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SEEKING INCOME DIVERSIFICATION: COMPLEMENTING FIXED INCOME WITH HIGH QUALITY DIVIDEND EQUITIES

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Key Takeaways

- High quality investment grade (IG) bonds have traditionally played an important role in well-diversified portfolios of investors seeking stable income, diversification, and capital preservation.
- Over the long term, IG bonds have exhibited low or negative **total return** correlations to stocks, highlighting strong diversification benefits through improved risk-adjusted returns and downside protection.
- Similarly, equities have exhibited low **income return** correlations to corporate and municipal bonds outlining potential benefits to utilizing a combination of stocks and bonds when structuring diversified income portfolios.
- Equity income generated from regular dividend payments has outpaced inflation historically, as companies tend to share more of their profits with investors on anticipated financial strength.
- For tax-aware investors, combining municipal bonds with dividend paying stocks in a single separately managed account (SMA) could potentially result in greater tax-efficiency, among other benefits.



INVESTING FOR INCOME WITH BONDS & BEYOND

Significant wealth creation and aging demographics, combined with lesser prevalence of traditional pension benefits, are tailwinds that are driving many investors to convert their lifelong savings into long-term steady streams of income. Investing for income necessitates an understanding of the end investor's goals as well as their risk tolerance and time horizon. Fixed income has traditionally played an important role in well-diversified portfolios and continues to be a go-to investment for those seeking capital preservation, diversification, and stable and predictable income.¹

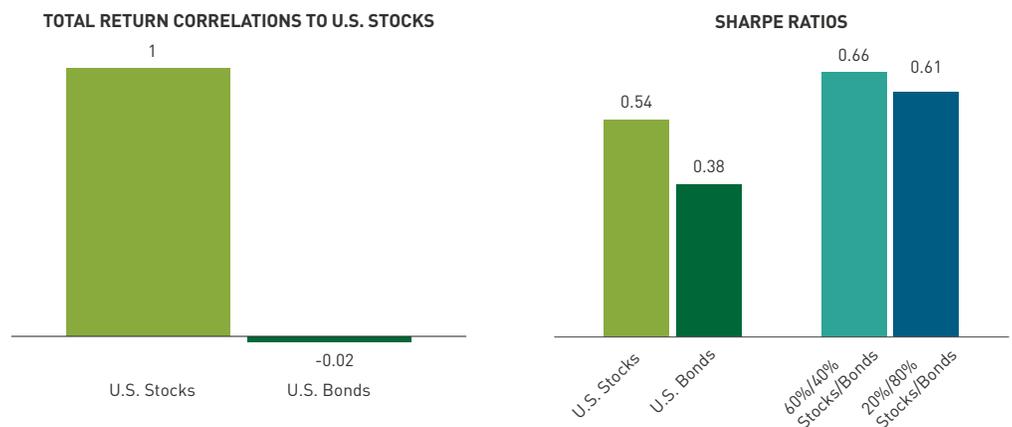
In this piece, we analyze the merits of constructing income generating portfolios using a combination of U.S. IG bonds (as represented by the Bloomberg (BBG) U.S. Corporate IG Bond Index and the BBG Municipal Managed Money Index) and U.S. large cap equities (as represented by the S&P 500 Index), with particular emphasis on the complementary characteristics of income derived from dividend paying stocks.²

While we expect bonds to continue to play a dominant role in income generating portfolios, our research shows that some mix of stocks and bonds has the potential to improve income diversification and reduce erosion of purchasing power while adding the opportunity for longer-term capital appreciation.

PORTFOLIO DIVERSIFICATION: BONDS COMPLEMENT STOCKS

Over the last three decades, our research suggests that investing in a diversified mix of equities and bonds would have resulted in improved risk-adjusted returns relative to holding either stocks or bonds in isolation (See Figure 1).

FIGURE 1: CORRELATIONS, SHARPE RATIOS & TOTAL RETURNS—JANUARY 1994 THROUGH SEPTEMBER 2024



Source: Breckinridge Capital Advisors, as of September 30, 2024.

	Income Return	Total Return
U.S. Stocks	1.93	10.60
U.S. Bonds	4.62	4.48
60% Stocks/40% Bonds	3.00	7.18
80% Bonds/20% Stocks	4.08	5.87

Source: Breckinridge Capital Advisors as of September 30, 2024.

