

VAN HULZEN ASSET MANAGEMENT

Risk Managed Solutions

WHERE HAS ALL THE INCOME GONE?

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By at least one measure, massive government efforts to regain economic growth have been successful. Stock indexes have trended higher for two years with prices surging during portions of the “quantitative easing” programs. Many investment professional (myself included) have written about the potential future dangers that lie ahead if we do not take steps to reduce debt burdens and rein in the flow of easy money. However, in the short run, stocks have certainly benefitted.

Evidence suggests government efforts are having an impact, although it is hard to measure exactly how different the economy would be under other circumstances. It is logical that any action involving such huge sums of money will affect the outcome of open markets. Designed to increase consumption and expand the economy, these actions are a continuation of policy decisions since the 1980’s.

In the 80’s and 90’s, easy monetary policies and credit conditions provided the US economy with a steroid injection and growth accelerated. In what we now commonly refer to as the “credit boom” prices of assets increased dramatically and consumers spent more freely. With rising asset prices and easy access to money, people felt free to spend more than previous generations. Booms are often followed by busts, and periods of relatively low growth. And a heavily debt-laden economic system cannot afford slowdowns in growth. Rates have been lowered time after time and now sit at effectively zero.

The Federal government is doing everything in its power to keep growth going. The “cash for clunkers” program and the home buyer tax credit are examples of stimulative government actions which have served to accelerate activity, and essentially pull growth forward from future years into the present.

Geert Noels¹ said it this way:

*“....debt advances future spending. **Hence, it brings forward future economic growth.** There is nothing magical in creating more growth fueled by excessive debt. The only problem is that this debt has to be repaid in the future, and will dampen the economy on that moment”.* (<http://www.econoshock.be/the-growth-obsession>)

Growth being pulled forward leaves the future in more doubt. Slower growth in the future suggests a need for finding more reliable profits from income and depending less on price appreciation of assets. But income is hard to find. At some stage, heavy debt burdens and government stimulus

¹ **Geert Noels** (~1967) is founder/partner and chief economist of Econopolis (www.econoshock.be). His book ‘Econoshock’ was a bestseller. His voice is regularly heard through the media, his advice sought by various organizations as well as the authorities. He has extensive experience of economics, financial markets as well as asset management. Econopolis is a trusted corporate partner of Van Hulzen Asset Management.

actions push interest rates higher, adding to bond investor price risk. Savers are presented with a uniquely difficult challenge. They must find a way to earn income at a rate high enough to offset price inflation, but do so without exposing their portfolio to risky investments that could decline in value.

As our economy slowed, the Federal Reserve lowered rates in an effort to re-ignite the growth engine. With Fed funds rates at zero, rates paid to investors and savers have also come down. In prior cycles, an investor could rely on 3-4% stock dividends and 5-7% bond interest. Even cash balances would pay out 1-2%. Today, the stock market pays out 1.8% in dividends and the 5 year Treasury pays 1.5%. Cash pays 0%. Prior to the 90's, an investor with a balanced portfolio could expect to earn 5.0% in income plus the price appreciation of their stocks. Today, that same allocation yields less than 2.0% in income. The difference in yield really adds up over time.

Beyond the obvious problem of lower income is the associated rise in volatility. Assets with generous income payments tend to have more price stability. Investors are less inclined to sell a solid income producing investment. Assets that rely on growth and price appreciation are often quickly sold when the economy turns sour (with the proceeds going into income assets) and move more violently on a day to day basis.

Bonds are an obvious part of the solution to the income dilemma; they are liquid and they pay better interest yields than most other investments. And bonds are an appropriate allocation for nearly every investor at any stage of their life. But with mounting debt burdens and "sovereign default" on everyone's mind, bonds also present some current challenges. And bonds don't offer a lot of upside potential; they are good for income and for safety, but not for growth. A good bond manager will find opportunities and they are an important component of most portfolios.

Equities that pay healthy dividends are also a good place to achieve total return. The best companies should have a track record of paying dividends from free cash flow (not from borrowing), be committed to raising the dividend annually, have an active share buyback program, and be a leader in their industry. Those qualities have a good chance of producing good total return results in any market cycle.

In addition to owning quality dividend payers, the use of call options can increase the yield on some stock positions. When used in the right context, calls can double or even triple the yield on a stock position. A portfolio of dividend paying stocks and calls can generate income of 8-10% annually. In a time when a traditional balanced portfolio of stocks and bonds will yield 3-4%, earning 8-10% income is a substantial difference. The picture looks even better when you consider that using the other benefits of the strategy. A stock and call position is less volatile than the stock position by itself, and the strategy is allowed in retirement account, effectively deferring all that income into the future.

