Income: An important part of total return

February 11, 2019

When it comes to generating income most people think of bonds and little else, but they're not the only option. A range of income-generating assets may offer more yield and time-tested benefits of diversification.

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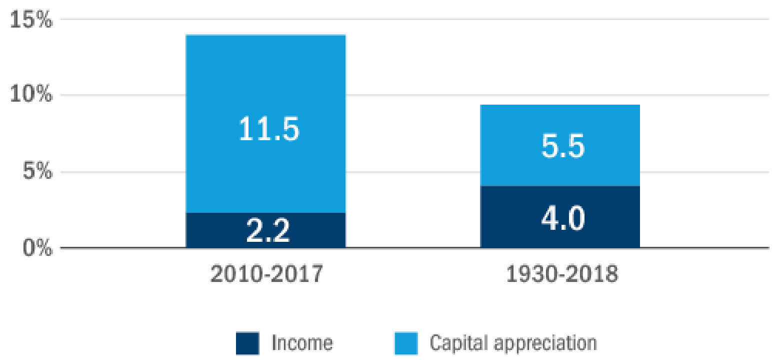
Financial advisors use income-generating investments for clients who are near or in retirement. Such investments represent a source of reliable income that retirees can count on. But reliable income isn't the only attractive feature of this strategy. Studies have shown that income can be an important driver of total returns for most asset classes — not just bonds. While bonds are a traditional source of income, they can be risky and overvalued at times, underscoring the potential benefit of a multi-asset approach that includes stocks.

Income drives investment returns

It may come as a surprise to some, but income is a significant component of equity returns. In the short term, equity market returns are driven by movement in stock prices, but going back to the 1930s shows that over longer periods of time, dividends — the income-generating component of equities — can provide even greater returns than stock price appreciation. In fact, dividend income accounted for over 40% of the returns from equity since 1930. More recently, stock appreciation has been strong and dividends have played a less important role in total return. From 2010–2017, dividends contributed just over 15% of total return, because it was a bull market and stock prices were increasing. As we return to more normal expectations for equity growth, dividends may again make up a larger portion of investors' total return.

U.S. equity market average annual returns: Income vs. capital appreciation

Going back to 1930, more than 40% of returns have come from dividend income



Source: Ned Davis Research as of 12/31/18. U.S. equities represented by the S&P 500 Index, which tracks the performance of 500 widely held, large-capitalization U.S. stocks. Past performance is not a guarantee of future results. It is not possible to invest directly in an index.

Melda Mergen, Deputy Global Head of Equities, often discusses how finding income in equity markets doesn't mean you need to focus solely on the sectors that tend to deliver higher dividends, such as consumer staples or utilities. Income is an important component of equity returns across the entire stock market.

For fixed income, over a period as short as five years, well over 90% of the returns come from the coupon, which is the income component of bonds.[1] Since this will primarily determine returns, the focus within fixed income tends to be on finding sectors that provide the best value.

Diversify your income sources

Diversification is as important for an income-generating strategy as it is for any other investment goal. A well-diversified multi-asset portfolio may generate more income for the risk taken compared with stocks or bonds alone. It's the result of thoughtfully combining asset classes with low correlation to each other. As many of us know, too much exposure to one part of the market can be dangerous.

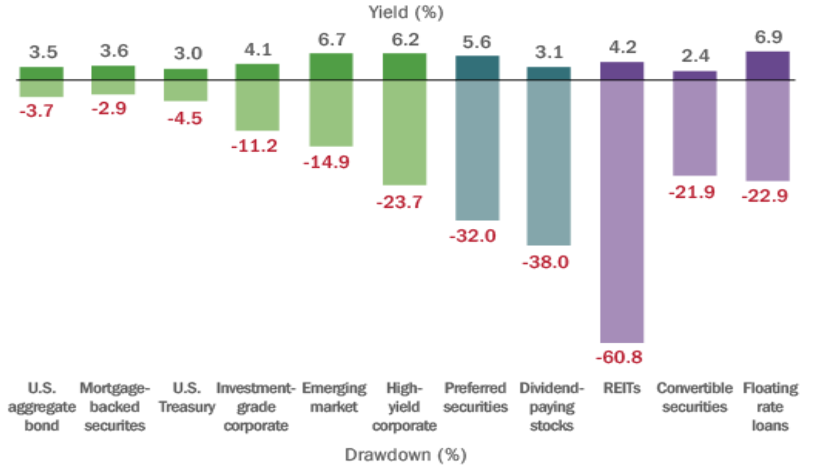
Advisors often gravitate toward parts of the financial market that have an attractive yield component, even though these areas can contain significant underlying volatility. This is true within the fixed-income portion of a multi-asset income portfolio. As Colin Lundgren, Global Head of Fixed Income, says, "I worry that investors stretch for yield at the wrong time. They're taking a risk in some of the lowest quality rungs of the corporate bond market or investing in emerging market countries they can't point to on a map."

