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MONTHLY

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INCOME VS. TOTAL RETURN

Introduction

Often, investors express a desire for their portfolios to generate sufficient amounts of cash income to fund a certain level of spending. This is generally the case as they move from employment and earning into the retirement and non-earning phase of life. A principle of investing maintains that people should focus on total return instead of concerning themselves solely with income as the appropriate investment objective. This month, we will look at some of the relevant issues of this "income versus return" debate.

Example

Take a couple, recently retired, who had been earning enough each year to sustain annual spending of $300,000. In retirement, perhaps they anticipate somewhat lower expenses, so they will need $250,000 each year. Given their investment portfolio's value of $5 million, if they rely solely on it for spending money, they calculate that they'll "need" 5% income generated annually. This requirement doesn't even take inflation into account, which is an important consideration because of its detrimental effect on a portfolio's real value over time.

Figure 1 shows the income yields produced by broad US stock and bond asset classes over time. Although it is not the case today, historically bonds have carried substantially higher income yields – from their interest payments – than have stocks. So, it is understandable why this "income hungry" couple would consider skewing their portfolio toward bond investments for income.

The Problem

Why is it that approaching portfolio construction with income as the sole objective is not ideal? The answer has

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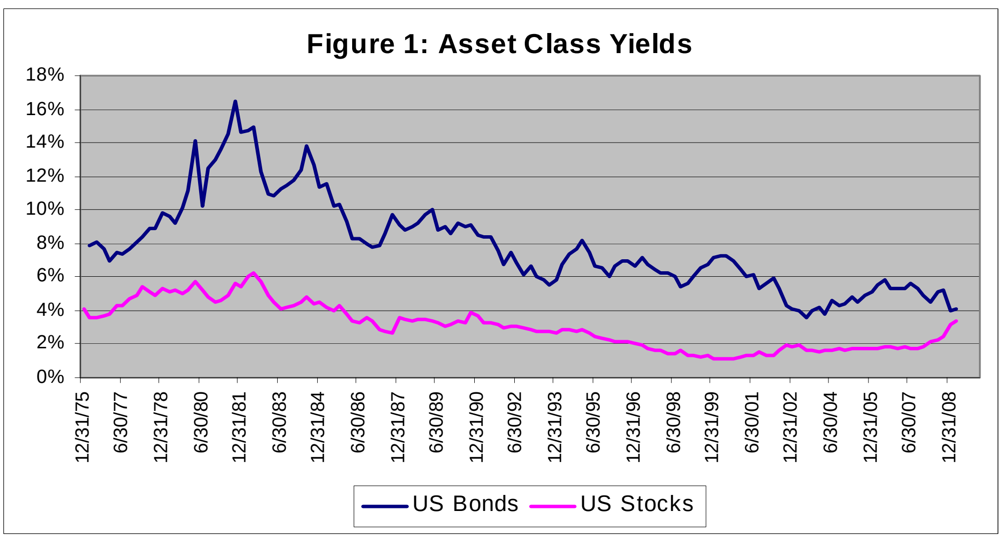

Sources: Barclays, S&P, Stairway Partners

CURRENT TOPIC

Income vs. Total Return

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Strategy

- *We made no strategy changes during the month of June*
- *Portfolio strategies remain overweight equity markets and high yield bonds*

"ALTHOUGH IT IS NOT THE CASE TODAY, HISTORICALLY BONDS HAVE CARRIED SUBSTANTIALLY HIGHER INCOME YIELDS THAN STOCKS"

INCOME VS. TOTAL RETURN- CONT'D

to do with two observations: income is only one part of return and the investor is not explicitly taking risk into account. In other words, we (and many others) believe that portfolios should be constructed by understanding the tradeoff between risk and return. Focusing on income, to the exclusion of risk and return, can lead an investor to receive less return than could otherwise be earned, or in some cases take more risk than necessary – for instance, losing important diversification benefits by concentrating the portfolio in bonds.

Return vs. Income

The income yielded by an investment may account for the entire return for certain types of assets – short-term Treasury bonds, for example. Figure 2 shows that, for the bond market as a whole, return over longer time frames has been fairly well described by the initial yield. Note that today's low interest rate environment implies correspondingly low bond returns in the years ahead.

However, for many other investments, there can be other significant components to return. Growth in dividends paid, derived from earnings growth, has historically accounted for a substantial portion of equity returns. While the initial income yield for stock market investment may have been modest (recall Fig 1), earnings growth has provided for increases in the value of dividends over time. Figure 3 shows the time series of the dollar amount of dividends paid on the S&P 500 Index.

In some asset classes, such as high yield bonds, the income yield actually overstates the dollars received by the investor. Because of defaults, some of these bonds stop paying interest, so the realized or actual income received is below the initial yield.

