

Investing for Low Risk, High Yield

January 24, 2024



Cycles, Loss and Uncertainty

Investments ride on cycles. It would be simple if they were bi-cycles, balanced and symmetrical. Neither are they unicycles. The cycles investors must ride are not uniform. There are innumerable small cycles buried within larger cycles. They are chaotic, like the way a tree branches out, our blood vessels do the same, or waves on water have ripples within waves.

Different sectors have different cycles. There are business cycles, interest rate cycles, and stock market cycles. Cycles may vary by risk, by small cap/large cap, or growth vs value. On top of that, the life cycle brings different priorities to investment goals.

There might be relationships between all these cycles, but the patterns are not typically that clear or mathematical. The mathematics of chaos is more complex than a normal distribution. Cycles may be very short-term or stretch over years. The very concept of cycles is our way of trying to make sense of chaos.

For example, looking just at income from investments, if we frame income as Yield on Cost and have relatively long duration to holdings, the cycles will have long undulations. If we frame the income as Current Yield, assuming one would be continuously purchasing or choosing to stay in an investment, and thus measure yield based on current prices, the cycles will be shorter and more pronounced.

Cycles mean that investors will see prices and income go up and down. Investors generally dislike losing or seeing prices or returns going down, no matter how they are calculated. We expand who we are by buying things and making them part of us, by seeing improvement, or merely by growing up. We are distressed when we lose something, it breaks or is stolen. Because we inherently dislike loss, the fear of loss is often confused with actual loss. We confuse realized losses with unrealized losses. Most investors have an inherent growth premise of things getting better, of momentum that what is going up will continue going up. If the price goes down and we have no need to sell, what have we lost? We've gained an opportunity to reinvest dividends at a better price.

Sometimes we don't know what to fear, which is anxiety. Loss has the component of being without, in addition to the experience of being blindsided and unprepared. The feelings of loss of control when blindsided may be as significant as the loss itself.

Few investors have a balanced or mathematical foundation for risk or uncertainty. In the investment industry risk is defined by standard deviation or volatility. It equally measures prices going up or prices going down. Most investors either carry too much cash, losing on the opportunity costs, or have too little cash or other security protections from their optimism. If an investor can optimize total gains when there is a minimal loss ratio, the losses become anticipated and part of the overall strategy for success. Losses then have a very different meaning or significance.

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Equity or Debt

Investments ride on equity, debt, or some combination of the two. With equity the investor has ownership. If the investment reflects ownership, income may be in the form of rents, earnings, or in the case of publicly traded securities, dividends which are usually minimal relative to price volatility. If the investment is in debt, the dividend or interest income is typically higher and the risk of variations in income is absorbed by the equity ownership making the commitment to issue the debt. Issuing debt is a very deliberate process requiring confirmation that the owners can meet the debt obligations and thus cushion the investor from business variability. With debt, the investor does not have ownership in a company but rather owns an obligation or contract.

Rely on Price Changes or on Income?

The investors' returns vary by being from income and/or changes between purchase price and the price at sale. Few investors have a mental picture of the contrast between income and price fluctuation encompassed in Total Return. Total Return is measured either as Time Weighted Returns (TWR), which is how mutual funds are required to report, or Return on Investment (ROI), which is more meaningful for an investor looking at their own returns. No one that I have found reports returns with yields subtracted from Total Return to isolate the pricing variable.

Total Returns of the US stock market over the last hundred years are about 9.6% compounded annually. As reported below, our fixed income will give us that for the next year, removing the uncertainties of market volatility. Based on current prices, future calls and gains add 25% as a bonus, but not annually. We buy for the income and try to ignore prices except for reinvesting dividends in new positions. But I'm jumping ahead in this essay and report.

Price Change Gains or Losses

Changes in the price of publicly traded securities are supposedly driven by company earnings. In reality, earnings are often ignored by momentum investors buying what is going up and Price to Earnings ratios (P/E) become unsustainable. A P/E ratio of 50, not at all uncommon, implies earnings of 2% on the stock valuation. Rather than buying current earnings, the buyer is buying the prospect of future earnings or growth, or merely the prospect of "a greater fool" bidding the price higher.

