



February 16 2021

THE SEARCH FOR INCOME

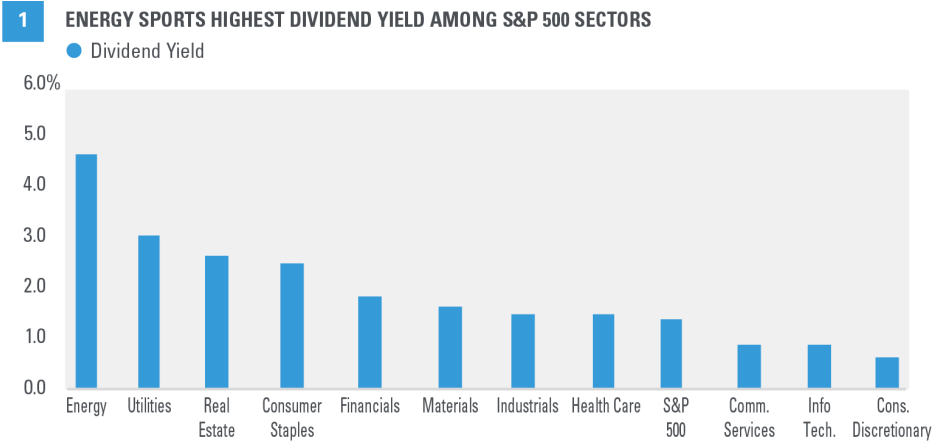
Jeffrey Buchbinder, CFA, *Equity Strategist, LPL Financial*
Lawrence Gillum, CFA, *Fixed Income Strategist, LPL Financial*

Interest rates have risen steadily over the past six months but remain low by historical standards. That means the traditional high-quality bonds that many of us owned for decades are not doing the job for investors looking for income, while the potential for interest rates have risen steadily in recent months brings more risk in the bond market than has been evident historically. Here we look at some income ideas that may help with these challenges.

When investors think about income, or yield, they would normally think bonds first. More on that below. Next they might think about getting extra yield from their stock portfolios, maybe with a dividend strategy that might be heavy on real estate investment trusts (REITs) and utilities. While we don't have anything against using those types of strategies for a portion of a portfolio to get some yield, they can also carry unwanted interest rate sensitivity if rates rise. We highlight some equity income ideas that we would expect to perform well in a rising rate environment for you to consider when building your portfolio.

INCOME IDEA #1: ENERGY

The first idea is energy stocks. You may be surprised to learn that the energy sector currently yields about 5% based on dividends paid in 2020, topping all S&P 500 sectors [FIGURE 1]. In this month's [Global Portfolio Strategy](#) report, we upgraded our view of the energy sector to neutral. Our increased optimism was driven primarily by three factors. First, as we get closer to a fully reopened economy and travel activity picks up—potentially in the second half of this year—energy is likely to be a big beneficiary. Second, our technical analysis work revealed attractive upside potential based on recent price appreciation after an extended period of weakness. Third, we see the sector as attractively valued, especially when considering the income potential.



Source: LPL Research, FactSet 02/11/21
Sector data represents S&P 500 GICS Classifications

Keep in mind that dividends can be cut, so this investment is not without risk. Oil prices can be volatile, and alternative energy is gaining market share. So this may be more of a medium-term trade than a long-term investment. That said, we believe the chances are good that oil prices at least hold steady in the \$55--60 per barrel range this year, sufficient for the sector to maintain rich yields while potentially seeing some additional price appreciation—on top of the 17% year-to-date gain.

INCOME IDEA #2: BANKS

You may be surprised to see banks on here as another income idea. The financials sector, which we upgraded in our *January Global Portfolio Strategy* report, carries a dividend yield of 1.9%, but banks yield 2.6%, based on the S&P 500 Bank Index. Although plenty of bond strategies carry yields in that range or higher, banks do not bring the interest rate risk that bonds do. Historically, bank stocks have exhibited positive correlation to interest rates (the stocks have tended to outperform as yields have risen). Bank stocks also tend to like a steepening yield curve—long-term interest rates rise faster than short-term rates—which we expect to see over the balance of 2021 as the economic recovery gains steam.

We also expect bank dividend payouts to rise over the next year or two as the Federal Reserve eases up on payout restrictions. More progress on vaccine distribution should also enable a fully re-opened economy and drive stronger economic growth, which should bode well for the profitability and, therefore, dividend payout potential for the financials sector.

Yields from banks may not look great on the surface—certainly not compared to the energy sector or some of the higher yielding segments of the bond market. But in a low rate environment with rates more likely to rise than fall, in our view, we think banks can make sense for income oriented investors with an eye toward total return.

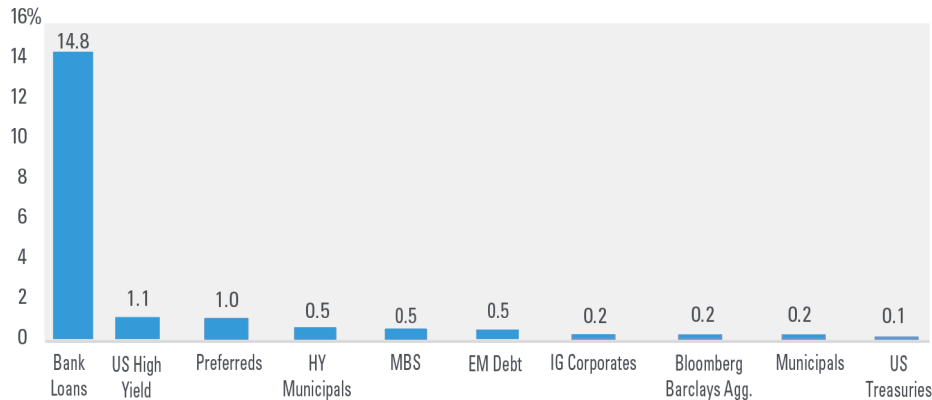
INCOME IDEA #3: BANK LOANS

There are a number of fixed income options that may be suitable for income-oriented investors. For investors looking to limit interest rate risk, we believe bank loans, which we upgraded this month, may be an attractive option due to the improving economic environment and limited rate sensitivity (see our [February Global Portfolio Strategy](#) report for more details).