While bonds usually generate higher income than stocks, the flip side is no participation in growth; the growth in income over time in equities (Figure 3) stands in clear

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"TODAY'S LOW INTEREST RATE ENVIRONMENT IMPLIES CORRESPONDINGLY LOW BOND RETURNS AHEAD"

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"EARNINGS GROWTH HAS PROVIDED FOR INCREASES IN THE VALUE OF DIVIDENDS OVER TIME"

Figure 2: Bond Yields & Subsequent Returns

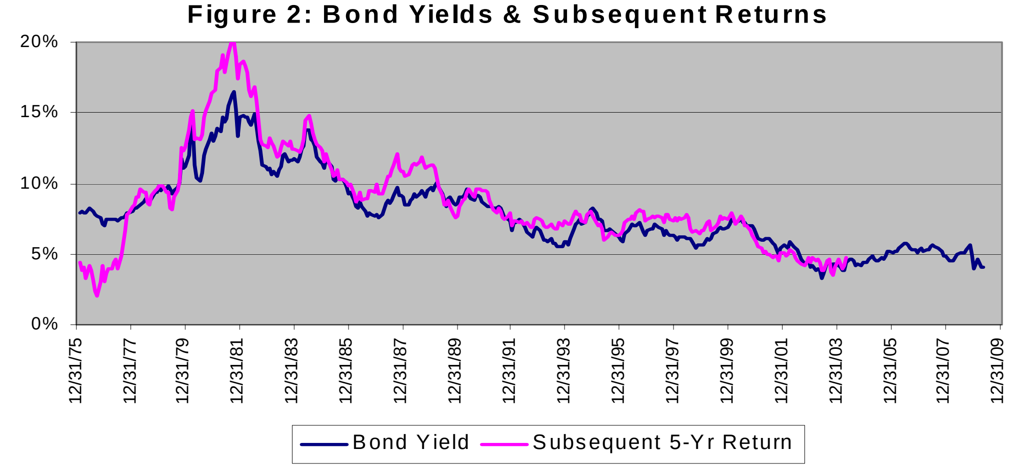
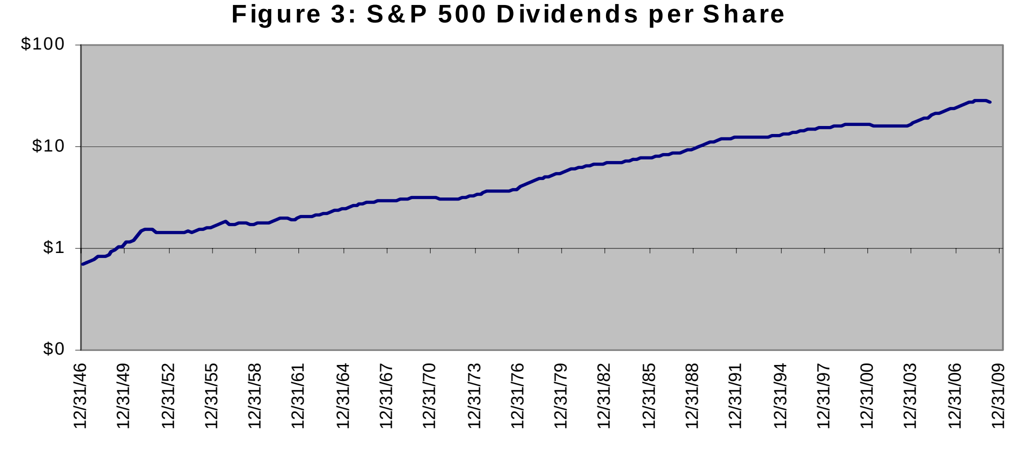


Figure 3: S&P 500 Dividends per Share



Sources: Barclays, S&P, Stairway Partners

Note: Vertical axis on Figure 3 is a log scale

About Stairway Partners, LLC

Stairway Partners was formed to provide our clients (starting with ourselves) with an effective and comprehensive solution for managing their wealth. Our disciplined and rigorous approach comes from our collective knowledge in serving large institutional clients over many years.

Our core investment belief is that asset allocation is the single most important determinant of success in any investment plan. The dominant amount of risk and return comes not from your choice of individual investments but from your asset class mix. Stairway Partners focuses our resources on risk management and asset allocation. This includes building your custom blueprint (investment policy and benchmark) and aligning your portfolio with our investment strategy utilizing the global capital markets.

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contrast with the lack of growth in bond income. Although bonds have lower returns than stocks, they also have lower risk. (Figure 4: total return index levels for stocks and bonds over time?)

In some cases, an investor's desire for income may indicate low risk tolerance, which could mean that lower-risk bonds are entirely appropriate (although that does not necessarily have to be the case). Despite their lower risk, bonds do have large exposure to the risk that inflation turns out to be much higher than anticipated – equities should provide better protection against inflation over the long run.

