The Almost-Lost Concept of Investing for Income

For the past 20 years or so, investing has changed perspective to investing for growth. An investor became accustomed to putting in $100 and expecting to take out $200. The dot.com boom and the relative bull market we've had for the past two decades has taught new investors more about investing for growth than investing for income.

As the financial markets rise and fall, one of the oldest principles of investing has become clouded—that of investing for income. The concept of investing for income is based on putting together a variety of assets such as stocks, bonds, mutual funds, real estate, and other investments that generate the highest possible annual income at an acceptable level of risk. This income is then used to provide a means for the investor to pay their living expenses and recreation, or it may become a component of total return for the portfolio if not needed for current income.

The history of income investing goes back to the days when pensions were the norm. The man worked and was provided for through a pension, and the woman was regarded in somewhat of a helpless capacity. Upon the husband's death, the neighborhood bank had a trust department who would take the life insurance proceeds and create a portfolio of stocks, bonds, and other assets that would generate a monthly income so that the widow could pay her bills to maintain a certain lifestyle. This kind of portfolio had to maintain a high degree of safety and security.

Today, women are as likely to have a career as a man, and 401(k) plans have replaced pensions. This is one reason growth-oriented portfolios have pushed aside income –producing portfolios. Many investors evaluating their retirement have determined there to be a shortfall in the value of their retirement plans, especially after the effects of the 2008-2009 market decline.

Investing for income generally involves three major areas. The first is dividend paying stock, the second is bonds, and the third is real estate.

Dividend paying stock includes both common and preferred stock, as well as mutual funds and Exchange Traded Funds (ETF's) invested in such stock. The companies represented by these stocks return a portion of their profits back to their shareholders based on the number of shares owned. Preferred stock is a hybrid security that represents debt from the issuing company and is usually in a higher priority than common stock with respect to dividends and repayment. Preferred stock may also be rated by one or more of the major credit-rating agencies (Standard and Poor, Moody, etc.) in the same manner that bonds are rated.

Bonds are widely ranging from government and agency bonds, to municipal and corporate bonds. Bonds represent debt obligations from the issuer and their promise to pay along with a specified interest rate, which is known as a coupon. Bonds may be purchased individually, or in a"basket" such as in mutual funds, Exchange Traded Funds, or Unit

Investment Trusts (UIT's). With any bond, you are lending funds to the institution in exchange for their promise to repay you at maturity and a stated rate of interest for the life of the obligation.

Real estate may be purchased individually or through instruments known as Real Estate Investment Trusts (REIT's). The individually owned real estate provides the owner with rental income. This requires direct property management whereas the REIT allows a real estate investor to take a more passive role while receiving income from the investment.

It should be noted that there are many variations of each type of income category, and these asset categories may be found in a wide variety of investment options. As with any investment, income investments have their own unique characteristics and risks. An investor should carefully discuss these investments with their advisor and understand the effect that interest rates, credit quality, and other factors will have.

Investing for income should be part of a well-diversified portfolio. Individual bonds and bond funds have unique characteristics that should be understood with respect to duration, maturity, and yield pricing. Most bonds are sensitive to changes in interest rates and other factors. Because of this, the income investor should discuss their objectives and needs with a competent advisor who can help structure a suitable portfolio that minimizes and addresses these risk factors.

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