# CLEARPOINT

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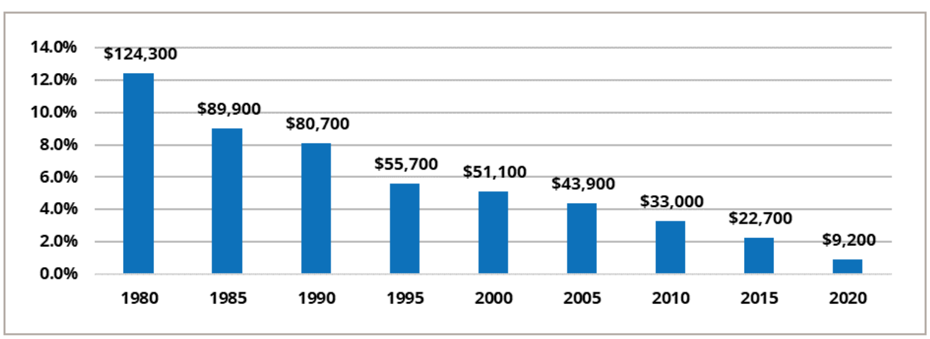
TOM SEAY, SENIOR MANAGING DIRECTOR, RESEARCH

## WHERE'S THE INCOME?

BY TOM SEAY, SENIOR MANAGING DIRECTOR, RESEARCH

In the not-too-distant past, fixed income investments provided sufficient yields, and one could invest in U.S. Treasury 10-year bonds and maintain a comfortable lifestyle.  But, as the following chart illustrates, the decline in yields has made this strategy challenging.  For most investors, being able to meet one's living standards by buying U.S. Treasury bonds alone are gone; but, on the other hand, meeting living standards does not require 100% investing in stocks, either.  Seeking income in today's environment necessitates new strategies that not only meets one's investment objective but are within one's investing comfort zone.  Sources of income as diverse as coupon clipping to music royalty streams can be accessed in both public and private markets.

**ANNUAL INCOME FROM $1 MILLION INVESTED IN 10-YEAR U.S. TREASURY BOND**




Source:  Bloomberg; Clearstead.

## CLEARSTEAD CONTINUES TO BOLSTER TEAM WITH NEW TALENT

We are pleased to announce that we have added talent to the Research and Investment Management and Private Client teams with John Rodriguez, Joe Elbert, and Sheena Paulic, respectively.

John Rodriguez joined Clearstead as an Associate Portfolio Manager.  John previously worked with Sequoia Financial Services as Head of Trading and Reporting and as a Trader/Fixed Income Manager at Fairport Asset Management.  He has most recently been in the real estate and mortgage industry.  John has a Bachelor's degree from the University of Dayton, majoring in Finance and Business Economics.

Joe Elbert joined Clearstead as a Client Planning Associate.  Joe has a Bachelor's degree from Ashland University, majoring in Accounting and a Masters of Accountancy focusing on tax from Cleveland State University.  Prior to joining Clearstead, Joe was a Manager at Gannon Real Estate Management and has additional tax experience from J.A. Haney and Company and Zinner & Company.

Sheena Paulic joined Clearstead as a Sr. Client Service Associate.  Sheena brings nearly 15 years of related experience, most recently as a Client Service Specialist at MAI Capital Management.

These changes underscore the firm's commitment to building its investment consulting practice, promoting the next generation of leadership, and maintaining a rigorous investment process.

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## SAFE?

Safe investments have taken a beating in 2022.[1]

- As inflation soared and the Federal Reserve aggressively hiked the Fed Funds rate, strategies like ultra-short funds surprised investors with losses. The Bloomberg 1-3 Year Government/Credit index has a -4.3% return year-to-date as of November 21st.
- The Bloomberg U.S. Treasury Inflation-Protected Securities (TIPS) Index is down 12.5%.
- The Bloomberg U.S. Treasury 20+ Year index is down 31.5%.
- The bellwether of investment grade fixed income investing performance measurement—Bloomberg U.S. Aggregate Index—has produced a -13.7% year-to-date return following a negative return in 2021.

The main culprit behind the abysmal returns is insufficient coupon income compensating for the price decline as interest rates rose.

## WHAT SHOULD I DO?

Fixed income analysis, at its simplest, is a mathematical exercise and involves three components:

1. **Coupon** – the annual income an investor can expect to receive while holding a particular bond.
2. **Maturity** – the date when a bond's principal (initial investment) is repaid. In general, the longer the maturity, the more sensitive the bond's price is to changes in interest rates. A bond's duration (or more accurately, its modified duration) is the metric used to measure price sensitivity due to changes in interest rates. Modified duration measures the price change in a bond given a 1% change in interest rates.
3. **Credit Risk** – the possibility of loss due to a borrower's defaulting on a loan or not meeting contractual obligations. The metric used to measure credit risk is default rate, which is the percentage of all outstanding loans that a lender has written off as unpaid after a prolonged period of missed payments.

