



Cash flow is king
Seek income while waiting

In a roaring bull market, investors often don't pay much attention to the composition of their returns. Security prices climb and income (bond interest and stock dividends) rolls in. It's all good. But in today's uncertain market, the components of total return are more distinct and divergent. Although we are all conditioned to fixate on price, now is a good time to focus on the income engine of your portfolio, particularly through the use of index ETFs.

Dissecting return

Portfolio return only comes in two flavors – appreciation/depreciation and income. For equity investors there has been plenty of depreciation over the last 18 months with few exceptions, and the income from stocks through dividends has hardly offset the massive declines. For bond investors, especially in Treasury securities, the reverse has been true. It has been a feast for the high-quality bondholder – generous appreciation coupled with some income.

Both asset classes present confounding price issues. It is impossible to know and pointless to guess where stock prices will go from here. And interest rates have gone so low (driven primarily by government bailout and stimulus interventions) that rising bond prices are close to their mathematical limits. It would be naïve to count on significant price appreciation for either asset class. While we are waiting for these longer-term supply and demand issues to sort themselves out, one sure step you can take is to focus on portfolio income.

How much income is reasonable, and at what risk?

The index approach to bond income

The case for bond indexing is pretty straightforward (see our 2008 article “Bonds 2.0”). Bond indexes provide institutional pricing (via \$1 million lots), plenty of diversification, and index returns. Furthermore, the transparency of ETFs and their index structure leads to a “no surprises” outcome. Any single default or large downgrade is too small to significantly affect overall results.

The typical objection to indexed bonds is their average maturity, i.e., they are not the same as a buy and hold portfolio. We would avoid owning single issues (buy and hold) with few exceptions for the simple reason that the future is unknown, and what looks enticing today could be tomorrow's disaster. Bad things can happen to “good” companies. Remember how reasonable it seemed to buy GM bonds over the last several years? Each buy recommendation seemed to carry a higher yield than the last...until there is no yield today and bondholders will be lucky to get even ten cents on the dollar.



So long as the average maturity of the bond ETF is not too long, then the ETF's will be relatively less volatile in price, which is important if you want to sell. BND (see below) has an average maturity of 5.7 years, for example.

Note that there are much higher yielding bond ETFs, like State Street's High Yield Bond (well named with the symbol: JNK) with an indicated yield of 17.02%. My only comment is that you can't get equity-like returns from bonds unless you take equity-like risk. I would consider JNK to be part of an equity strategy.

The index approach to equity income

The case for income through equity indexing is similar to bonds – diversification, no surprises, and a history of beating most active managers. (The Wall Street Journal reported on April 22, 2009 that 70% of the large cap funds that use the S&P 500 as a benchmark failed to beat the index over the previous five years.) When you consider the *after-tax* results of indexing, the case is even stronger. And don't forget that dividends are taxed at 15% for now, allowing you to keep 85% of the current yield.

The key item here is to focus on the index itself, not the strategy, such as “dividend growth” indexing that some ETFs promise. Such a narrow focus on dividends alone (see our 2007 article, “How to Index”) would have been disastrous in the last two years, as most of the high dividend payers were financial companies. Who knew? Ironically, seemingly safe dividend-oriented ETFs, funds, and stocks declined much more than the averages.

Will dividends survive? We won't speculate about the future. Simply note that recent events paint a very blurry picture. Dividend cuts by many financials, GE and Pfizer have been countered by dividend increases from 3M, Home Depot, Johnson & Johnson, and Wyeth. It might surprise you to know that so far this year 51 companies have cut or suspended their dividends, while *60 companies have increased them*, according to the Wall Street Journal 4-23-09. Go figure.

Yield alone is not the story

Now is a great time to evaluate the cash flow capacity of your portfolio. Consider the yields on some of the ETFs below. But avoid buying on yield alone – yield says nothing about dividend sustainability for stocks or default potential for bonds. Still, index ETFs can be a good source of cash flow. And for now, cash flow is all we have. With no inflation in sight, 4-8% cash flow looks pretty good.



Benchmark yields as of 4-22-09*	
DJIA	3.83%
10 year Treasury	2.91%
90 day T-Bill	.14%

Some Higher Yielding ETFs		
Symbol	Description	Indicated Yld 4-22-09*
Fixed Income		
BND	Vanguard Total Bond Market	4.32%
LQD	iShares Investment Grade Corporate Bond Fund	6.46%
MUB	iShares National Municipal Bond Fund	3.87%
Equity		
VTV	Vanguard US Value	4.10%
VWO	Vanguard Emerging Markets	4.47%
VGK	Vanguard European Stock	8.51%
Alternative		
VNQ	Vanguard REIT	6.30%

*source: Bloomberg

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