Another driver of price volatility is that stocks are mostly purchased by index funds. Index funds are designed to enable the investor to eliminate price volatility coming with an individual stock and thus carry only the systemic risk or volatility of the entire market or a selected aspect of the market. When an investor buys shares of SPY, for example, that investment buys a portion relative to size of every stock in the S&P 500. For most companies, this buying or selling pressure influences stock prices far more than the strategy or wisdom of the executives running the company and collecting the gains or losses in their options. The result is that for most stocks, one can buy the stock or buy the index and it makes little difference in returns.

Everyone knows that the trick for gains is to buy what is going to go up and sell what is going to go down. (I think it was Will Rogers who said that if it didn't go up, don't buy it.) That means that successful investing based on price changes is to be able to predict reversals in price, to sell near the top and to buy near the bottom on what is presumed to be an oscillating cycle around a mean.

The other driver of price increases is increasing earnings and growth. This relies on buying into a story about probable success. I usually find the stories seductive, appealing but statistically difficult to achieve overall excess returns.

The price increase aspirations create a lot of hope and anxiety as one observes charts or statements of current prices, all of which are only hypothetical until there is a sale.

Fixed Income

Fixed income is where the dividends are “fixed” or contractually defined relative to a par value. An example would be a bond. We buy a lot of preferred stocks and notes (more than a thousand positions) issued at \$25 par, meaning that the issuing company collects \$25 per share, minus some IPO expenses, when it is initially offered for five years. At the end of five years, the company has the option, but not the requirement, to call the preferred stock or buy it back. The notes are the same except they also have a maturity date, like a bond, at which time they will be called or bought back from the investor. Both the preferred stocks and the notes are distinguished from bonds by being issued in much smaller amounts and paying higher dividends relative to a bond’s interest. Preferred stocks are really debt rather than stocks but are called stocks and pay dividends rather than interest, probably for tax reasons. The misnomer confuses both stock and debt buyers, creating an opportunity. Preferred stocks and notes trade on stock markets both before and after their call dates.

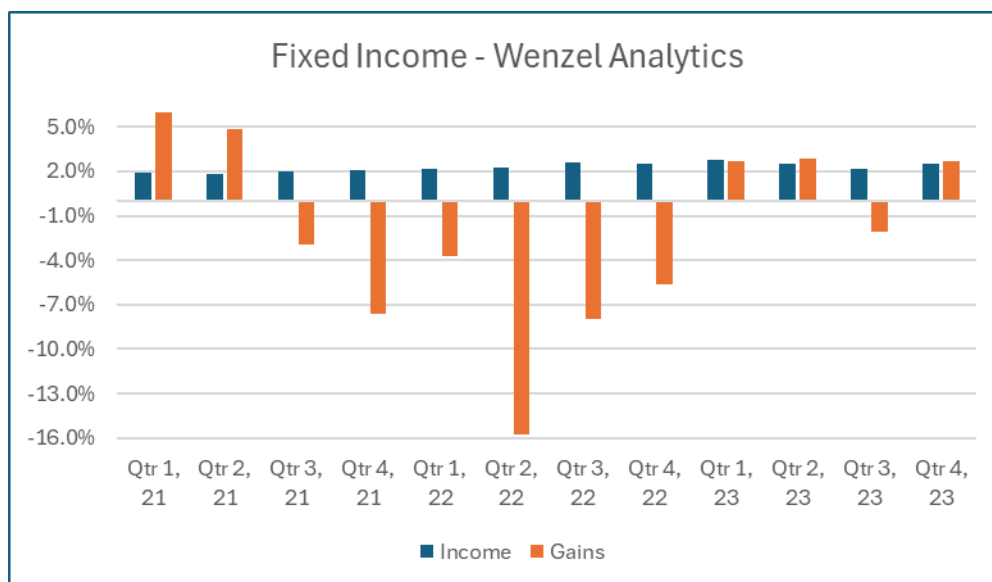
We have a competitive advantage in the marketplace because of the limited liquidity. The size of the positions we buy are usually less than \$10,000 and they often take a day or more to fill. There just isn’t that much trading. A fund or institutional investor cannot invest a million or ten million dollars in any one position, nor could they sell it if they owned it, without moving the price point dramatically. With commissions typically near a dollar, we average thirty-five positions for each client, the diversification providing bankruptcy risk protection. The primary risk is deferral of dividends, with the company making it up later, or a possible bankruptcy, which happens but rarely. The buying for income is altogether different than buying for price gains, about which we care little since we buy and hold, collecting the dividends. My main concern is that the price of the underlying common stock not be declining more than the market, pointing to trouble.