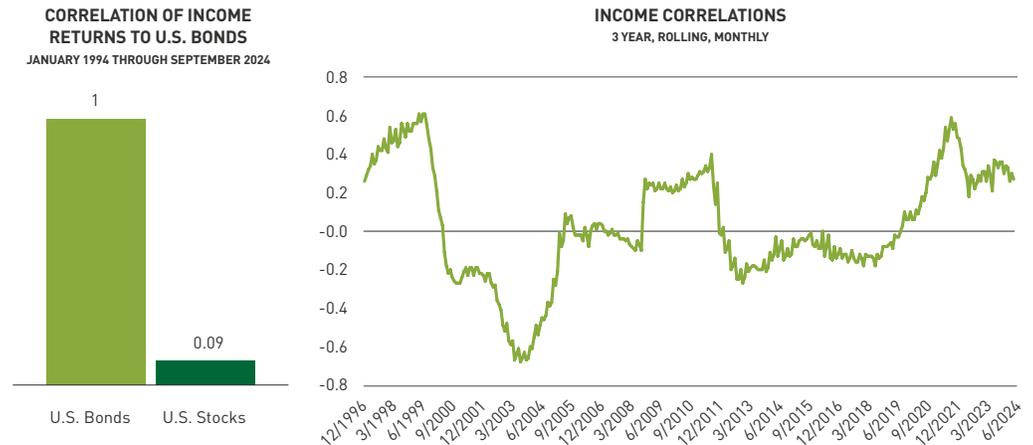
Past performance is not indicative of future results. For illustrative purposes only. Results based on monthly index data for the period January 1994 to September 30, 2024. During period, correlations of returns were low, as shown in Figure 1. Correlation is defined as the extent of the interdependence of variable quantities. The Sharpe ratio measures investment returns relative to risk. A higher ratio generally means a more attractive risk-adjusted return. Total return consists of price changes and income from interest or dividends.

1. Diversification cannot assure a profit or protect against loss. Investments in fixed income securities involve risks.
2. Dividend payments are not guaranteed. Investors cannot invest directly in an index.



Diversification benefits observed over the period studied can be attributed to low total return correlations between the two asset classes that tend to persist over time despite periodic spikes to positive and negative territory. For most investors during the wealth accumulation phase, bonds have the potential to offer a great deal of balance to portfolios otherwise dominated by equity risk, hence the rise in popularity of the 60 percent equities 40 percent bonds asset mix (See Figure 2).

FIGURE 2: INCOME CORRELATIONS OF U.S. STOCKS & BONDS



Source: Breckinridge Capital Advisors, as of September 30, 2024.

Past performance is not indicative of future results. For illustrative purposes only. Results based on monthly index data for the period January 1994 to September 30, 2024.

INCOME DIVERSIFICATION: EQUITY DIVIDENDS COMPLEMENT BOND COUPON INTEREST

Our research covering a 30-year period of performance across equity and bond markets³ suggests that adding equities to a portfolio of bonds can not only improve risk adjusted returns, but also diversify income returns with additional benefits.

While we believe most investors consider total return correlations when constructing portfolios, in our view income return correlations also are a useful measure to consider when building diversified income portfolios.

Similar to total return correlations, stock and bond income return correlations vary over time (range -0.6 to 0.65) with observable diversification benefits over the long-term (~0.1) (See Figure 2).

THERE IS NO FREE LUNCH IN INCOME INVESTING

Investors looking to supplement their income or hedge future liabilities have typically turned to bond investments to meet most of their needs. More specifically, high quality IG bond portfolios are designed to generate predictable income while also preserving capital. But achieving these objectives comes at an opportunity cost, most notably, the purchasing power of income generated would likely erode over time. Complementing nominal bond income with 'real' dividend income may help mitigate some of the risks, while introducing others (See Figure 3).

While bond investors have typically earned higher nominal income, their principal has been paid back at par, absent default, limiting upside potential. On the contrary, stocks have typically yielded lower, but growing income, while also giving investors an opportunity for long-term capital appreciation, albeit at higher standard deviation of returns.