Over the past 100 years, stock prices grew approximately 4% per year. A balanced portfolio of stocks and bonds (50% stocks and 50% bonds) earned 8-9% per year with a "moderate portfolio" risk.

Today, a balanced portfolio needs stock prices to rise by 12% per year in order to achieve the same return.

Call options are quite prevalent in real estate transactions, but they are often called a “right of first refusal” or a “lease with an option to buy.” Options are also prevalent in insurance. The fire insurance policy on your home or the life insurance policy that benefits your loved ones, are put options. The use of calls in a securities portfolio is a new concept to many people, and the strategy should be managed by a knowledgeable and experienced professional. But a fund or asset manager that offers this strategy can be a good way to earn higher income in a low income world. Here is a comparison of a stock call to a real estate option and an example of how calls work:

Many, who invest in securities, have also invested in real estate at some point in their lives. Real property is an asset, which can be seen and touched; it is tangible. Physically standing on a property provides a certain degree of comfort. Comfort is a form of risk tolerance, and the willingness of an investor to undergo a temporary loss in exchange for the opportunity to profit in the long run.

Like stocks, real estate assets are varied and have diverse characteristics. Several broad real estate categories are “undeveloped land or parcels”; “rental properties”, and “agricultural/commodity acreage.” These categories can range from “speculative growth” on one end of the spectrum to “conservative income” on the other.

One common transaction in real estate is a “right of first refusal” (ROFR) which gives the holder of the property the right the ability to enter into a purchase a later date for a specific and predetermined price. An owner of a rental property may offer a right of first refusal or similar contract to another investor. The owner gets to set the sale price and the time length of the contract. The buyer of the contract will often pay the rental property owner a non-refundable cash payment that the owner gets to keep as income.

In a ROFR transaction, the property owner receives income, gets to set the sale price (we presume the owner would be smart enough to set the sale price higher than his purchase price and also at a level he is really willing to sell), and gets to set the time limit. Once that time limit is reached, the owner is no longer obligated to sell his property and the contract is completed.

Here is an example:

Bill and Mary own a rental house they purchased earlier this year for \$100,000. They have a tenant and after they pay taxes, maintenance, and insurance, Bill and Mary are netting \$400 per month. They are happy with this investment and are receiving income of 4.8% (\$4,800 annual income on the \$100,000 value).

Bill and Mary are approached by an investor who would like a right of first refusal to buy their property. While they are happy to continue owning their rental unit, they would also be interested in selling at a profit. Bill and Mary tell the investor that they would be willing to sell the rental unit at \$120,000 for the 12 months if he will pay them \$2,000 for the right.

The investor agrees. He pays Bill and Mary \$2,000 and has the right to buy the rental unit for \$120,000 anytime in the next 12 months. Bill and Mary now have two possible outcomes for the next 12 months. Either they sell to the investor or they keep the rental unit and the contract expires.

Here are their possible outcomes:

Keep the property and the contract expires:

Income from tenant:	\$4,800
Income from Investor:	<u>\$2,000</u>
Total Income	\$6,800 (6.8% yield)

Sell the rental unit for \$120,000:

Income from tenant:	\$4,800
Income from Investor:	<u>\$2,000</u>
Total Income	\$6,800 (6.8% yield)
Asset Gain from Sale:	\$20,000
Total Return for the Year:	\$26,800 (26.8% profit)

If the investor takes no action, Bill and Mary still own the rental unit and earn nearly 7% income on their asset. If the investor does buy the unit, they make a 26.8% profit. Bill and Mary will either continue to hold the unit and collect income or they will make a good profit or decide how to re-invest the profits into a new property (or properties).

In this example, the rental unit is an asset, just as owning shares in a corporation is an asset. The tenant paying income is like the dividend payment a corporation pays to its shareholders. The right of first refusal is known in securities parlance as a call option. The possible outcomes are the same, and the mechanics of the transaction are the same.

There are currently dozens of well-known corporate brands that are paying dividends to shareholders and have investors who will buy a right of first refusal from the shareholders. The yields and potential total returns are similar to our rental unit example.

A combination of bonds (and other income securities) and dividend paying equities (with some call income exposure) re-creates the investment profile of years past and also provides a higher probability of attaining reasonable returns without taking on extraordinary downside risks.