A huge advantage of fixed income investing is that if purchase costs have already been incurred (except for reinvesting dividends), and the dividends are fixed at a given rate times par, we know within a very narrow range what the income will be for the coming year. In the current market, our median buy price is about \$20. That means if the dividend is 8% times \$25, the \$2 annual dividend is 10% of our cost. When the stock is called, we get another 25% in gains, although we don’t know when that might be.

I offer here various snapshots contrasting income and price variations which would mean gains or losses if the investments were sold.

Of the approximately ten million dollars I manage, 60% is in fixed income. That is relatively high because for some investors I manage their fixed income allocation while they manage the equity portion.

The snapshot below of fixed income managed by Wenzel Analytics separates by quarter over the last three years the dividend income from the pricing variation.

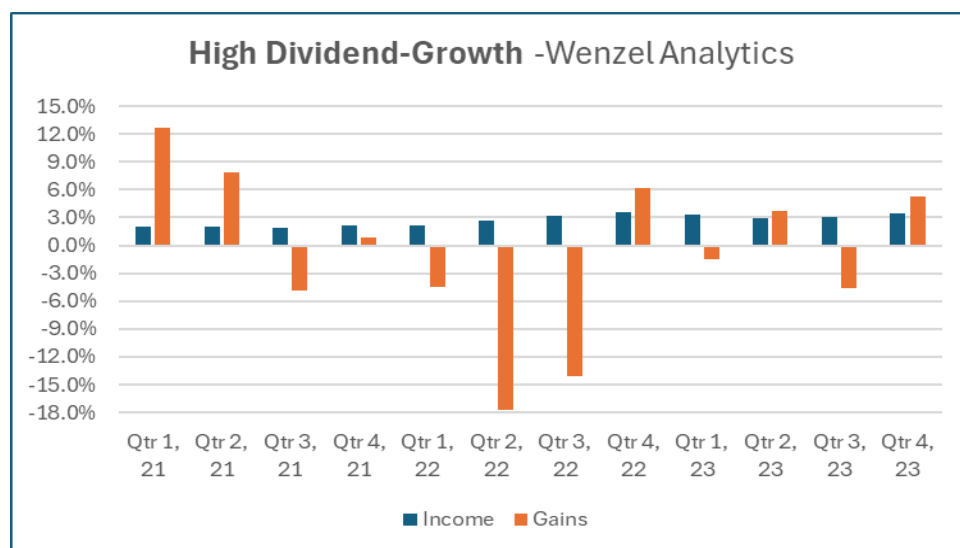


Fixed Income	Qtr 1, 21	Qtr 2, 21	Qtr 3, 21	Qtr 4, 21	Qtr 1, 22	Qtr 2, 22	Qtr 3, 22	Qtr 4, 22	Qtr 1, 23	Qtr 2, 23	Qtr 3, 23	Qtr 4, 23	SD
Income	1.9%	1.8%	2.0%	2.1%	2.1%	2.3%	2.6%	2.5%	2.8%	2.5%	2.2%	2.5%	0.3%
Gains	6.0%	4.9%	-2.9%	-7.7%	-3.7%	-15.8%	-8.0%	-5.6%	2.7%	2.8%	-2.1%	2.7%	6.1%

Comparing income to price changes in the chart above, you will note that the income is much less volatile and is always positive. Note again that the income is cash received while the orange bars are hypothetical valuations if one were to sell, of which very little was required.

