Off-the-Radar Cash Generators
Although the need for investment income has never been greater, decent returns are getting harder and harder to find.

Today, unlike a generation or two ago, many retirees can reasonably expect to live another 20 or 30 years. That's fantastic. But it means that maintaining financial health will be much more difficult. In order to make your savings last, you will have to find a way to generate a decent income while protecting your principal.

Yet, look at the current rates on traditional safe investments.

- 10-year Treasury Bond: 0.64%
- iShares iBox Investment Grade Corporate Bond ETF: 3.20%
- 2-year CD: 0.65%
- AAA rated 20-year municipal bond: 1.75%
- Money market account: 0.73%

These rates won't get you anywhere. Even the best yields from this list barely even keep pace with inflation and taxes. You need a ton of money to earn a substantial income at these rates. Most people will need a much higher percentage return to generate a meaningful income.

Income is the key to maintaining principal. Ideally, you want your savings to spin off interest and income that you use for expenses while leaving the principal intact, or growing it over time. Without sufficient income, you might spend principal and quickly deplete savings. This is a problem, especially for someone who is no longer working. What happens when the principal runs out?

But fear not. There is a place where you can still find a decent income. Dividend stocks or income-paying securities offer payouts of 5% or 6% and in some cases even higher. Of course, these securities need to be carefully selected so as to maintain and even increase principal over time. Cabot Dividend Investor and Cabot Income Advisor specialize in finding income-paying securities and with high payouts and prices that should increase over time.

Dividends are the most underrated things in the market today. Since 1926 dividends have accounted for more than 40% of stock market returns. But that's just the dividends themselves. Stocks that pay dividends have vastly outperformed stocks that don't.

Between 1972 and 2019 dividend-paying stocks generated an average annual return of over 8.78% while non-dividend payers provided just 2.4% returns. Companies with the cash flow and balance sheets to pay dividends tend to be more solid and established companies whose stocks perform well over the long term.
But dividend stocks don’t pay out the yields they used to. Historically, the dividend yield for the S&P 500 Index has averaged over 4%. But today that yield is a paltry 2.09%. While Cabot Income Advisor will seek out the most attractive and high-paying dividend stocks on the market, there are also certain classes of stocks that pay much higher dividends than the average.

You see, in order to incentivize certain businesses the U.S. government has granted special tax status. Companies with this advantage pay no taxes at the corporate level provided the bulk of earnings are paid out in the form of dividends or distributions. Because these securities are able to pay out money normally lost to taxes, they pay higher yields than regular corporations.

Let’s go over some of these types of high-yield stocks.

**Master Limited Partnerships (MLPs)**

Master Limited Partnerships are a form of investable security that benefit from special tax status.

According to Section 7704 of the Revenue Reconciliation Act of 1987, for a partnership to be classified as an MLP, 90% of its income must be generated from real estate, natural resources or commodities. That includes exploration, development, mining, production processing, refining, or transportation of any mineral or natural resource.

MLP designation provides a special tax loophole that was created to encourage the natural resource industry. The effect is that MLPs pay no tax at the corporate level so long as 90% of income is paid out to shareholders in the form of distributions.

This is a huge income advantage over regular dividend-paying stocks because money otherwise lost to taxes is added to the dividend. As a result, MLPs are some of the best income-paying securities on the market. Profits go right into your pocket instead of Uncle Sam’s.

While MLPs can include shippers, agricultural companies, and miners, the overwhelming majority are in the energy industry. Most of the energy MLPs are involved in what is called midstream energy, which is the middle of the process of getting oil and gas out of the ground and selling it to end users.

Midstream companies provide infrastructure support for the industry, such as piping and storing of oil and gas. The beauty of the midstream business is that these MLPs are not overly exposed to the risk posed by volatile energy prices. They simply charge a fee for the services of transporting and storing oil and gas. Such companies are like toll collectors on the energy highway and have dependable and predictable income streams.

