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Income Trap

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Yields from government and corporate bonds continue their precipitous decent and major central banks implement negative interest rate policies, pushing interest on bank deposits further down. Even dividends, as this year has shown, can be fickle. The question of how one can safely generate an income stream from an investment portfolio without taking on excessive default risk has become more important than ever.

Natural human tendency is to split the income and principal portion of one's portfolio into two buckets. The income is meant for either re-investment or spending while the principal is preserved for future growth.

Behavioural economists Hersh Shefrin and Meir Statman discovered that this sort of mental accounting, while appearing irrational at first, can actually be a useful way of solving a difficult problem. By mentally partitioning a portfolio into "income" and "principal" silos, investors are less likely to engage in immediate gratification. "As the light switch hides the liquor bottle from the alcoholic, dividends hide the pool of capital available to finance immediate gratification".

This mental partitioning has been, for most investors and across much of history, a useful discipline. However, the current low yield environment presents new risks.

Investors perpetually chasing yields commit the same folly as Thales, the Greek philosopher who was so intent on counting the stars that he kept falling into potholes in the road.

Dividends are appealing because dividend yields appear precise. And they are a promise of income in your pocket at a specified date, not an investment return that may or may not materialise. However, financial engineering carried out by some blue-chip companies distorts how real and reliable the dividend really is.

Some well-known, blue-chip dividend payers are often large, net issuers of shares. The high dividend yields simply act as a loss leader to induce investors to buy shares. This mirage of promised income never materialises into anything real if the company's net share issuance exceeds the dividend payment. What matters is the shareholder yield, not the dividend yield.

The shareholder yield is simply the sum of the dividend yield and the net buyback yield. If a company is a consistent net issuer of shares, it will have a negative buyback yield and hence a lower shareholder yield.

The shareholder yield is more difficult to calculate than the dividend yield. It is also less precise since it is driven by new share issuance or share buybacks, which can often be sporadic. It is not quoted in fund factsheets; analysts do not talk about it, and the average investors can't even look it up on a google search, whereas the dividend yields are easily available.

However, studies have shown that a high shareholder yield is a much better predictor of superior long-term performance compared to a high dividend yield. A high dividend yield and a low shareholder yield can often be a sign of unsustainable dividends since the issuance of new shares is likely funding the dividend payments in the first place. This sort of financial gymnastics is a powerful bait used to lure unsuspecting investors in search of ever declining yields.

In a low yield environment, the partitioning of investments into "income" and "principal" buckets will encourage investors to move into ever-more risky yield- chasing behaviour, forgetting that dividend yields can be fickle and fictitious. Focusing on shareholder yields is the rational approach. However, it is difficult for most investors to remove the invisible barrier that separates their “income” and “principal” investment buckets.

The problem with any strategy that has an explicit yield target is that the embedded risks required to achieve the goal of high yields can often lead to both the loss of income and principal. At Tacit, we avoid this “Income trap” by refusing to be seduced by high yields that are often illusionary and can be incredibly risky.