High Yield Growth

We can take the same look at high-yield-growth investments which currently represent 23% of assets in all managed accounts. Like fixed income they have strong dividends. They differ in that the earnings and related board decisions can change the dividend rate each quarter for each position. While fixed income has a final sale (call) price of \$25/share, these positions do not have a fixed terminal price. Rather than owning the debt, in this case we own companies whose primary business is managing debt. They are mostly Closed End Funds (CEF), Business Development Companies (BDC), and Real Estate Investment Trusts (REITs). These are highly regulated companies, and in some sectors have never had a default.



	Qtr 1, 21	Qtr 2, 21	Qtr 3, 21	Qtr 4, 21	Qtr 1, 22	Qtr 2, 22	Qtr 3, 22	Qtr 4, 22	Qtr 1, 23	Qtr 2, 23	Qtr 3, 23	Qtr 4, 23	SD
Income	2.0%	2.0%	1.9%	2.2%	2.2%	2.7%	3.1%	3.5%	3.3%	3.0%	3.1%	3.4%	0.59%
Gains	12.6%	7.9%	-4.8%	0.9%	-4.5%	-17.7%	-14.0%	6.2%	-1.5%	3.7%	-4.7%	5.3%	8.52%
Total	14.6%	9.9%	-2.9%	3.1%	-2.3%	-15.0%	-10.9%	9.7%	1.8%	6.7%	-1.6%	8.7%	

The above charts are Time-Weighted Returns. The income bars are dividends received divided by the average of the beginning and ending valuation for each quarter. It is thus a Current Yield rather than a Yield on Cost. The gains/losses are calculated by subtracting the income from the total Time Weighted Return. Return rates are the quarterly percent change as the industry requires reporting of returns for less than one year. Rates beyond one year are annualized.

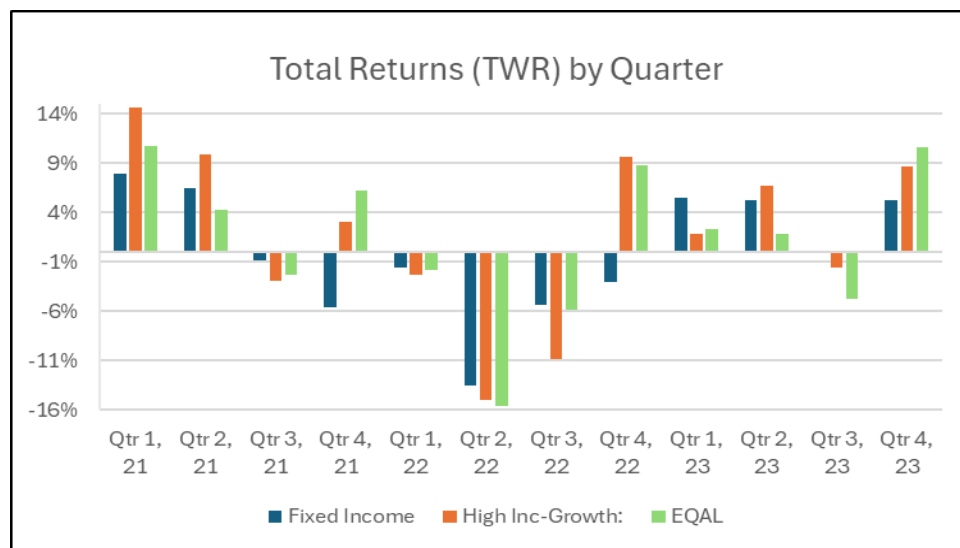
At least for income stocks, income carries the day with far less volatility than buying for gains. Many investors say they are “buy and hold”, but when prices are down severely and the future is uncertain, they bail.

Comparing Our Income Investments to Total Market Returns

How do these strategies compare to Total Market Returns?

For a market benchmark I choose the Russell Equal-Weighted 1,000 (EQAL). It is an average of the 1,000 largest stocks by market capitalization (shares times price). Apple affects the index as much as the company ranked 1,000 by size. It omits the Russell 2000 stocks which comprise approximately 10% of the U.S. stock market valuation. I choose not to use the S&P 500 because it reflects a strategy weighted to large cap stocks. I buy positions equal-weighted, i.e. if an account has \$500,000 and I want 50 positions for purposes of diversification in each category, each position is approximately \$10,000.

