reserve continues to prolong its policy of keeping interest rates at low levels, some of our clients have been searching for ways to generate more yield (income) from their investments. This idea sets off alarm bells in my head! Let me tell you why.

At the simplest level, investments in securities include:

- bonds, which are designed to protect capital over a period of time, and to provide regular interest payments; and
- stocks, which represent ownership in a company that may pay a dividend.

Historically, investors seeking yield would purchase bonds or low-growth, high-dividend stocks. With current interest rates being very low, this focus has shifted.

First alarm bell: Be careful with definitions!

"Yield" is generally understood as the interest or dividend payment earned on an investment, over and above the return of principal.

Today, when clients hear about an investment product with a 10% distribution, many ask "How can I buy it?" As an example, we were recently asked to research a utilities mutual fund where the distribution was 10 cents on every dollar. Reading the fine print, we learned that 3 cents was earned as a dividend "yield" and that the remaining 7 cents was a "payout" of the principal investment. In other words, the 7 cents would not be a return ***on*** your money; it would be a return ***of*** your money! With this example, "yield" and "payout" are used interchangeably (but incorrectly) when describing the distribution.

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Second alarm bell: Income streams may not be consistent!

With the increase of energy-related investment opportunities, clients looking for more yield are also asking about royalty trusts that tout double-digit distributions. A royalty trust is a pool of investors owning the royalty rights on a group of oil or natural gas wells. As the gas from the wells is produced and sold, the investors in the royalty trust receive a distribution representing their pro rata shares of the proceeds. When the gas is depleted, so are the assets. (Think of the natural gas as being stored in a warehouse: once you have sold what is in storage, the warehouse is empty.)

It's important to remember that nearly all gas wells produce at a declining rate, with higher rates at the beginning. Using the warehouse as our example, let's assume we sell 100% of the contents over the next 20 years: 10% is sold in the first year, declining to 1% in the 20th year. As a result, your first-year distribution is not be representative of the later years. In other words, you would not be receiving a level income stream.

Third alarm bell: You may be paying too much for more income!

Because of their popularity, the money flowing into these types of "high-yield" investments has driven their prices up. Remember, there is an inverse relationship between price and yield: when the price of an investment goes up, the yield goes down. At Muhlenkamp & Company, we are concerned that some investors are paying too much for potentially more income.

We believe that if you don't completely understand what you are buying, then you shouldn't buy it. When it comes to looking for more income, be sure to read the fine print—check the numbers and check the underlying assumptions!

The comments made in this commentary are opinions and are not intended to be investment advice or a forecast of future returns.