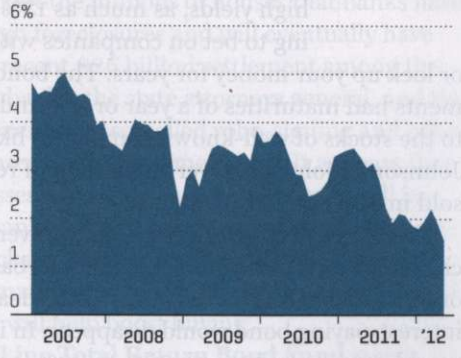
# THE QUEST FOR YIELD

With interest rates near zero, attractive dividend-paying investments are harder than ever to find. Here are four areas for income-starved investors to look.

*by Stephen Gandel*

**U.S. 10-YEAR TREASURY YIELD**
Economic turmoil has helped drive the yield on U.S. government debt to an all-time low.

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> **Rob Arnott, founder of Research Affiliates, prefers emerging-market bonds to U.S. debt. "You get much stronger credits with higher growth rates," he says.**

IF YOU WENT LOOKING for a high-yielding investment a few years ago, you might have stumbled upon something called a revertible. The Wall Street concoction, also called a reverse convertible, seemed like easy money. Revertibles offered extremely high yields, as much as 13%, without having to bet on companies with lousy credit or lock up your money for years. The bondlike investments had maturities of a year or less and were tied to the stocks of well-known companies like Apple and Johnson & Johnson. Over $15 billion of revertibles were sold in 2007 and 2008 alone.

There was, of course, a catch. In the event that the blue-chip stock on which your revertible was based fell 20% or 30%, depending on the terms of the deal, your high-interest-paying bond would disappear. In its place you would receive stock worth 20% to 30% less than what you had invested. And in late 2008 and early 2009 when the market tanked, that's exactly what happened to revertible investors. Many of them sued, claiming that brokers sold the high-yielding revertibles as near-riskless investments. Last year brokerage-industry regulator FINRA fined Wells Fargo and Santander Securities $2 million each for unsuitable sales of reverse convertibles.

Since then, the search for yield has only gotten dicier. A slow recovery, coupled with worries about Europe and a general sense that global economic growth is faltering, has caused investors to flood into the relative safety of U.S. Treasury bonds. That's driven yields on government bonds to their lowest levels in history. Factor in inflation, and these days Treasuries look like a money-losing investment.

The result is a global search for yield that has driven the price of nearly every traditional income-generating investment up, and yields down. Highly rated corporate bonds have an average yield of 3.8%, compared with an average payout of 7-7% over the past 50 years. Real estate investment trusts, a traditional favorite of yield lovers, are paying only 4.4% in dividends, vs. an average of 6.4% over the past two decades. That's not bad compared with Treasuries, whose yields dipped below 1.5% on 10-year bonds in early June. But in REITs you also have to shoulder a number of other risks, including further economic slowdowns, which could hurt rents, and higher interest rates, which would boost financing costs. High-yield bonds do still offer relatively good payouts—nearly 8% on average—but there, too, you have to trust that the economy won't get much worse, affecting the ability of less creditworthy companies to make their debt payments.

The answer for many investors may be to avoid yield investments altogether. But that's probably not an option for retirees, who often need their savings to produce some income. What's more, while you will have to take more risk in income-producing stocks and bonds than you used to, that's probably true of any investment these days. And high yielders might still be safer than investments that pay no income. Rob Arnott, who as the founder of money-management firm Research Affiliates has devised strategies that manage $100 billion, recently looked at the historical returns of investments that paid a yield vs. similar

investments that offered no income. What he found was that in times of market stress, like now, the investments that paid a yield tended to hold their value better than investments that had no income stream. With that in mind, here are four areas for yield-starved investors to explore.