These MLPs have the ideal business model from which to pay shareholders a regular income. In addition, many pipelines face little competition and operate near-monopolies in their area. Once these pipelines are built, they require little expense beyond routine maintenance and just spit out cash.
And the timing may be excellent for many energy MLPs. America has undergone an energy resurgence in the last decade. New technologies in hydraulic fracturing (fracking) and horizontal drilling have unlocked massive deposits of previously irretrievable oil and gas trapped in shale rock formations across the country.

As a result, the country went from producing just five million barrels of oil per day, and importing two thirds of our oil needs, to producing 13 million barrels per day in 2019. The U.S. has now become the world’s largest producer of both oil and natural gas.

The is plenty of business to go around to fuel future growth, but the energy sector has been clobbered in the recent bear market as demand for energy has plummeted during the lockdown. The recent selloff has created great value and high yields in certain well-selected companies. The Alerian MLP ETF (AMLP), which tracks an index of many MLP energy infrastructure companies, is more than 70% below the all-time high and yielding over 15%.

Real Estate Investment Trusts (REITs)

Real estate has historically been one of the best investments. After all, they’re not making any more land.

A home is the single largest investment most people will ever make. In fact, home ownership has typically been the number one means for individuals to build wealth. Aside from owning a residence, there are other ways to invest in property that are well worth considering for a number of reasons, including:

- **Inflation protection:** Land as well as any building on top of it is a hard asset. Real estate is a tangible thing that tends to increase in value during times of inflation or a falling dollar. After all, paper money isn’t backed by anything but confidence while real estate has enduring physical properties that are always worth something.

- **Diversification:** Real estate is a great way to diversify your investments outside of the stock and bond markets. Holding more asset classes can lower the overall risk of your investments.

- **Income:** Few investments lend themselves to generating an income like real estate does. You allow a tenant to live or work on your property in exchange for paying you a regular income in the form of a lease or rent.

While there are many benefits to owning real estate directly, there is a downside — it’s a lot of trouble.

First, you have to decide on a property or type of property that you can afford and manage. Then you have to shop around to find something. If you’re lucky enough to hunt down a property that fits your parameters, you will likely have to haggle over price.
When you've jumped through those hoops, you get to deal with lawyers and closing costs. At that point, you can make repairs and then go out and sign up tenants, who — it's to be hoped — turn out to be reliable. Only after all that are you ready to begin your new job as a landlord.

If that sounds like an awful hassle, relax. There is a much easier way to reap the benefits of investing in real estate.

The modern real estate investment trust (REIT) was created in 1960 as part of the Cigar Excise Tax Extension Act, signed into law by President Dwight D. Eisenhower. The intent was to give all investors the opportunity to invest in real estate without significant outlay and to give real estate ventures access to capital.

The first REIT was listed on the New York Stock Exchange in 1965 and since then, REITs have become a fairly common and widespread asset class. In fact, REITs have spread to markets all over, enabling access to real estate investments across the globe.

Today, there are over 200 actively traded REITs on U.S. exchanges. These REITs are involved in a wide array of real estate investments including apartments, office complexes, hospitals, shopping centers, and mortgages.

So what does an investor need to know about REITs? A REIT is a highly liquid security that can be bought and sold just like any stock on major exchanges. It represents shares of an entity that uses pooled capital of many investors, through stock issuance, to purchase and manage income properties.

The feature that differentiates REITs from regular stocks is a special tax consideration. Just like master limited partnerships (MLPs) and business development companies (BDCs), REITs enjoy special tax privileges whereby they pay no income at the corporate level provided 90% of income is returned to shareholders in the form of dividends.

The ability to pay out to shareholders the money that ordinary corporations pay in taxes makes REITs among the best income-paying securities on the market, yielding as high as 4, 5 or even 6 percent, and higher in some cases.

