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You can still buy securities that offer reasonable rates of return, but that don't carry the risk associated with stocks

If you want income from your portfolio, be patient

Keith Richards

If you've been faithfully reading my dispatches — and why wouldn't you? — you'll remember that in the June 14 issue, I wrote about sector rotation.

I noted that as we move into summer, we'd see investors switch out of leading sectors for ones that weren't so hot.

And this is exactly what's happening. Folks are dumping high-flying dividend-payers in utilities, pipelines, REITs and telecom for names in underappreciated sectors such as agriculture, technology and metals.

For where you can find value in the coming months, see my column in the June 14 issue of the *Digest*.

Because of investors' dislike of stocks that are interest-rate sensitive, you'll need to structure your portfolio for an income stream that's both safe and predictable. I'll show you how to do so.

But first, you might review my column of May 17 where I listed five common investment mistakes.

In discussing two of them — improper asset allocation and following a theme — I noted how many investors were buying high yield stocks instead of traditional fixed-income securities.

But because of this, I warned, investors could be setting themselves up for disappointment when the party for high yields eventually comes to an end.

And the party will eventually end, as I note in my book, *SmartBounce: Three Action Steps to Portfolio Recovery*.

There, I recount the downfall of an investment advisor with whom I once worked at one of Canada's big brokerage firms.

In 2006 and '07, this gent began shifting his clients' money out of bonds and into REITs, income trusts and other high-yield securities.

But these sectors took it on the chin during the market meltdown of 2008-2009, leaving both this advisor and his clients flat on their backs.

I don't predict a similar crash this time around. But I've been warning investors in my speaking engagements and on my book tours to avoid chasing high yields.

In fact, I've said it before and I'll say it again: if it's income you want from your portfolio, be patient.

Not only will interest rates rise, but you can still buy suitable securities that offer a reasonable rate of return, but which don't carry the risk associated with stocks.

Meanwhile, let's look at some alternatives to high-yield equities that offer reasonable returns — and which are safer than stocks.

Given that I like holding these securities as fixed-income plays, I'll focus on exchange-traded funds. After all, ETFs are often more liquid than individual bonds. In addition, they're usually safer.

Moreover because of the potential for volatility in the bond market, I'll focus on ETFs that are invested in fixed-income securities with short durations.

Let's first turn to floating rate ETFs. In our ValueTrend fixed-income funds, we now own two different types of floaters.

One is the **Horizons AlphaPro Floating Rate Bond ETF** (HFR-TSX, $10.22), which holds a portfolio of Canadian debt securities.

To keep the duration of these securities at two years and under, the fund hedges the portfolio's interest rate risk.

And although the fund's yield, now about 2.5 per cent, tops that of a two-year corporate bond, its volatility level has been very low.

The other floater I now hold is the **iShares DEX Floating Rate Note Index Fund** (XFR-TSX, $20.13).

It differs from other funds. Instead of actively managing a short-duration bond portfolio, the fund simply holds the DEX index of 10 floating rate bonds.

As implied, the yield rises or falls with interest rates, making the bond prices more stable than traditional bonds when rates are rising.

Although the fund now yields less than two per cent, it nonetheless protects investors from a bearish cycle in bonds.

Choices are many

Then, there are preferred share ETFs, of which there are now literally scads in Canada. Still, there are just two categories into which all such funds fall: Canadian preferreds and U.S. preferreds.

Canadian preferred shares come in a wide range of offerings: fixed/reset, perpetual, floating and soft retractable.

But to avoid confusion, stick to the ETFs from iShares such as its **S&P/TSX Canadian Preferred Share Index** (CPD-TSX, $17.14).

You could also buy the **BMO S&P/TSX Laddered Preferred Share Index** (ZPR-TSX, $15.05).

Although it has the same holdings as its iShares rival, the BMO fund pays more attention to capitalization and maturity diversification.

If you want an active approach to Canadian preferreds, consider the **Horizons Active Preferred Share ETF** (HPR-TSX, $10.30).

It's managed by Montreal-based Fiera Capital, which also runs **Horizons Active Corporate Bond ETF** (HAB-TSX, $10.76).

And that's a good thing. For starters, all the closed-end income funds I've bought from Fiera have always been successful.

Funds are faring well

Moreover, the company's preferred share funds are doing well; indeed, they're outperforming the competition.

Keep in mind that If you buy U.S. preferred ETFs, you'll get no dividend tax credit, although you will likely get a higher yield than if you bought Canadian preferreds.

For a preferred share ETF denominated in U.S. dollars, consider **iShares S&P U.S. Preferred Stock Index** (PFF-NYSE, $39.83). Its yield is just below six per cent.

You can also buy **iShares S&P/TSX North American Preferred Stock Index, Canadian hedged** (XPF-TSX, $20.18).

Combining the indices for

both Canadian and U.S. preferreds in one security, this fund now yields more than 4.5 per cent.

Until recently, some fixed income securities, such as **PowerShares Senior Loan Canadian-hedged Index** (BKL-TSX, $20.46), were unavailable to retail investors.

The Power Shares product is an ETF with a diversified index of floating rate securities — securities whose credit quality ranges between bonds that are investment grade and bonds that are not.

Because loans are negotiated directly between corporations and lenders, the fund is able to bypass the syndication process involved in a bond issue.

And because of the loans' 90-day reset feature, this ETF is likely less sensitive to interest rates than traditional bonds. The fund now yields about four per cent.

Finally, for folks who can stomach a bit more risk in the smaller part of their fixed-income portfolio, consider ETFs that hold bonds from emerging markets.

To some extent, these funds are tied to their equity markets. And those markets have lagged their U.S. counterparts over the past year.

But certain technical signs suggest equities in emerging markets will heat up again.

Should this happen, emerging market bonds could see some upside. To take advantage of this, consider **iShares J.P. Morgan U.S.-dollar Emerging Markets Bond Index** (XEB-TSX, $21.60). It now pays about 3.5 per cent.

In all cases, build your fixed-income portfolio from high quality bonds, adding some of the securities I've mentioned for diversity.

Resist the temptation to chase yield by dumping fixed-income investments for stocks — no matter how safe your favorite telecom or pipeline may appear.

Remember, the hallmark of a good portfolio is suitable asset allocation.

[I own positions in all the securities mentioned].

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