## EMERGING-MARKET BONDS

**THE ECONOMIC TURMOIL** in Europe has cast a pall over sovereign debt. Investors who fear that countries such as Spain, Italy, and France won't be able to pay their debts have been dumping their bonds. In America we have the opposite problem. The flight to relative safety has driven up bond prices—and sent yields tumbling to all-time lows. But a number of well-known investors, including bond king Bill Gross of Pimco, think that situation makes little sense at a time when the U.S. government owes nearly $15 trillion, the economic recovery has slowed, and Washington seems unable to do anything about the rising debt. Eventually yields are likely to rise and prices to drop.

All this turmoil might be distracting investors from an opportunity in the debt of emerging markets such as Brazil and Indonesia. These days the nearly 150 countries generally considered to be emerging markets now collectively generate the same percentage of world GDP as the seven largest nations in the world, according to Arnott. Yet the emerging-market countries together have one-seventh the amount of debt. An emerging-market bond has traditionally been a riskier bet than a bond from a G-7 nation, but that might be changing. "You get much stronger credits with higher growth rates," says Arnott.

Still, it makes sense to spread the risk around. One way to do that is to buy the **Powershares Emerging Market Sovereign Debt** exchange-traded fund, which holds a basket of bonds from different emerging countries. It pays a dividend of nearly 5.2%. Another way to play emerging markets is to buy into the **Pimco All-Asset Fund,** which is managed by Arnott and has a ***6.6%*** yield. The fund has about a quarter of its assets in emerging markets. On top of that, Arnott has about 15% of his fund in floating-rate loans and high-yield bonds, two areas that he thinks will do well even if interest rates rise.

## MORTGAGE BONDS

**HERE'S A SURPRISE**: Mortgage bonds, particularly those backed by Alt-A, subprime, jumbo, and other types of home loans that were at the center of the financial crisis, have held up better during the recent market turmoil than most other investments. Why would that be? First of all, mortgage bonds are a U.S.-centric investment at a time when most of the worry is coming from Europe. Second, the bonds are attracting a growing number of bargain-hunting investors. Goldman Sachs, hedge fund Cerberus Capital, and others have recently launched funds dedicated to buying mortgage bonds. Third, while the housing market seems to be improving, that doesn't yet seem to be reflected in the price of mortgage bonds.

Recently, on average, nonagency mortgage bonds—pools of loans not backed by the giant government-controlled mortgage guarantors Fannie Mae and Freddie Mac—were trading anywhere from 25% to 60% less than their original price, depending on the credit quality of the borrowers and the riskiness of the loans. At those discounted prices, though, even the highest-rated bonds are factoring in that as many as 25% of all borrowers will end up in default and that home prices will fall an additional 20%. But the default rate for the loans is actually much lower—more like 10%. And some prominent investors, including Warren Buffett, have recently said they think home values have bottomed. "Even if half the homeowners default and these homes sell for only 50% of the loan amount, nonagency Alt-A mortgage securities are attractive at today's prices," says Philip Barach, the president of DoubleLine Capital. Right now, adjusting for all expected loan losses and assuming flat housing prices, nonagency mortgage bonds are yielding about 7%. But if conditions in the housing market improve, the bonds could end up paying much more.

Hanging over the mortgage market has been the concern that the government will push through more modifications and force investors to take losses. There is also concern about the millions of houses that banks have acquired through foreclosures and will eventually have to sell. But the recent $26 billion settlement among the nation's largest banks, the state attorneys general, and the federal government over so-called robo-signing and other foreclosure abuses is adding some clarity. It appears that much of the losses from mortgage write-downs will be forced on the banks, though investors will certainly have to take some licks as well. And while there will be more houses on the market, the new influx of hedge fund and other investors will help boost buying.