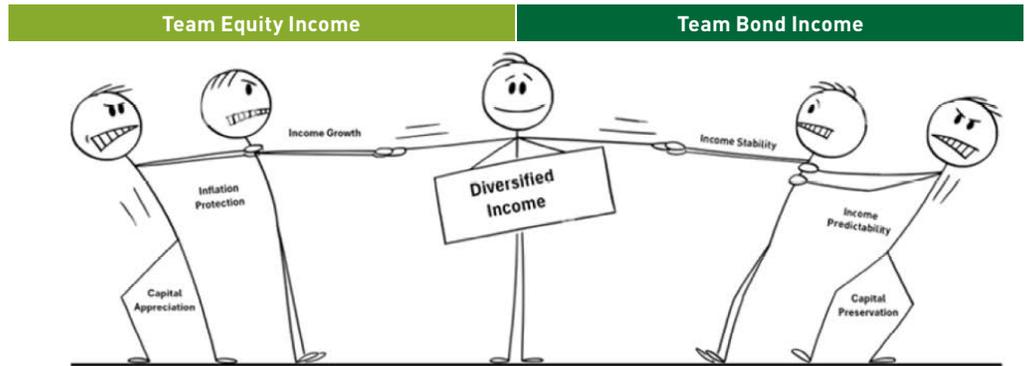
THE INVESTMENT CASE FOR HIGH QUALITY INVESTMENT GRADE BONDS

The future is uncertain, and capital market assumptions that drive portfolio allocation decisions need to account for that uncertainty. The level of confidence around outcomes that we can assign to any one financial instrument varies greatly across the asset class spectrum.

3. The indices selected to represent the equity and bond markets are generally viewed as reasonable measures of their respective asset class's performance. Results may differ if other indices were used in the same analysis.



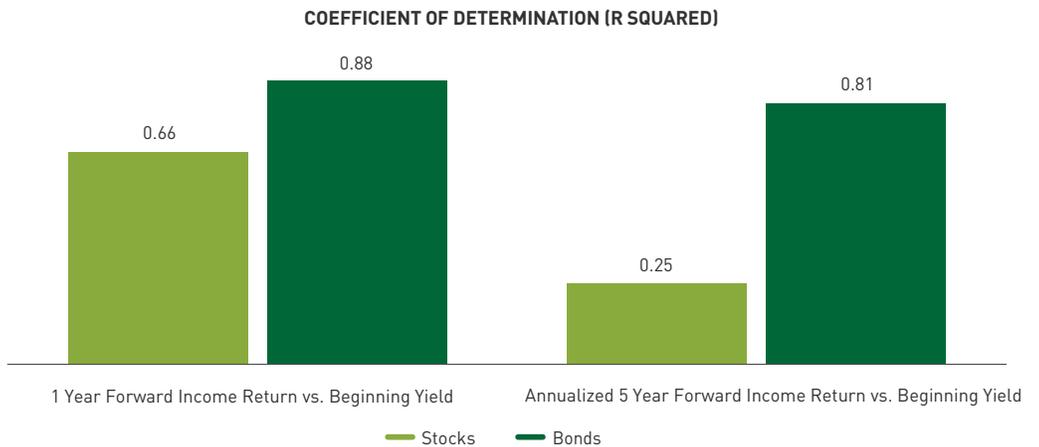
FIGURE 3: THE BENEFITS OF COMBINING DIVIDEND & INTEREST INCOME



For illustrative purposes only. Diversification cannot assure a profit or protect against loss. Illustration credit to Zdenek Sasek, Dreamstime.com and Breckinridge Capital Advisors

With that in mind, we know that high quality IG bonds rarely deliver surprises. While the value of fixed income investments is sensitive to interest rate moves, historically and as expected, the vast majority of the total return for fixed income investments is derived from interest income from issuer coupon payments, which only change if they are variable (or have steps) or in the worst case, if there is a default, which is extremely rare in the IG market.⁴ Bond income is inherently more predictable, as companies in most instances cannot adjust payouts once bonds are issued (see Figure 4). Bond coupons typically re-set only as debt matures or is called and is potentially refinanced, at prevailing market rates.

FIGURE 4: FORWARD INCOME RETURNS VS. BEGINNING OF PERIOD DIVIDEND YIELD (STOCKS) OR YIELD TO WORST (YTW) (BONDS)



Source: Breckinridge Capital Advisors, as of September 30, 2024.

Past performance is not indicative of future results. Yields are snapshot metrics for securities that can help investors in valuing a security, portfolio or strategy. Yields do not represent performance results but are one of several components that contribute to the return for a security, portfolio or strategy. The chart is based on analysis of monthly index returns for the period January 1994 to September 30, 2024. It is intended to illustrate that equity dividend yields are not as reliable predictors of realized income returns as bonds, especially at higher dividend yields. Historically, investment grade bonds have a low default rate compared to non-investment grade bonds. For example, S&P Global reported that the highest one-year default rate for AAA, AA, A, and BBB-rated bonds (investment grade bonds) were 0 percent, 0.38 percent, 0.39 percent, and 1.02 percent, respectively. It can be contrasted with the maximum one-year default rate for BB, B, and CCC/C-rated bonds (non-IG bonds) of 4.22 percent, 13.84 percent, and 49.28 percent, respectively. [Source: [Corporate Finance Institute](#), as of September 18, 2024]. Yield to worst (YTW) is a metric that calculates the lowest possible yield for a bond, assuming the issuer doesn't default. It's a way to evaluate a bond's worst-case scenario and helps investors manage risk. R2 is a statistical measure that shows how closely a security's price movements are related to a benchmark index's movements. It's a percentage that ranges from 0 to 100, with higher numbers indicating a stronger correlation. Forward income returns reflect realized returns immediately following a given date. Breckinridge calculated the forward income data depicted in the chart by geometrically linking each individual monthly return as provided by Bloomberg.



