MARKET OBSERVATIONS
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SCHLINDWEIN ASSOCIATES
INVESTMENT COUNSEL

In Search Of

Investors have been in search of yield for more than a decade. It began as policy responses to the Great Recession of 2007-2009 brought short-term interest rates to zero or less. The most recent policy responses to the Coronavirus pandemic have resulted in historically low yields on investments in and among asset classes. However, yield alone is not the full measure of investment outcome. That measure is total return, income received plus change in investment value. And most accurately, it is total return after inflation and taxes. A high-level review of yields and returns can provide perspective for investing yet ahead.

PERSPECTIVE

Through its policies, the Federal Reserve's mandate is to promote maximum employment and price stability. Targeting short-term interest rates is the Fed's primary policy tool. Interest rate targets have been set at low levels for some time, resulting in meager yields for savers and investors on money market and other short-term investments. The extent of this yield "suppression" is shown in Chart I. While inflation has remained low, generally less than two percent, real returns both before and after taxes have been negative for most of the past decade.

Low short-term interest rates can act as an anchor on bond yields, pulling them down to historically low levels. However, yields do not translate directly into return for bond investments, especially as maturity lengthens and credit quality is lowered. Indeed, longer maturity and lower quality bonds should provide higher yields reflecting their higher inherent risks. A maturity premium is included but credit quality is not material for a U.S. Treasury note. Chart II shows how realized total returns (income plus change in value) over a bond's maturity can vary materially from its initial yield. This outcome reflects the impact of reinvesting bond interest payments at rates different than the initial yield. While nominal yields currently are low, realized bond total returns should be boosted in the years ahead if interest rates trend higher.

Stock dividend yield is a partial measure of relative value and yet attracts much attention. A more complete assessment includes earnings yield. Chart III shows the combined dividend and earnings yield versus subsequent total return for the S&P 500 stock index. For comparability with the above bond analysis, returns for the S&P 500 are measured over a ten-year horizon. As with bonds, the realized return from stock investments can vary widely from the initial yield. The relationship between total stock yield and stock total return varies in part with interest rate levels. Lower rates impact stock prices favorably as experienced most recently. Current total stock yields portend more modest returns ahead.

CHART I

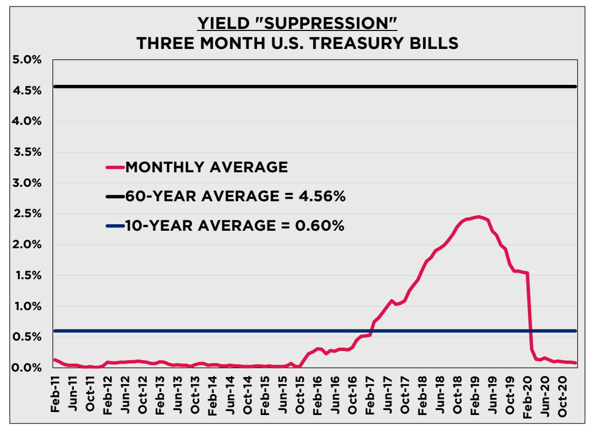


CHART II

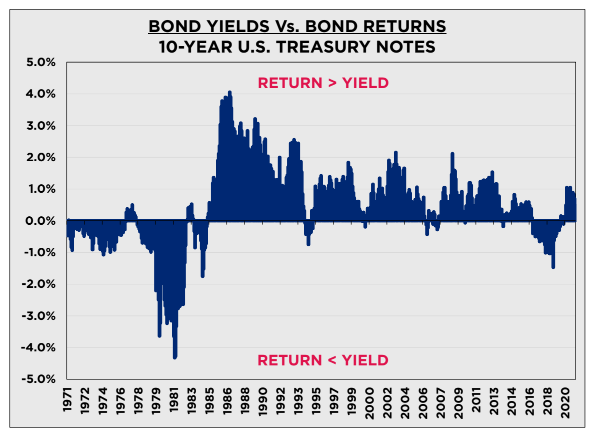
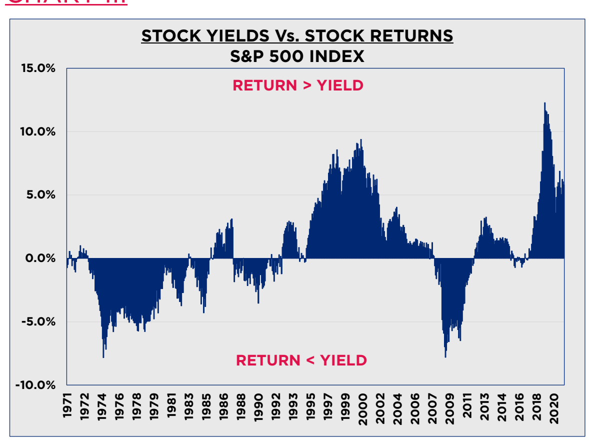


CHART III



INVESTMENT IMPLICATIONS

Yields are but one variable when in search of investments. Higher absolute yield does not ensure subsequent realized total return. In fact, higher yield should be considered as an indicator of potential risk – default risk for bonds and dividend risk for stocks. Incremental yield may bring adequate return for associated risk. Assessing such tradeoffs is an essential element of prudent portfolio management.