The **DoubleLine Total Return Bond Fund** is one of the best ways for a regular investor to play the mortgage bond rebound. The fund is co-managed by Jeffrey Gundlach, one of the few mortgage investors to emerge from the financial crisis with an enviable record. Dur-

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ing the worst of the crisis from 2007 to 2009, Gundlach returned *9%* a year while managing a fund for Trust Co. of the West. (For more on the colorful Gundlach, see "25 Picks From Great Investors" on fortune.com.) He's done even better since then. DoubleLine, which was launched in April 2010, has annualized returns of 14.3%. And Gundlach has been able to produce high returns without too much exposure to the worst of the mortgage lot. Just 7% of the fund is invested in bonds tied to subprime borrowers. What's more, despite sticking with higher-quality issues, the fund still has a yield of slightly more than ***6%.***

## BLUE-CHIP EUROPEAN STOCKS

Dividend-paying stocks typically make up a substantial portion of the portfolio of income investors. The problem is that, as with most bonds, stocks aren't generating very much income right now. The average dividend for a company in the S&P 500 is just 2%. In Europe, though, the debt crisis and worries over the euro could be creating an opportunity to buy European large-cap stocks with high dividends on the cheap. (For more on European stocks, see "Europe Needs a Herro") Certainly, any slowdown in Europe due to falling government spending will hurt the earnings of companies on the continent. But, as in the U.S., many of Europe's largest companies are multinationals and are getting an increasing portion of their earnings in faster-growing developing nations.

A good example is **Vodafone.** While Vodafone is the largest wireless service provider in Europe, it's also the second-largest wireless service provider in the world, after China Mobile, with 252 million customers in 66 countries. The company, based in the U.K., has a dividend yield of 5.6% from its internal businesses. But Vodafone also owns 45% of Verizon Wireless—a joint venture with U.S.-based Verizon. Verizon Wireless has a net cash position and is growing rapidly. Last year the joint venture paid Vodafone shareholders a special dividend, and Verizon has hinted that it will do that again next year. Based on last year's payout, Vodafone's combined yield could top 8%. While the company's bottom line could suffer from Europe's woes, Vodafone's own dividend should be safe. The company currently pays out only 60% of its earnings as dividend, meaning it has plenty of cushion.

Another European stock with a large, seemingly safe dividend is **Électricite de France.** The French government owns 84% of the utility, so it carries the country's credit risk. But Jason Brady of the $450 million Thornburg Strategic Income Fund thinks the government ownership is a reason to like the stock as well. Since the French government collects the majority of the dividend, he says it is likely that politicians will do what they can to keep the company paying its 7-6% yield. "You are aligned with the idea that the French government needs more dough," says Brady, who has been hunting European investments looking for yield and says Electricite de France is one of his top picks.

## MASTER LIMITED PARTNERSHIPS

New drilling techniques, such as hydraulic fracturing, or fracking, have unlocked huge oil and gas reserves in the U.S. in recent years. Since 2005, production of natural gas in the US. has increased 28%. That, in turn, has caused prices to plummet, making the boom a mixed blessing for energy producers. Master limited partnerships, though, are benefiting from the growing demand for infrastructure. MLPs are similar to REITs. They trade like stocks, but are required by law to pay out nearly all of their income in dividends. Most MLPs are in the business of providing the equipment needed to either drill or transport oil, gas, and other resources. They do carry some commodity price risk. What's more, if the economy continues to slow, it's likely we would use less natural gas and other commodities, which is why MLP stocks have been falling recently—and their yields rising.

One big winner in the infrastructure boom has been **Kinder Morgan Energy Partners,** the largest pipeline owner in the U.S. It ships everything from natural gas to jet fuel. Kinder s shares have recently fallen 15%, to $76. At that price, the shares have a dividend of 6.3%. And the dividend is likely to increase. The recent acquisition of rival El Paso is expected to save the combined company $350 million a year. Kinder executives have said they expect to boost shareholder payouts 12.5% a year through 2015.

MLPs have an odd tax structure that requires investors to file an additional form with the government. But in the past two years a number of MLP funds have sprung up that make it easier to own MLPs. The **Steelpath Income Fund** is one of the biggest, with more than $400 million under management. Nearly 60% of the fund is invested in companies that transport oil and gas, and it has a dividend yield of 7-5%. In a low-yield world, that's hard to beat.

Fonte: Fortune, Amsterdan, v. 166, n. 1, p. 48-52, 2 July 2012.