To the right is an exhibit showing the relative changes in total return—the interaction of the above components—under different interest rate scenarios for three- and five-year US Treasuries and High Yield Bonds.

| HYPOTHETICAL ANALYSIS | TREASURY | TREASURY | HIGH YIELD |
|---|---|---|---|
| Maturity | 3-Year | 5-Year | 5-Year |
| Coupon | 4.00% | 4.25% | 9.00% |
| Modified Duration | 2.75 | 4.50 | 4.00 |
| Default Rate[1] | 0.00% | 0.00% | -3.59% |
| **TOTAL RETURN** | | | |
| **No Change in Interest Rates** | | | |
| Coupon Income | 4.00% | 4.25% | 9.00% |
| Price Change | 0.00% | 0.00% | 0.00% |
| Default Rate[1] | 0.00% | 0.00% | -3.59% |
| Total Return | 4.00% | 4.25% | 5.41% |
| **Interest Rates Increase 1%** | | | |
| Coupon Income | 4.00% | 4.25% | 9.00% |
| Price Change | -2.75% | -4.50% | -4.00% |
| Default Rate[1] | 0.00% | 0.00% | -3.59% |
| Total Return | 1.25% | -0.25% | 1.41% |
| **Interest Rates Decrease 1%** | | | |
| Coupon Income | 4.00% | 4.25% | 9.00% |
| Price Change | 2.75% | 4.50% | 4.00% |
| Default Rate[1] | 0.00% | 0.00% | -3.59% |
| Total Return | 6.75% | 8.75% | 9.41% |

[1] J.P.Morgan Asset Management Guide to the Markets as of 9/30/2022, long-run average.

The total return information provided in the chart is hypothetical and NOT based on any index, actual or model performance. The total return information is simply a mathematical calculation based on the data shown. For example, using the 3-Year Treasury column as an example, the Total Return shown under "Interest Rates Increase 1%" is calculated by subtracting the expected Price Change (-2.75%) from the Coupon Income (4.00%) which equals 1.25%. Clearstead is using this chart to illustrate the hypothetical 1-Year Total Return of different types of bonds as a result of interest rate changes. The total return information is gross of any fees since Investors cannot invest in the hypothetical bonds shown; however, if a client were able to invest in the bond shown, and a client were charged a Clearstead advisory fee the total return would be lower than the return shown. Clearstead is making no representation that the performance information can or will be achieved and should not be construed as a recommendation or advertisement.

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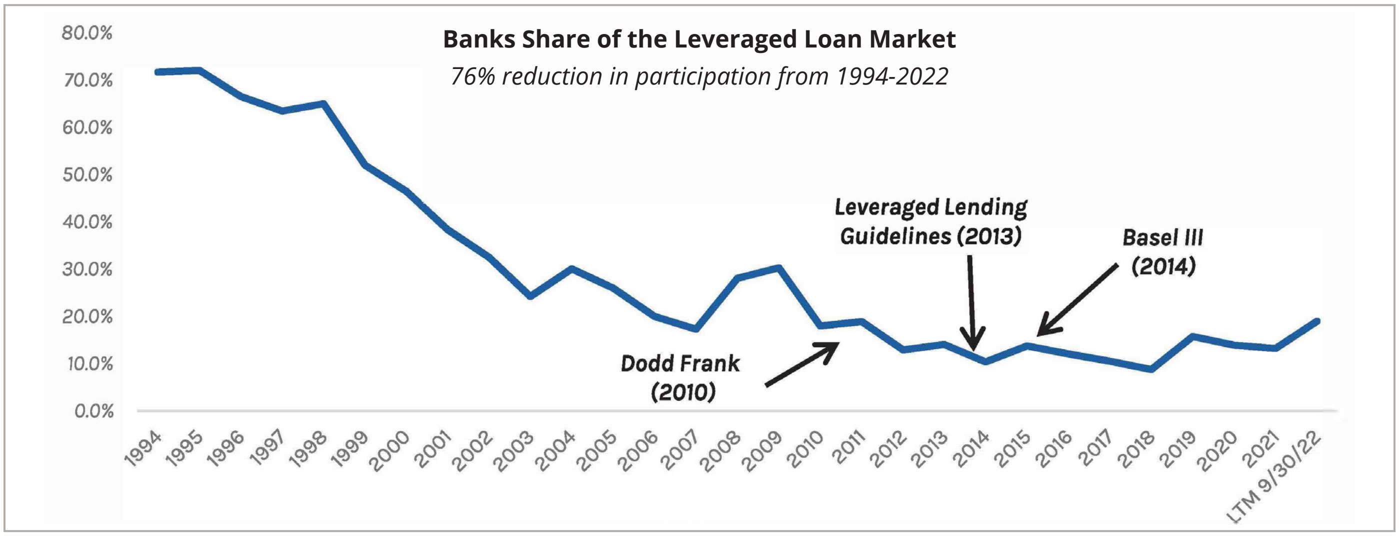
Because high yield outperforms in all scenarios, one might decide to invest all in high yield and stop. But high yield investments have other factors that affect price changes (e.g., correlation to stock market activity); and as such, high yield bonds can be more volatile than U.S. Treasury securities. However, for long-term investors who venture through the ups and downs and fully capture the high yield's enhanced income earning potential, high yield investments do warrant consideration in portfolios.