THE INVESTMENT CASE FOR HIGH QUALITY DIVIDEND PAYERS

Unlike earnings yields which are not great at predicting future total returns on equities, dividend yields may be decent predictors of realized income returns. When compared to bond coupon income, variability⁵ of income streams is higher in equities, as companies have more flexibility to reduce or increase dividends based on anticipated financial strength or weakness (See Figure 5). To that point, over prolonged periods, historical dividend growth rates have exceeded the rate of inflation as represented by the Core Personal Consumption Expenditures Index (Core PCE) (Figure 6).

FIGURE 5: STANDARD DEVIATION OF INCOME RETURNS



Source: Breckinridge Capital Advisors, as of September 30, 2024.

Past performance is not indicative of future results. For illustrative purposes only. Results based on monthly index data for the period January 1994 to September 30, 2024. Standard deviation is used as a measure of historical volatility, the larger the number, the greater the volatility.

FIGURE 6: DIVIDEND GROWTH HISTORICALLY OUTPACES INFLATION



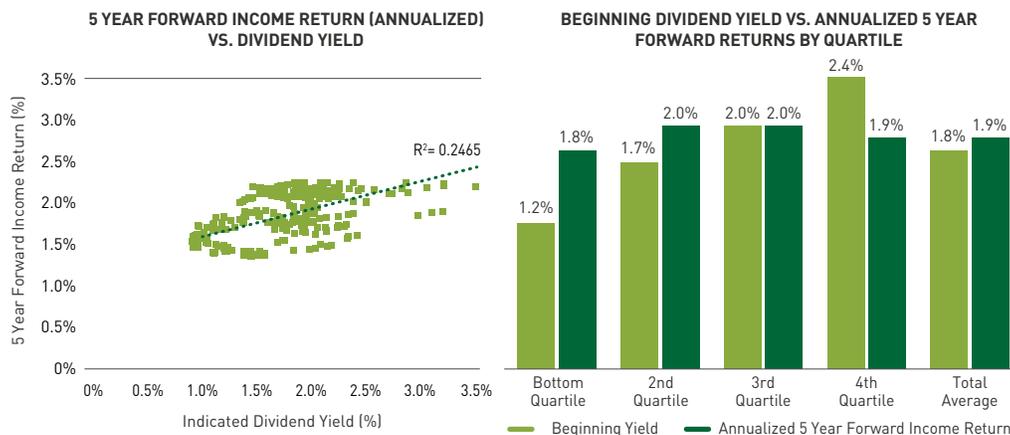
Source: Breckinridge Capital Advisors, as of September 30, 2024.

Past performance is not indicative of future results. For illustrative purposes only. Average year-over-year dividend growth is calculated based on the S&P 500 Index. Investors cannot invest directly in an index.

As stocks reprice lower and reflect increased risks to the fundamental cash flow generating ability of a company, dividend yields that screen as high relative to a stock's history can be indicative of a potential dividend cut or elimination in a worst-case scenario. This dynamic highlights the importance of a more discerning approach to constructing portfolios of high-quality dividend paying stocks that are likely to at least maintain and ideally grow dividends over time. There is a notably stronger element of predictability of dividend payments at lower dividend yields when analyzing expected 1 year forward returns. Over longer-term horizons, the predictive power of the beginning dividend yield to forward income returns declines, however interestingly, though the predictability declines, there is upside to income from the levels indicated by beginning dividend yields (Figure 7). At dividend yields of up to 1 standard deviation above the mean yield of 1.78%, forward annualized income tends to exceed levels predicted by beginning dividend yield. We believe this represents upside for investor's expected income returns as companies increase dividends on fundamental strength over time.



FIGURE 7: LOW DIVIDENDS YIELDS TEND TO UNDERSTATE FORWARD INCOME RETURNS, WHILE HIGHER DIVIDEND YIELDS TEND TO OVERSTATE IT



Source: Breckinridge Capital Advisors, as of September 30, 2024.

