# INTRODUCTION TO THE UNIVERSE OF INCOME-GENERATING FINANCIAL STRATEGIES

Retirement Income Source®
Fort Lauderdale

# Introduction to the Universe of Income-Generating Financial Strategies

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There are three basic categories of investments: conservative, moderate, and aggressive.

| CONSERVATIVE | MODERATE | AGGRESSIVE |
|---|---|---|
| Certificates of Deposit | Corporate Bonds | Common Stocks |
| Government Bonds | Indexed Annuities | Stock Mutual Funds |
| Fixed Annuities | Preferred Stock | Commodities |
| Insured Municipal Bonds | REITs | Speculative Real Estate |
| | | BDCs |

Aggressive instruments are those primarily invested in for growth. As the chart shows, they include things such as common stocks, stock mutual funds, commodities, Business Development Companies (BDCs), and speculative real estate. Again, these are typically invested in growth or capital appreciation, not income. They are considered aggressive because, while they can provide large short-term gains, they can also carry a higher risk of sudden losses.

On the left of the chart are investments that are considered conservative because, in theory, they are deemed to have no default risk. These include bank CDs, government bonds, fixed annuities, and insured municipal bonds.

In the middle of the chart are moderate instruments that have some default risk but are generally considered to have a much lower risk of loss than aggressive investments. These moderate options include corporate bonds, indexed annuities, preferred stock, and Real Estate Investment Trusts (REITs).

The instruments on the left and in the middle have two things in common:

1. They're considered to have less risk of loss than the instruments in the aggressive category.
2. They are instruments that people invest in primarily for income.

In other words, they are not instruments that people typically invest in first for growth — although they do appreciate in value. The interest and dividends that are typically yielded by the vehicles on the left and in the middle represent a way for investors to generate reliable income and grow their money "organically" through the reinvestment of any interest and dividends they may not need for income. This is known as the "bird-in-hand" approach to portfolio growth. You aren't crossing your fingers and toes and hoping for capital gains to provide you with growth. Instead, you're building growth strategically through a dependable process.

## Bond Mutual Funds

If you're considering investing in the vehicles on the left and in the middle of the chart, and most of your previous experience has been investing for growth in the stock market, avoid taking a do-it-yourself approach. Instead, seek professional guidance from a qualified financial advisor who specializes in investing for income. There are many complex factors to consider when investing in these conservative and moderate options, some of which we'll share in the next few pages. First, let's talk about a popular investment tool you may have noticed is conspicuously absent from the previous chart: bond mutual funds.

Generally, advisors who specialize in income-generating strategies, as opposed to growth-oriented strategies, work with individual bonds and bond-like instruments rather than bond funds. That's because when an investor buys an individual bond, they have two important guarantees: a fixed rate of interest for the life of the bond and the return of their face-value investment upon maturity. Both guarantees assume that there have been no defaults, but with that assumption, an investor knows exactly what they're going to earn on the individual bond if they hold it to maturity.

By comparison, interest rates on bond funds can fluctuate, so they aren't guaranteed, and bond funds also have no fixed maturity date. If they end up not maturing, then you can't hold them to maturity and therefore can't get your face-value investment back. In short, the two guarantees that mitigate your investment risk in individual bonds don't exist with bond funds.

That's important because many factors can cause bonds and bond mutual funds to fluctuate while you hold them. Most people have heard that when interest rates go down, bond values tend to go up, and vice versa. However, that's an oversimplification and just one of the many factors that can impact bond prices during their lifetime.

## Paper Loss vs. Real Loss

With all that in mind, imagine that you're a client of an advisor who specializes in individual bonds while your friend Joe is with an advisor who's put him in bond mutual funds. If something happens in the bond market to cause bond values to drop, a portfolio of individually held bonds and a bond mutual fund might drop similar amounts in value, but because you're in individual bonds, yours is only a paper loss. If you choose to hold those bonds in your portfolio to maturity, then, as noted, you will get your face value back at that time — assuming, once again, there have been no defaults. But, because Joe has mutual funds, his loss might never be recaptured, since bond mutual funds never mature. In other words, a loss that might have only been a temporary paper loss in individual bonds can turn out to be an actual monetary loss in bond funds.