FIGURE 2 ranks the major fixed income sectors by income per unit of interest rate risk. Since fixed income indexes have different degrees of interest rate sensitivity, this exercise allows us to determine compensation for taking on interest rate risk. Bank loans are an obvious standout by this measure, offering potential yields in the 4% range with extremely low interest rate sensitivity.

2 BANK LOANS OFFER JUICY YIELDS WITH LITTLE INTEREST RATE SENSITIVITY

● Yield Per Unit of Interest Rate Risk



Source: LPL Research, Bloomberg 02/11/21

Yield Per Unit of Interest Rate Risk represented by yield to worst versus index duration, a measure of interest rate sensitivity

Indexes represented include: S&P/LSTA US Leveraged Loan Index, Bloomberg 2% High-Yield Index, ICE BofA Hybrid Preferred Index, Bloomberg Municipal High-Yield Bond Index, Bloomberg MBS Index, Bloomberg EM USD Aggregate Index, Bloomberg Corporate Index, Investment Grade Corporates, Bloomberg Aggregate US Bond Index, Bloomberg Municipal Bond Index, Bloomberg US Treasury Index

While the actual yield bank loans may offer in the future is not certain, this analysis does show that bank loans provide an attractive income option relative to other fixed income alternatives for investors looking to limit interest rate risk at the beginning of a possible rising rate cycle.

It's important to understand the trade-off between interest risk and credit risk. We know there is no such thing as a free lunch. That additional income compensation comes with assuming credit risk (the risk of a default or credit downgrade) and the risk that prices drop sharply in a risk-off environment if demand suddenly dries up.

CONCLUSION

Yields across much of the fixed income market are low, which leads us to increasingly look to the equity market for additional income. Our preference for stocks over bonds—supported by low interest rates—is one of our highest conviction recommendations for 2021. Several segments of the equity market—particularly the energy sector and banks—offer higher yields than traditional high-quality bonds and offer attractive capital appreciation potential as interest rates rise. For suitable fixed income investors looking for yield and concerned about rising rates, we believe now is a good time to give bank loans a look.

IMPORTANT DISCLOSURES

This material is for general information only and is not intended to provide specific advice or recommendations for any individual. There is no assurance that the views or strategies discussed are suitable for all investors or will yield positive outcomes. Investing involves risks including possible loss of principal. Any economic forecasts set forth may not develop as predicted and are subject to change.

References to markets, asset classes, and sectors are generally regarding the corresponding market index. Indexes are unmanaged statistical composites and cannot be invested into directly. Index performance is not indicative of the performance of any investment and do not reflect fees, expenses, or sales charges. All performance referenced is historical and is no guarantee of future results.

Any company names noted herein are for educational purposes only and not an indication of trading intent or a solicitation of their products or services. LPL Financial doesn't provide research on individual equities.

All information is believed to be from reliable sources; however, LPL Financial makes no representation as to its completeness or accuracy.

US Treasuries may be considered "safe haven" investments but do carry some degree of risk including interest rate, credit, and market risk. Bonds are subject to market and interest rate risk if sold prior to maturity. Bond values will decline as interest rates rise and bonds are subject to availability and change in price.

The Standard & Poor's 500 Index (S&P500) is a capitalization-weighted index of 500 stocks designed to measure performance of the broad domestic economy through changes in the aggregate market value of 500 stocks representing all major industries.

The PE ratio (price-to-earnings ratio) is a measure of the price paid for a share relative to the annual net income or profit earned by the firm per share. It is a financial ratio used for valuation: a higher PE ratio means that investors are paying more for each unit of net income, so the stock is more expensive compared to one with lower PE ratio.

Earnings per share (EPS) is the portion of a company's profit allocated to each outstanding share of common stock. EPS serves as an indicator of a company's profitability. Earnings per share is generally considered to be the single most important variable in determining a share's price. It is also a major component used to calculate the price-to-earnings valuation ratio.

All index data from FactSet.

Please read the full [Outlook 2021: Powering Forward](#) publication for additional description and disclosure.

This research material has been prepared by LPL Financial LLC.

Securities and advisory services offered through LPL Financial (LPL), a registered investment advisor and broker-dealer (member FINRA/SIPC). Insurance products are offered through LPL or its licensed affiliates. To the extent you are receiving investment advice from a separately registered independent investment advisor that is not an LPL affiliate, please note LPL makes no representation with respect to such entity.

Not Insured by FDIC/NCUA or Any Other Government Agency | Not Bank/Credit Union Guaranteed | Not Bank/Credit Union Deposits or Obligations | May Lose Value

RES-658604-0221 | For Public Use | Tracking # 1- 05111346 (Exp. 02/22)