Past performance is not indicative of future results. Yields are snapshot metrics for securities that can help investors in valuing a security, portfolio or strategy. Yields do not represent performance results but are one of several components that contribute to the return for a security, portfolio or strategy. These charts are based on the data used in our analysis of monthly index returns for the period January 1994 to September 30, 2024. See Figure 4.

GOING BEYOND ALPHA & BETA: BUILDING TAX-AWARE DIVERSIFIED INCOME SMAs

Municipal bond investors have had an added benefit of generating tax-advantaged income as compared to taxable income received from stocks and corporate bonds (Figure 8). While tax benefits from dividend payments are limited to qualified dividends, the largest tax benefit stemming from stocks is the price volatility that provides an opportunity to engage in regular tax loss harvesting. Tax loss harvesting of equity securities, subject to the 30-day wash sale rule, can help to reduce an investor’s year-end tax liability and may be a material investment consideration within the context of broader financial plan⁴. When considering investing for income, advisors may be well served by identifying managers with experience across equity and bonds strategies that seek to generate consistent income and reduce tail risks by targeting high quality assets across portfolio sleeves that are intended to fit the investment goals and risk tolerances of their clients.

FIGURE 8: COMPARING POTENTIAL TAX ADVANTAGES OF EQUITIES & MUNICIPAL BONDS

Tax Efficiency	Domestic Equities	Municipal Bonds
Tax-Loss Harvesting	+++	++
Tax-Advantaged Income	+	+++

Source: Breckinridge Capital Advisors, as of September 30, 2024.

Domestic Equities: S&P 500; Municipal Bonds: Bloomberg Municipal Bond; Bloomberg Managed Money Index. For the purposes of this table, our analysis established a ranking of characteristics for equities and municipal bonds. The ranking ranged from 0 to 3 positives (+), with 0 being the weakest and 3 the strongest. Ratings were assigned based on Breckinridge’s data observations over the research period (1/1994 to 9/30/2024). Other definitions and approaches may differ and produce different results.

4. The effectiveness of any tax management strategy is largely dependent on each investor’s entire tax and investment profile. Tax loss harvesting involves risks and other considerations. Breckinridge is not a tax advisor and does not provide tax advice. Investors should consult with their tax professionals regarding tax strategies and associated consequences. Separate accounts may not be suitable for every investor.



CONCLUSION

Based on historical returns, IG bonds rarely deliver surprises, offering investors a stable and predictable source of income while also contending with gradual erosion of purchasing power. Equity income generated from regular dividend payments can exceed expectations set by beginning dividend yields as companies tend to share more of their profits with investors on anticipated financial strength. For tax-aware investors, combining municipal bonds with dividend stocks in a multi-strategy SMA (See: [Separate Accounts Align With Our Client-Centric Values](#)) could potentially result in greater tax-efficiency, among other benefits. We believe that a discerning approach to adding high quality dividend paying equity securities to an investor's income oriented portfolio contributes to positive risk adjusted returns, a better ability to keep pace with inflation and additional opportunities to engage in regular tax loss harvesting for tax-aware investors.

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Fixed income investments have varying degrees of credit risk, interest rate risk, default risk, and prepayment and extension risk. In general, bond prices rise when interest rates fall and vice versa. This effect is usually more pronounced for longer-term securities.

Equity investments are volatile and can decline significantly in response to investor reception of the issuer, market, economic, industry, political, regulatory or other conditions. In addition, when interest rates rise, equity investments, including dividend-paying securities, may become less attractive to investors as bonds and other fixed-income investments may offer higher yields. There is no guarantee that a company will continue to pay, increase or declare a dividend.

Tax loss harvesting may generate a higher number of trades in an account due to our attempt to capture losses. This can mean higher overall transaction costs to clients. To the extent that a client's custodian uses a different pricing source, cost basis or tax lot accounting, actual tax efficiencies could be greater or lower than what has been shown. Also, a client may repurchase a bond at a higher or lower price than the price at which the original bond was sold. The replacement bond is subject to price fluctuations.

Federal and local tax laws and rates can change at any time; changes to tax laws and rates can impact tax consequences for investors. Further, the Internal Revenue Service (IRS) and other taxing authorities have set certain limitations and restrictions on tax loss harvesting. The tax consequences of an advisor's tax loss strategy may be challenged by the IRS. Investors should consult with their tax professionals regarding tax loss harvesting strategies and associated consequences.

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