Since that's the case, you might wonder why so many financial advisors utilize bond mutual funds instead of individual bonds. One possibility is that most advisors today specialize in growth-oriented strategies (those in the aggressive column) rather than income-generating options. Advisors who specialize in growth are often not very proficient in fixed-income analysis, which is very different.

Therefore, it is easier for those advisors to recommend a bond mutual fund because, in so doing, they are leaning on the fund manager to pick individual bonds. Bond funds offer a simpler way for growth-based advisors or even do-it-yourselfers to invest in the bond market. But, like most things in life, this simplicity comes at a cost. In this case, it's the cost of Joe being exposed to significantly more risk with his bond fund than you are exposed to with your actively managed portfolio of individual bonds and bond-like instruments.

## Variables to Consider

Returning to the chart, understand that if you are investing in the different categories of individual bonds or even preferred stocks, there are many variables to consider. The first is the credit worthiness of the issuer. The higher the issuer's credit rating, the less the interest or dividend that gets paid, and the lower the credit rating, the higher the interest or dividend that gets paid. In the case of municipal bonds, you also need to understand how your marginal tax bracket affects your decision.

The next thing you need to consider is the maturity date. However, you should also look at the yield curve to see where you will get the most bang for your buck. Consider the yields offered on various types of fixed-income securities. There are at least four different types of quoted interest rates that all mean different things, which means you need to understand such things as an individual security's coupon rate, current yield, yield to maturity and yield to call, and whether a bond is callable or noncallable or convertible or nonconvertible.

This is all just an overview, but hopefully, it gives you a sense of why we strongly suggest working with a qualified advisor who specializes in fixed-income instruments if you have no real-world experience with them yourself. You can probably also better understand now why many growth-based advisors prefer to "keep it simple" by working with bond funds.

## A Word About Interest Rates

If interest rates are low, you may wonder about the wisdom of buying bonds, thinking that when interest rates go back up, your bonds will invariably drop in value. Your concerns are probably based, to a large extent, on the fact that many growth-based advisors and Wall Street firms actively tout that very message. But typically, any talk you hear about a "bond bubble" is primarily a scare tactic being used to keep investors from moving out of growth stocks and into bonds. As explained, if you plan to hold bonds to maturity, interest rates largely become moot — plus there are many factors that impact bond values besides interest rates.

## Annuities and REITs

Returning to the chart, let's look at annuities. Odds are you already know these can be extremely complicated investment tools. Some have embedded fees, and some have no fees at all. Some are subject to market volatility, and some have zero volatility risk. Some are irrevocable, and others are more flexible. There are so many factors to consider with annuities that unless you have real-world experience with the various types of annuities, you certainly shouldn't pursue this option without the help of a qualified specialist in income-generating investment strategies.

Regarding REITs, the options are also extremely varied. When choosing REITs, one needs to look at the type of real estate that the REIT is invested in, the average length of the leases within the REIT, and the profile of the major tenants, along with many other factors. Simply put, REITs are every bit as varied and complex as annuities.

## Educational Process

More than 30 years ago, conservative financial investment options such as those in the left-hand column were extremely popular with retirees and those approaching retirement. Since the ‘80s and ‘90s, however, when investors became addicted to stock market growth, these investments have often been thought of as dull, boring, or old-fashioned. As a result, many investors today have, at best, a very basic understanding of these investment strategies and little or no real-world experience. But an experienced financial advisor who specializes in these income-generating investments can guide you through an educational process to help you understand the pros and cons, potential risks, and expected returns of each investment vehicle and how they may or may not fit in with your personal goals and situation. Except for bank certificates of deposit (CDs), all the conservative and moderate investment vehicles discussed here are designed to generate competitive returns in today’s market. All are generally considered to have less risk of loss than common stocks or stock mutual funds.

Again, building your wealth by receiving consistent interest and dividends from your investments is a “bird-in-hand” approach that, for most people in or nearing retirement age, represents a better alternative than crossing your fingers and toes and hoping for capital gains. The best way to get started and to learn more is, once again, by contacting an experienced financial advisor who specializes in The Universe of Income-Generating Financial Strategies.

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