The first chart below has the same format as the charts above, showing Total Return (dividends and price changes) for each quarter, along with the equal-weighted index.



	Qtr 1, 21	Qtr 2, 21	Qtr 3, 21	Qtr 4, 21	Qtr 1, 22	Qtr 2, 22	Qtr 3, 22	Qtr 4, 22	Qtr 1, 23	Qtr 2, 23	Qtr 3, 23	Qtr 4, 23	SD
Fixed Income	7.9%	6.5%	-0.9%	-5.6%	-1.6%	-13.5%	-5.4%	-3.1%	5.5%	5.3%	0.1%	5.2%	6.1%
High Inc-Growth	14.6%	9.9%	-2.9%	3.1%	-2.3%	-15.0%	-10.9%	9.7%	1.8%	6.7%	-1.6%	8.7%	8.5%
EQAL	10.7%	4.3%	-2.3%	6.2%	-1.8%	-15.6%	-5.9%	8.8%	2.3%	1.8%	-4.7%	10.6%	7.4%

The chart shows how income modulates the price volatility of Fixed Income.

The chart below gives TWR Total Returns, or dividends and price changes in another format.



The red High-Income Growth runs close to the EQAL, sometimes exceeding it by a bit. The blue Fixed Income trails. In defense of Fixed Income, we observe that:

1. This was a period of rising interest rates with Treasuries and cash accounts competing with the preferred stocks. Interest rates appear to now have peaked and are likely to decline while the price of preferred stocks is rising.
2. We are mixing realized and unrealized returns (Cash received and gains if sold).
3. We have been buying and not selling during this period of bargain prices. Thus the pricing in the chart does not reflect our income or potential gains.
4. The 1,017 preferred positions (average of 35 per client) have a median current price of \$20.72. At some point they will be called for \$25, a gain of 20.7%.

If we look at the same chart for just the last year, the picture changes with Fixed Income and High-Yield Growth both exceeding general market performance.



Note in the chart how the income portion of the blue Fixed Income line minimizes the volatility such as seen in October.

The 2023 year-end allocation for all accounts managed by Wenzel Analytics:

Allocation	Percent
Cash	6%
Fixed Income	60%
High Inc-Growth	23%
Price Appreciation	6%
Uncorrelated	6%
Total	100%

The breakdown in returns between income, price change and fees for the past three years for the entirety of the above allocation:

Source as % of Starting Value	2021	2022	2023
Income	7.4%	7.3%	9.4%
Price Change	5.1%	-28.2%	4.6%
Expenses	-0.8%	0.6%	-0.7%
Gain or Loss	12.5%	-20.9%	14.1%

2023 returns for only the Fixed Income and High-Yield-Growth portfolios:

2023	Fixed Income	High Yield-Growth
Income	10.2%	15.6%
Gains	7.7%	0.9%
Total	17.9%	16.5%

Standard Deviation between the twelve quarters:

Standard Deviation, 12 Quarters	Fixed Income	High Income-Growth	EQAL
Income	0.3%	0.3%	
Gains	6.1%	8.5%	
Total Return	6.1%	8.5%	7.4%

What has been reported above is history. Looking forward to next year, the Yield-on-Cost of the Fixed Income (income divided by original cost) is 10.2%. Current Yield (income divided by current price) for the next year is 11.3%, before taking account of income from reinvesting dividends in new positions.

A detailed paper reviewing the various ways and merits to calculate yield is available on my website under Preferred Stocks titled [Comparing Yields and Gains.pdf](#). A detailed description of my business process for selecting preferred stocks is also available on the website as [High Dividend Investment Process.pdf](#). For High-Yield Growth investments I rely on Rida Morwa and his newsletter High Dividend Opportunities.

You can do this! It is administrative work like following a recipe to get known results. Contact me if you have questions or want help with implementation of an income strategy, either by you or by me, with low risk (volatility) and high yields.