Income Investing: Don’t Get Burned!

After eight years the one constant in this market has been that interest rates are still sitting near zero and investors are still starving for income.

For decades academic models for investing (which we despise) teach people that as you grow older you must shift more money into interest bearing investments like bonds (including bond funds) and dividend producing stocks (or stock funds). Most advisors that manage money subscribe to the same theories which only adds fuel to the fire.

So what is the fire?

The fire is the valuations that people are currently buying assets. By valuation we are referring to the price that something is actually worth versus the current market price.

Something under-valued means that it is cheaper than the actual value that it’s trading for on the market. Something over-valued means that it is more expensive than what its actually worth.

Howard Marks, one of our favorite investors, said this regarding the key to investing:

“It shouldn’t take you too long to figure out that success in investing is not a function of what you buy, it’s a function of what you pay….”

Our summary of Howard Marks would go something like this . . .

• If you overpay for something, you will likely lose money.
• If you underpay for something, you have a high likelihood (not a guarantee) of making money.

Imagine the scenario that we find ourselves in. Investors are starving for some sort of income. They are willing to pay whatever price to get it. Demand for these income products increases to a point that they are completely overvalued. Yet too many people, including too many money managers, overpay simply to have the “income” in their portfolio. This is a recipe for disaster. We’ve already seen the destruction it in the high yield bond space, and it may not be over.

So what should an investor do?

Here’s four ideas that we have been talking to our clients about over the last few years. They don’t apply to everyone as situations and goals differ:

1. Focus on growing the portfolio and building your wealth rather than focusing on “income.” If you grow your portfolio through solid investing than you can use the growth rather than the income when you need it. Don’t be forced into income products when you don’t have to be.

2. Utilize options strategies that can produce wonderful monthly income.
3. Understand the true value of the asset that you are buying. Don’t overpay! This often takes 50 plus hours of research, but its well worth it. (Not knowing the true value of an asset that you considering buying is another mistake that investors make way too often).
4. Find the distressed areas of the market where you can buy great assets for 60 – 70 cents on the dollar. There are areas of the bond market that are terrific investments right now. (These investments are often too complex for most people to take advantage of, which is where we come in!)