INCOME INVESTING IN UNCERTAIN MARKETS

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Why flexible income strategies provide a bedrock for income-oriented investors

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Investors seeking reliable income streams often find themselves navigating turbulent market conditions, particularly when interest rates fluctuate. In such environments, the strategic combination of high-quality fixed income instruments and dividend-growing equities emerges as a beacon of resilience and consistent returns.

It is important to understand the underlying merits of these investments and why they should be considered a bedrock of an income-oriented investor's portfolio. Historically these two asset classes have not only shown the ability to generate a high level of income but also to provide ballast to investor portfolios during periods of market instability. This article delves into the resilient characteristics of these asset classes, highlighting their ability to weather market storms and provide investors with sustainable cash flows, even amid market volatility. While these types of portfolios are not full portfolio solutions, they can play a valuable role when combined with other investments.

Resilience in rate-cutting scenarios

Periods of falling rates are generally challenging for capital markets investors, especially those who rely on their portfolios to maintain their lifestyles. Such periods have been characterized by falling rates necessitated by slowing growth and weak economic data. In these periods it is tough to overemphasize how valuable diversification and a focus on high-quality assets can be for providing continued income.

High-quality fixed income and dividend-growing equities are two asset classes that have not only shown resilience but also consistently positive returns during similar scenarios.

Companies that have the ability and dedication to growing their dividends over time tend to be very high-quality companies with sustainable, growing, and highly durable cash flows. As a result, their ability to maintain high payouts during periods of shrinking yields comes at a premium.

This contrasts with high dividend-paying companies with only recent or more short-term records of paying dividends. These companies tend already to be allocating a high portion of cash flows to their dividends, calling into question their ability to continue doing so during falling-rate periods that may lead to dividend cuts and/or periods of poor equity performance.

Notice in the chart below that the S&P Dividend Aristocrat Index generated strong returns relative to both the broad S&P 500 and S&P High Dividend indices during periods of falling rates.

Annualized equity returns following pauses in Fed rate-hiking cycles

	1-year return			3-year return			5-year return		
Federal fund rate hiking cycle	S&P 500	S&P High Dividend	S&P Dividend Aristocrat	S&P 500	S&P High Dividend	S&P Dividend Aristocrat	S&P 500	S&P High Dividend	S&P Dividend Aristocrat
2/4/1994 – 2/1/1995	39.2%	26.8%	32.4%	30.5%	22.8%	29.1%	26.8%	14.4%	16.7%
6/30/1999 – 5/16/2000	-11.3%	27.3%	18.2%	-12.4%	7.9%	5.6%	-3.0%	12.9%	9.9%
6/30/2004 – 6/29/2006	20.3%	22.2%	17.0%	-8.0%	-14.7%	-4.9%	2.7%	2.4%	6.3%
12/16/2015 – 12/19/2018	30.4%	18.6%	27.7%	24.7%	10.9%	19.5%	15.7%	7.6%	12.2%

Source: Bloomberg, as of 12/19/23. Based on monthly returns rounded to the nearest month-end.

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Annualized fixed income returns following pauses in Fed rate-hiking cycles

	1-year return			3-year return			5-year return		
Federal fund rate hiking rate	S&P US Treasury Bill 0–3 Month Index	Bloomberg Municipal Bond Index	Bloomberg Aggregate Bond Index	S&P US Treasury Bill 0-3 Month Index	Bloomberg Municipal Bond Index	Bloomberg Aggregate Bond Index	S&P US Treasury Bill 0-3 Month Index	Bloomberg Municipal Bond Index	Bloomberg Aggregate Bond Index
2/4/1994 – 2/1/1995	5.6%	15.1%	17.1%	5.3%	9.6%	10.2%	5.2%	6.2%	7.3%
6/30/1999 – 5/16/2000	6.0%	12.8%	13.7%	3.4%	9.8%	11.1%	2.6%	7.4%	7.8%
6/30/2004 – 6/29/2006	5.1%	4.9%	6.5%	3.0%	3.9%	6.6%	1.8%	5.0%	6.6%
12/16/2015 – 12/19/2018	2.2%	7.9%	8.8%	1.0%	4.8%	4.9%	1.9%	2.3%	1.0%

Source: Bloomberg, as of 12/19/23. Based on monthly returns rounded to the nearest month-end.

