Economic and Market Insights

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By Joe Williams, CFA
Director of Investment Strategies
The Commerce Trust Company

Chronically Low Interest Rate Environment Keeps Pushing Investors Looking for Yield in Riskier Assets

During the past summer, we reached a point where more than 300 of the stocks in the S&P 500 index produced annual dividend yields that were greater than what investors could get for the benchmark 10-year U.S. treasury, now hovering between 1.5% and 1.7%.

On a percentage basis, about 60% of all the stocks in the S&P 500 could beat the 10-year Treasury yield. While there were few news headlines when the index reached this threshold, it was the first time the S&P 500 had been in this territory since we began tracking in the early 1970s. From 1977 to 2008, that percentage was typically in the 4% to 7% range.

With the average dividend yield for the S&P 500 currently around 2.1%, what does this mean for investors interested in stocks for income?

While many investors have increasingly sought out stocks and mutual funds that capture these seemingly consistent and attractive stock dividend yields, it is important to also remember that they have increased the risk factor in their overall investment portfolios.

In 2008, for example, base share prices for exchange-traded funds and mutual funds that invested heavily in dividend-paying companies were hit hard, often negating any gains from annual dividend yields by a long shot.

Long-term equity investors can better weather these fluctuations, but those who have forgotten that interest rates can go up can be adversely affected if overly allocated to these dividend-paying companies.

Bonds and treasuries can also be adversely affected as fixed-income security prices are inversely relational to interest rates. If you own a bond, you are exposed (positively or negatively) to changes in interest rates.

That will come as news to most people, because bonds are safe, right? You always get paid the par value in the end. But bonds have some risk as well, including the fact they can be called, or in some cases go into default. While people have been lengthening their bondholding maturities in order to get a little extra yield, they, too, increase their interest rate risk.

When declining interest rates of the last 30 years eventually reverse, then all of a sudden some historical dividend providers could start to underperform the S&P 500 index. For example, utilities could go from best performers to worst.

And that's the conundrum we live with at the moment. For those seeking more income, there is nothing wrong with owning dividend-paying stocks or mutual funds in your portfolio as well as bonds. Being aware of the risks, however, is critical.

Just consult with your Commerce investment advisor to make sure you are not over-allocating to any asset class in your investment strategy. Always keep in mind the duration of your investments so they match up with the timing of your life's financial objectives.

Takeaways:

- Do your homework on dividend-oriented stocks to make sure there is a record of consistent payouts over time. Has the dividend grown over the years?
- Keep your portfolio diversified -- do not over-allocate to one particular sector of high dividend-oriented stocks or mutual funds, or bonds either.
- Being aware of the risks will help you make good allocation decisions.