1 Columbia Threadneedle Investments.

![Columbia Threadneedle Investments]

Current yield and 10-year max drawdown across asset classes

Higher yielding assets can have bigger losses, measured by drawdowns



Source: Bloomberg, FactSet, Barclays, Columbia Threadneedle Investments. As of 09/30/18. Current yield represented as yield to worst for fixed income and current dividend yield for equity. Using weekly data. Updated on a quarter lag. See disclosure for indices used to represent asset classes. Drawdown represents a peak-to-trough decline in values during a specified time period.

It's critical to recognize the potential for volatility when it comes to a portfolio focused on single asset classes. A portfolio based around a multi-asset framework can achieve higher income and lower its overall volatility by holding bonds, equities and less traditional asset classes.

Tactical portfolio management

There are other, less conventional ways of eking out more income. One strategy is to invest in preferred and convertible securities, which over the long term may improve the performance of portfolios while potentially reducing the level of overall risk. Indeed, a well-structured multi-asset portfolio can access income from across the entire capital structure of a company's balance sheet.

Active management of an income portfolio is critical. Our preference is to be thoughtfully tactical so you're able to capitalize on compelling opportunities as and when they arise — for example, underweighting bonds when they appear overvalued and overweighting other assets in higher yielding parts of the market when they've reached a desired value.

A multi-asset approach that's tactically managed may give your clients access to a more secure, less volatile income stream.

U.S Aggregate bonds are represented by Bloomberg Barclays US Aggregate Bond Index, an Unmanaged index that measures the performance of the agency sector of the US government bond market. Mortgage-backed securities are represented by Bloomberg Barclays US Mortgage Backed Securities (MBS) Index tracks agency mortgage backed pass-through securities (both fixed-rate and hybrid ARM) guaranteed by Ginnie Mae (GNMA), Fannie Mae (FNMA), and Freddie Mac (FHLMC). The index is constructed by grouping individual TBA-deliverable MBS pools into aggregates or generics based on program, coupon and vintage. U.S. Treasury is represented by Bloomberg Barclays US Treasury Index ("U.S. Treasuries") measures US dollar-denominated, fixed-rate, nominal debt issued by the US Treasury. Investment grade corportate is represented by FTSE Broad Investment-Grade (BIG) Index tracks the performance of U.S. dollar-denominated bonds issued in the U.S. investment-grade bond market.
Emerging market is represented by MSCI Emerging Markets Index, an unmanaged market-capitalization weighted index, is compiled from a composite of securities markets of 26 emerging market countries. High-yield corporate is represented by Merrill Lynch US High Yield Constrained Index: the index is an unmanaged index comprised of U.S. dollar denominated below investment grade corporate debt securities publicly issued in the U.S. domestic market with remaining maturities of less than 5 years. The FTSE Broad Investment-Grade (BIG) Index tracks the performance of U.S. dollar-denominated bonds issued in the U.S. investment-grade bond market. REITs are represented by FTSE Nareit All Equity REITs Index is a free-float adjusted, market capitalization-weighted index of U.S. equity REITs. Constituents of the index includeall tax-qualified REITs with more than 50 percent of total assets in qualifying real estate assets other than mortgages secured by real property. Floating rate loans are represented by the Credit Suisse Leveraged Loan Index, also known as the Bank Loan Index, which provides broad and comprehensive total return metrics of the universe of syndicated term loans.

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