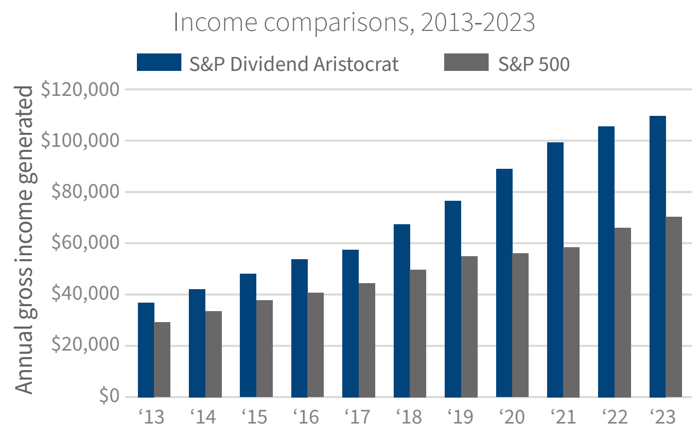
In a similar fashion, high-quality fixed income with duration allows investors to benefit from already having locked in yields for a period when markets offer less. In times of falling rates, bonds that were previously purchased at higher yields can enjoy immediate principal gains while the rest of the portfolio may struggle. This allows not only for a sustained level of income generation, but also provides diversification benefits.

High (and growing) levels of income generation

The investment case for holding equities that grow their dividends has been tested over time. Dividend-growing stocks have shown that they provide not only mitigation in turbulent markets, due in part to the dividend being paid, but also the potential to increase their income over time. The chart below details the income from a $1 million investment

Not only do dividend growers provide income growth

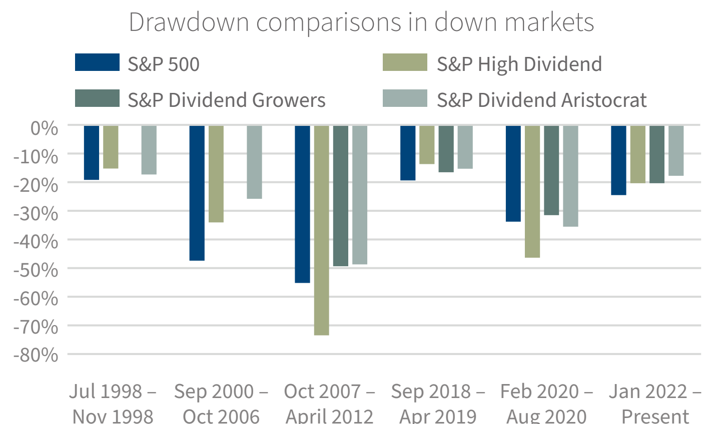
Income comparisons, 2013-2023



Source: Bloomberg, as of 3/31/24. Income shown is gross of fees on a $1 million investment made on Dec. 31, 2010, with all dividends reinvested.

They mitigate losses on the downside

Drawdown comparisons in down markets



Source: Bloomberg, as of 3/31/24. The S&P Dividend Growers Index was launched June 1, 2021 with hypothetical, back-tested, not actual performance, data that goes back to March 17, 2006.

in the S&P Dividend Aristocrat Index discussed previously. As this index tends to consist of lower-risk companies it won't generate the return of the S&P 500 Index during highly rising markets, but you will note the significant outpacing of the income generated by this account regardless of the market environment.

These characteristics allow investors to fund their needs through the dividend income of the portfolio rather than by tapping the principal balance. This is highly desirable for investors who need to either generate or replace income as their needs evolve.

Higher quality for less risk – especially with flexible asset allocation

Tactical asset allocation managed by professionals can provide significant benefits to retail investors. Investment professionals have access to extensive market research, data analysis, and sophisticated tools that allow them to identify market trends, opportunities, and risks more effectively. This enables them to make timely and informed decisions to adjust portfolio allocations based on changing market conditions, economic indicators, and geopolitical events.

Professional investors can also take advantage of market inefficiencies by shifting into available asset classes. This can be beneficial for returns, and it also allows a strategy to manage risks in portfolios during changing market conditions. A great example of this involves noting the different return characteristics of available asset classes as conditions change, which can help to preserve investors' portfolios during periods of market volatility or downturns. Strategies that focus on positioning investors in these conditions can prevent them from leaving an investment at the bottom, which can result in better investment outcomes.

Conclusion

As we navigate through various market cycles, it becomes clear that a steadfast commitment to a well-diversified portfolio comprising high-quality fixed income and dividend-growing equities can be instrumental in striving for long-term financial success. Despite the challenges posed by rate-hiking cycles or market downturns, the resilience and income-generating potential of these assets shine through, potentially offering investors a pathway to financial stability and growth. By staying focused on the long-term horizon and leveraging tactical asset allocation strategies, investors can seek to harness the full potential of these assets in their pursuit of a robust and sustainable income stream over time.