There are some key advantages and disadvantages of investing in REITs as opposed to purchasing property directly:

- **Ease of entry:** As mentioned above, buying physical property can be enormously time consuming and often quite troublesome. But few things are as easy as buying a stock. With REITs, you can invest in real estate on any day the market is open by purchasing a stock at the click of a button. The same is true of selling. It can be a long, painful process between the decision to sell a property and the point where you receive the sales proceeds. But you can affect a REIT sale in just seconds.
• **Lots of choices:** There are REITs that invest in many different types of properties, everything from hospitals to retail shopping malls to government offices. The choice of a REIT, unlike finding an individual property, is based on where a person believes the best opportunity lies, not whatever is more practical and affordable. You may only be able to afford and maintain a mediocre apartment building in your area. But with a REIT you are unlimited and can buy everything from high-end New York office space to shopping malls in Asia. Then there’s the affordability factor. Normally buying a real estate investment involves shelling out hundreds of thousands of dollars, at least. But with REITs you can invest $500 or $100,000 or whatever amount you’re most comfortable with.

• **Less risk:** One of the best ways to decrease risk is with diversification. Owning a single property is subject to risks peculiar to its individual area or market, whereas a basket of properties offers protection from such specific risks. A given REIT often owns hundreds of different properties and property types, usually held in many locations. REITs provide investors with huge and diversified property portfolios that individuals could never afford to access by themselves. Furthermore, you can tap into the expertise and clout that experienced managers bring to the table.

• **Regular payouts:** REITs are some of the very best income-paying securities on the market, partially because of the income-tax advantage they offer and partly because real estate is an asset class that lends itself naturally to income generation.

Sure, buying an individual property can also pay an income through tenants. But that income can easily be disrupted by unexpected expenses, maintenance, and renovations. Finally, REITs pay quarterly and sometimes monthly dividends that are often maintained and increased over multiyear periods.

The **Vanguard Real Estate Index Fund ETF (VNQ)**, which tracks an index and is considered a benchmark for the sector, currently yields 4.17%, about double the yield on the S&P 500.

**Business Development Companies (BDCs)**

Venture capital, or private equity (PE), is money provided to young and growing businesses that otherwise wouldn’t have access to sufficient capital. This money is typically lent at very high rates of interest and/or in exchange for equity stakes (a percentage of ownership).

Growing businesses with big ambitions need large amounts of capital in order to expand and grow to the next level. But such enterprises often have difficulty getting sizable enough loans from risk adverse banks, and they are too small to access the capital markets by issuing stocks or bonds. Thus, they are forced into the hands of wealthy individuals and institutions that have money and are itching to earn high returns.

In essence, these venture capitalists can provide desperately needed money to businesses that can’t get the necessary funding any place else. Thus, they are in a position to dictate very favorable terms.
For many years venture capital investments used to be the domain of the rich and famous. And the rich got richer. But now, every investor can tap into this lucrative practice though an investment security called a Business Development Company.

A Business Development Company (BDC) is a class of security that trades on the major exchanges in the United States. The securities are the publicly traded stocks of companies that specialize in providing capital to small, upcoming businesses in the initial stages of their development in exchange for high rates of interest and/or equity stakes.

Here are the three things BDCs do when they invest in privately held companies:

1. Lend money at high rates of interest.
2. Take a percentage of ownership in the form of equity stakes.
3. Provide an active consultancy roll in the management of a company.

A BDC provides stockholders with the ability to retain the liquidity of a publicly traded stock, while sharing in the possible benefits of investing in emerging-growth or expansion-stage privately owned companies.

But BDCs aren’t ordinary stocks. Similar to REITs and MLPs, they are tax-advantaged investments. Because of the economic desirability of fueling business expansion, BDCs are granted special tax status. They pay no taxes at the corporate level provided the company pays out at least 90% of net income in the form of dividends.