**Private Credit**

As banks have reduced their lending activities to middle-market companies (between $50 million and $1 billion in annual revenue), private market lenders have stepped in to fill the void and provide capital to borrowers shut out from traditional financing sources (see Chart *Banks Continue to Retrench from Middle Market Direct Lending*). There are over 200,000 middle-market companies in the United States alone: a vast market that accounts for one-third of U.S. private-sector GDP and employment—a sum that would make it the world's fifth-largest economy.[2]

**BANKS CONTINUE TO RETRENCH FROM MIDDLE MARKET DIRECT LENDING**




Source: Ares Management, S&P LCD Q3-22 Leveraged Lending Review, as of September 30, 2022.

Investors can participate in the new funding source for middle market borrowers by direct lending, a subset of private debt, which most commonly refers to first lien loans made to middle-market companies. Direct lending loans typically are floating-rate securities with average maturities around five years but are less liquid than publicly traded securities. Although an investor has less liquidity, direct lending loans generally have higher yields than public market securities and, due to the floating rate structure, the price is less sensitive to changes in interest rates. Another benefit to direct lending investments is that their performance has not historically been highly correlated with public debt and equity markets, making them a great diversifier in a client's portfolio. Investors can participate in the burgeoning direct lending market by both public market, SEC registered 40 act interval funds and private market, limited partnership funds.

**Real Assets**

Investing in real assets—such as real estate, infrastructure, royalties—may be appealing to investors due to their high current income, inflation protection, low correlation to equity markets, and, in some cases, favorable tax treatment. These investments have assets that historically provided a strong and consistent income stream derived from their fee-for-use nature. Although the income may not be as precisely known as a bond's coupon payment, most of the annual income generated from real assets is distributed to investors. Moreover, these steady income streams may help cushion total returns in times of volatility, potentially providing for added downside risk management.

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**Equity Income**

One last suggestion is to look consider dividend-paying companies. These typically are large, well-established corporations with mature revenue and earnings. Most dividend-paying companies also have a well-established commitment to paying shareholders dividends with a targeted annual dividend payout rate. Like real asset investments, equity income strategies' steady income streams may help cushion total returns in times of volatility, potentially providing downside protection.

## SUMMARY

The forty-year bull market in bonds lulled investors into complacency as they failed to appreciate the importance of income to achieve their financial goals and protect portfolios during difficult markets. We began 2021 with the 10-year U.S. Treasury yielding 1.51%, which means your projected return over the next ten years will be a whopping 1.51%. As for protecting the total portfolio, fixed income has failed miserably in 2022. As of November 30$^{th}$, year-to-date the S&P 500 index is down 13.1% and the Bloomberg Aggregate index is down 12.6%. Where is the protection?

Similar to the fixed income market, over the past ten years income has played second fiddle while capital gains drove equity market returns. Although dividends played a supportive role, investing only in non-dividend paying stocks would have been a superior strategy.

Should the Federal Reserve's longer run economic projections be realized, the economic environment will be one of slow growth (1.8% Real GDP), low inflation (2% PCE Inflation) and low interest rates (2.5% Federal funds rate).[3] There is no doubt that there will be significant winners in such an economic environment. But, when interest rates are close to the historical lows witnessed in the past forty years, traditional fixed income investments (U.S. Treasury and investment grade corporate bonds) provide minimal income and little protective cushion. When capital gains are hard to achieve, dividend-paying stocks provide a way for investors to get paid during rocky market periods. Investors have a multitude of options to enhance the income producing characteristics in their portfolios, by broadening our horizons and creatively building portfolios that produce more income, we can improve our chances of achieving our financial goals.

**Sources:**
(1) Bloomberg.
(2) Oaktree, The National Center for the Middle Market, as of May 2021.
(3) Federal Reserve - Federal Open Market Committee – as of September 21, 2022.



### MARKET BENCHMARK RETURNS

| November 30, 2022 | | 1M | 3M | 12M | YTD |
|---|---|---|---|---|---|
| US Large Cap | S&P 500 | 5.6% | 3.6% | -9.2% | -13.1% |
| US Small Cap | Russell 2000 | 2.3% | 2.7% | -13.0% | -14.9% |
| Developed Intl | MSCI EAFE | 11.3% | 6.3% | -10.1% | -14.5% |
| Emerging Intl | MSCI Em Mkt | 14.8% | -1.8% | -17.4% | -19.0% |
| Real Estate | NAREIT | 6.0% | -4.4% | -13.8% | -21.1% |
| Core Fixed | BarCap Agg | 3.7% | -2.1% | -12.8% | -12.6% |
| Short Fixed | BarCap 1-3Yr | 0.8% | -0.5% | -4.0% | -3.9% |
| Long Fixed | BarCap LT G/C | 8.1% | -4.6% | -26.7% | -26.1% |
| Corp Debt | BarCap Corp | 5.0% | -1.4% | -15.0% | -14.9% |

Source: Bloomberg

The performance data shown represents past performance. Past performance is not indicative of future results. Current performance data may be lower or higher than the performance data presented.