Risks associated with Fixed Income investing:

Many investors consider bonds to be "risk free" investment vehicles. Historically, bonds have indeed provided less volatility and less risk of loss of capital than has equity investing. However, there are many factors that may affect the risk and return profile of a fixed-income portfolio. The two most prominent factors are interest-rate movements and the creditworthiness of the bond issuer. Bonds issued by the U.S. government have significantly less risk of default than those issued by corporations and municipalities. However, the overall return on government bonds tends to be less than these other types of fixed-income securities. Investors should pay careful attention to the types of fixed-income securities that comprise their portfolio and remember that, as with all investments, there is the risk of the loss of capital.

This material may include forward-looking statements. These statements are not historical facts, but instead represent only beliefs regarding future events, many of which, by their nature, are inherently uncertain. You should not place undue reliance on forward-looking statements as it is possible that actual results and financial conditions may differ, possibly materially, from the anticipated results and financial conditions indicated in these forward-looking statements. There are uncertainties, unknown risks, and other factors that may cause actual results, levels of activity, performance, or achievements to be materially different from any future results, levels of activity, performance, or achievements expressed or implied by these statements.

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The risks associated with Equity Income investing are based upon the identification of companies that possess both moderate growth rates as well as higher than average and consistent dividend distributions. There are risks associated with dividend investing, including that dividend-issuing companies may choose not to pay a dividend, may not have the ability to pay, or the dividend may be less than what is anticipated. Dividends are not guaranteed and must be authorized by the company's board of directors.

Dividend-issuing companies are subject to interest-rate risk. High dividends can sometimes signal that a company is in distress. Historically, dividend yields have been relatively constant and therefore have created a cushion for investors when stock prices have declined. However, as with all equity investing, there is the risk that a company will not achieve its expected earnings results, or that an unexpected change in the market or within the company will occur, both of which may adversely affect investment results. The biggest risk of equity investing is that returns can fluctuate and investors can lose money.

Past performance: There is no guarantee that the investment objectives will be achieved. Moreover, the past performance is not a guarantee or indicator of future results.

Benchmarks: Any indices and other financial benchmarks shown are provided for illustrative purposes only, are unmanaged, reflect reinvestment of income and dividends and do not reflect the impact of advisory fees. Investors cannot invest directly in an index. Comparisons to indexes have limitations because indexes have volatility and other material characteristics that may differ from a particular hedge fund. For example, a hedge fund may typically hold substantially fewer securities than are contained in an index.

Definitions

Ballast, in finance, can refer to characteristics, factors or trading strategies that mitigate volatility or provide stability to a security or group of securities.

Dividend payers are the companies that distribute a portion of their profits to shareholders in the form of a dividend.

Duration incorporates a bond's yield, coupon, final maturity, and call features into one number, expressed in years, that indicates how price-sensitive a bond or portfolio is to changes in interest rates. Bonds with higher durations carry more risk and have higher price volatility than bonds with lower durations.

Indices

The Bloomberg U.S. Aggregate Bond Index is composed of the total U.S. investment-grade bond market. The market-weighted index includes Treasuries, agencies, commercial mortgage-backed securities (CMBS), asset-backed securities (ABS) and investment-grade corporates.

The Bloomberg Municipal Bond Index is a rules-based, market-value-weighted index engineered for the long-term tax-exempt bond market.

The S&P U.S. Treasury Bill 0-3 Month Index is designed to measure the performance of U.S. Treasury bills maturing in 0 to 3 months.

The S&P 500 Index measures change in stock market conditions based on the average performance of 500 widely held common stocks. It is a market-weighted index calculated on a total return basis with dividend reinvested. The S&P 500 represents approximately 80% of the investable U.S. equity market.

The S&P 500 Dividend Aristocrats® Index measures the performance of S&P 500 companies that have increased dividends every year for the last 25 consecutive years. The Index treats each constituent as a distinct investment opportunity without regard to its size by equally weighting each company.

The S&P U.S. Dividend Growers Index is designed to measure the performance of U.S. companies that have followed a policy of consistently increasing dividends every year for at least 10 consecutive years. The index excludes the top 25% highest-yielding eligible companies from the index.

The S&P 500 High Dividend Index serves as a benchmark for income-seeking equity investors. The index is designed to measure the performance of 80 high yield companies within the S&P 500 and is equally weighted to best represent the performance of this group, regardless of constituent size.

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About Eagle Asset Management

Eagle Asset Management provides a broad array of fundamental equity and fixed-income strategies designed to meet the long-term goals of institutional and individual investors. Eagle's multiple independent investment teams have the autonomy to pursue investment decisions guided by their individual philosophies and strategies.

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