BDCs pay out much higher dividends than ordinary corporations because money normally lost to taxes is available to fuel higher dividend payments. The securities have other peculiarities as well that are primarily designed to limit risk. For example, BDCs cannot invest more than 25% of assets in any one company and cannot borrow more than they have in equity capital (a maximum debt/equity ratio of 1:1).

Here’s a few of the outstanding qualities offered by BDC securities.

- **Big yield**
  Because of the special tax advantage enjoyed by BDCs, the securities are require to pay out 90% of net income in dividends. However, most publically traded BDCs pay out even more. The average payout ratio for large BDCs is actually about 98%.
  
  In addition, most BDCs invest primarily in debt securities with regular interest payments. The steady and predictable cash flow generated lead to steady and predictable income and dividend payments.
  
  The tax advantage combined with steady payments from double digit interest payments provides for stratospheric dividends. In fact, The Wells Fargo Business Development Company Index (established in 2011 to track the sector) holds 28 of the largest publicly traded BDCs and has an average yield of 9.78%.
That makes BDCs the highest yielding sector on the market next to mortgage REITs.

- **Diversification**
  VC has made fortunes in the past, but it’s not as easy as it sounds. Investing in start-up or rapidly expanding businesses is a high stakes game. While such investments can be wildly profitable, they are also fraught with considerable risk. Few young companies turn into Apples or Googles, and many don’t make it at all; they go broke.

  A great way to reduce the risk of failing ventures is to invest in many different companies in a wide variety of industries. Most BDCs have a portfolio of investments in dozens of companies and risk is spread in different industries. As I mentioned, these companies are also prohibited by law to have more than 25% of asset in any one company.

  It is important to identify those BDCs with a track record of success. For managers with considerable expertise and experience in analyzing early-stage companies, the successful companies more than compensate for the failures.

- **Low debt**
  As I mentioned, BDCs have strong limitations regard the amount of debt or leverage they are allowed to assume. Debt cannot exceed the level of equity capital.

  This debt limitation exists to insure that BDCs, which invest in relatively risky ventures, do not add undue risk by overextending themselves. Too much leverage has the effect of compounding the negative impact of losses on a portfolio.

  Low debt not only adds a measure of safety to the finances of the company but also holds costs down. As debt is limited, so are debt service payments. Also, a lower level of debt helps to increase the credit quality of a company which in turn enables the company to borrow money at lower rates of interest.

- **Limited exposure to rising rates**
  The debt markets are extremely treacherous right now. Interest rates have practically no place to go but up, and rising rates lead to falling bond prices. While BDCs invest mostly in debt, they are still not as vulnerable to rising rates as conventional bonds or bond funds.

  High yield debt typically doesn’t have nearly the negative price reaction to rising rates as ordinary debt. The primary risk is credit risk, not interest rate risk. While it’s true that rising rates can still have a negative impact on high yield securities, BDCs are safer than most. BDCs typically issue short-term debt, of about 3 to 5 years, which is far less volatile to a given rise in rates. As well, much of the debt issued is floating rate debt, where coupon payments rise with interest rates.

There is a special opportunity now as most BDCs have sold off during the coronavirus bear market. The VanEck Vectors BDC Income ETF (BIZD), which tracks most of the BDCs currently trading, now yields a staggering 13.73%.
About the Expert

Tom Hutchinson is the Chief Analyst of Cabot Dividend Investor, Cabot Income Advisor and Cabot Retirement Club. He is a Wall Street veteran with extensive experience in multiple areas within the financial world. His experience includes specialized work in mortgage banking, commodity trading and as a financial advisor at several of the nation's largest investment banks.

For more than a decade Tom created and actively managed investment portfolios for private investors, corporate clients, pension plans and 401Ks. He has a long track record of successfully building wealth as well as providing a high income while maintaining and growing principal. With Cabot Dividend Investor, Tom combines a scientific, quantitative approach to stock analysis with the practical, personal and honest advice that have characterized Cabot's services since 1970.