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# Danger lurks in a yield-starved world

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The marketing antennae of the investment industry are finely tuned to the buying impulses of the investing public.

In the late 1990s, growth was the buzzword — you couldn't read the financial media without being hyped on technology and Internet stocks and funds. In today's yield-starved world, the sales focus is on high income or enhanced yield strategies.

Unfortunately, just as a dehydrated man can gorge on water, the prospect of increased income is so alluring that it causes many investors to take on more risk than they can really handle. Contributing to this is the fact that the risks of these strategies are frequently glossed over.

Take high-yield bonds. There has been an explosion in the number of funds offering these bonds. High-yield ETFs in Canada have attracted hundreds of millions of dollars over the past few years. In the United States, the number runs into many billions. Who can resist yields of 7% to 8% compared to the paltry 2% to 3% of investment-grade bonds?

But investors need to keep a little background on these bonds in mind. Several decades ago, they were known as junk bonds — a term the industry's marketing people are happy to see recede into the past. To be fair, this spectrum of the bond market has grown tremendously in the number and variety of issuers, size and liquidity and is now a valid asset class. Nevertheless, credit rating agencies classify high-yield bonds as "speculative grade" because of their high default risk. In other words, companies that issue these bonds frequently go bust.

As any serious-minded investment professional will tell you, the expected return to be earned from speculative-grade bonds is not their current yield, but rather their yield less a credit loss for defaults net of recoveries. Moody's most recent Annual Default Study estimated that the annual credit loss for U.S. speculative-grade bonds from 1982–2011 averaged a whopping 2.74% a year. Deduct this cost from today's 7% or so yield and suddenly the number is not so mouth-watering.

Why are these credit losses so easy to overlook? It's because they don't occur evenly — credit losses soar in recessions and recede in recoveries so they are easy to disregard today. If you are heavily over-weighted in high-yield bonds today, you will learn all about this peril in the next recession. One very savvy investment manager I know predicts that this will be the next "great train wreck" for the investing public.

There are lots of other asset classes that are being touted for their dependable income. Canadian real estate investment trusts or REITs are one such class. I have been a proponent of including REITs in portfolios for nearly two decades — enhanced diversification and tax-advantaged yield are compelling reasons. However, I am also well aware REITs are as volatile as equities and capable of stunning price declines. In fact, they lost more than 50% in 2007-2009. Investors have to recognize that this dependable income is attached to undependable prices. Look hard and you might even see this risk in the fine print.

The same reasoning applies to high-dividend-yield stocks. In and of itself, investing in such stocks is a valid strategy. It is a form of value investing similar to low price-to-earnings or low price-to-book strategies. There is a solid theoretical foundation supporting the view that value strategies can earn a premium to the broad stock market over the long term. However, the risk of high-dividend-yield strategies is similar to that of the overall market. The Dow Jones Canada Select Dividend index suffered the same punishing losses of more than 40% in 2007-2009. Few people were happily counting their dividends while awash in that sea of red ink.

All of these asset classes — high-yield bonds, REITs and high-dividend-yield stocks — can have a valid role in many portfolios. However, that role should arise from its contribution to the return and risk parameters of an overall portfolio that matches the risk profile of the investor. It should not be determined by the quest for higher income or enhanced yield.

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