Portfolio Construction

What happens if the portfolio determined by looking at return and risk doesn't generate enough cash income to pay for spending? These days (in comparison to 20 or 30 years ago), investors can have very good liquidity in many asset classes. Of course, the liquidity depends on how asset exposure is obtained; for example, our bond exposures are extremely liquid because of our use of open-end mutual funds instead of holdings of substantially less-liquid individual securities. With liquidity, transacting portions of a portfolio can be accomplished simply and inexpensively. So the investor can hold a higher-return portfolio that should grow in value more quickly. To raise needed cash, a small portion of the investments can be trimmed.

Consider the earlier example: the investor might consider allocating 100% of their portfolio to bonds in an attempt to generate the necessary cash for spending. If the investor instead constructs a portfolio that's 25% equity and 75% bonds, it might have a yield of only 4½% – not enough to meet the 5% payout/income requirement (see Figure 4). However, the additional ½% each year can be raised by selling a small slice of the investments. By making no distinction about income (i.e., the composition of the return), the risk and return profile of the portfolio can be set appropriately given the preferences and tolerances of the investor. As a result, the portfolio might have better long-term return prospects and inflation protection than one that's composed of 100% bonds in order to generate sufficient income.

In addition, we should note that the current environment really presents a challenge to the buy-bonds-for-income approach. The dividend yield on the stock market is substantially higher than it has been in years, and yields on the safest bonds had been at record lows until very recently. (Note: In our January 2009 *Monthly,* we mention dividend yield being higher than the Treasury yield for first time since late 1950s.)

Summary

When a portfolio's objective is generation of income, there is an implicit, but potentially significant, tradeoff being made: the foregoing of return in order to gain higher yields. If, instead, risk and return form the basis for portfolio construction, the investor may be able to withdraw and spend at the desired rate, while at the same time being able to enjoy better growth and capital preservation prospects. Replacing the income goal with a total return objective can provide better portfolio characteristics and thus may enhance the investor's long-run investment success.

Figure 4: Income & Return

	Income (Yield)	Total Return	Risk
Stocks	2½ - 3 %	7½ - 8 %	15%
Bonds	4½ - 5 %	4½ - 5 %	5%
25/75 Portfolio	4 – 4½ %	5¼ - 5¾ %	5¾ %
50/50 Portfolio	3½ - 4 %	6 - 6½ %	8½ %

Source: Stairway Partners   Note: Figure 4 uses long-term normalized assumptions

Strategy

Asset Class	Expected Return	Hurdle Return	Strategy Exposure	Comment
Equities				
US	23.9%	5.9%	over	Exposure above benchmark weight due to attractive pricing
Non-US Developed			over	Asset class remains attractive despite recent rally
Eurozone	28.1%	6.1%		
Japan	16.4%	4.4%		
UK	23.3%	6.2%		
Emerging	11.8%	10.8%	neutral	Asset class is attractive but developed equities priced better
Fixed Income				
US Treasury Bonds			under	Treasuries expensive, but non-Treasury sectors are more attractive
2-Year	0.7%	2.8%		
5-Year	0.8%	3.6%		
10-Year	1.5%	4.4%		
30-Year	1.3%	4.9%		
US Municipal Bonds			under	In most maturities, municipal bonds are modestly overpriced
2-Year	1.1%	2.3%		
5-Year	1.4%	2.8%		
10-Year	2.8%	3.6%		
30-Year	8.8%	4.5%		
US High Yield	14.6%	4.4%	over	Sector offers good return prospects relative to its risk
Non-US Government Bonds			under	Yields remain below fair levels
Euro 10-Year	2.1%	4.3%		
Japan 10-Year	0.1%	2.0%		
UK 10-Year	1.3%	4.5%		
Emerging Markets Debt	5.0%	4.6%	under	Although sector is priced attractively, other asset classes offer better value
Cash	2.6%	---	minimal	

Currencies	Expected FX Change	Equity Return with Currency	10-Year Bond Return with Currency	
Euro	-7.7%	20.4%	-5.6%	Euro is moderately overpriced
Japanese yen	-1.6%	14.8%	-1.5%	Yen is slightly overpriced
UK pound	-0.6%	22.7%	0.8%	Pound is near fair value

Notes: **As of: May 31, 2009**

The expected return is our estimate of the annualized return likely to be generated over a 3-year horizon.
The expected returns are expressed in local currencies (e.g., Japanese equity return is stated in yen terms).
The hurdle rate represents the annualized return that an asset needs to generate in order to cover its risk.
Equity Return with Currency (in Currencies section) is the annual return we would expect a US dollar investor to earn from holding foreign equity markets.