Where Can Investors Find Income in 2021

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Summary

- Low interest rates for much of the last ten years have made it much tougher for investors seeking income from traditional sources such as bonds.
- Despite a recent improvement in performance, midstream yields remain well above historical averages and are superior to other income-oriented equity sectors such as utilities and REITs.
- Diversified equity income strategies and closed-end funds also represent attractive income opportunities in today's low-rate environment.

While 2020 is finally behind us, income investors are facing similar challenges as 2021 begins. The low interest rate environment has made finding yield challenging for income-focused investors, and the landscape is unlikely to change much in the near term. While some investors looking for yield may be primarily focused on fixed income, there are viable alternatives, often with higher yields, that are worth exploring. This note highlights income opportunities from a multi-asset perspective outside of the usual income-focused sectors like fixed income, real estate investment trusts (REITs), and utilities, which are currently offering yields below historical averages.

Yields in fixed income and other income-oriented sectors are below historical averages.

Historically, investors have sought the comfort of steady income generated by bond coupons at a generally lower risk level than equities. For much of the last ten years, however, the US economy has experienced a period of "lower-for-longer" interest rates, as shown in the chart of 10-year Treasury yields on the following page. Treasury yields dropped substantially during the Great Recession in 2008 but reached a second bottom in 2012 and again in 2016 at slightly above 1%. Despite the long economic recovery, interest rates have struggled to exceed 3% for much of the past 10 years, most recently reaching a relative peak of 3.24% in November 2018, a significantly lower apex than in previous recoveries. With interest rates once again low to start 2021 amid the COVID-19 pandemic, investors face the challenge of managing risk levels in portfolios given low yields on offer from the safe havens in fixed income like Treasuries. While investors can adjust to lower rates by taking on greater risk within fixed income sectors, there are other alternatives to consider for income that are detailed on the following pages.

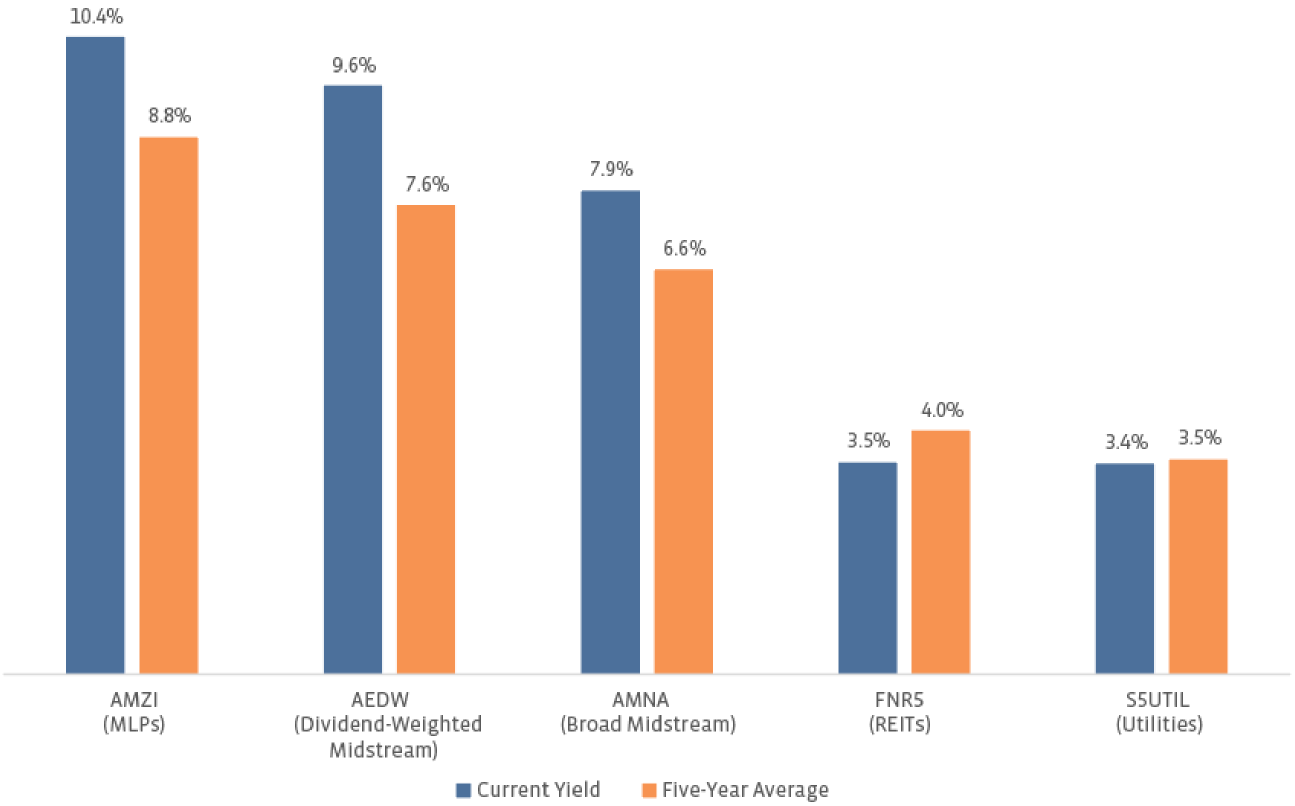
10-Year Treasury Notes Yielded Below 1% in 2020 and Remain at Historically Low Levels

Source: Bloomberg as of January 8, 2021

The midstream income opportunity is compelling and includes exposure to a COVID recovery.

Midstream energy infrastructure offers an attractive income proposition that may not be as familiar to investors outside of the energy space. Midstream companies generate fees for providing services such as transporting hydrocarbons through pipelines, which has resulted in steady cash flows to support generous dividends. Notably, Master Limited Partnerships (MLPs) do not pay taxes at the entity level, which allows them to pay out more cash to investors in the form of distributions (dividends). In addition, the character of these distributions is advantageous given that around 70-100% of MLP distributions has historically been considered a tax-deferred return of capital (read more). Midstream C-Corps draw on the legacy of MLPs and similarly provide attractive income supported by fee-based businesses. Despite a recent improvement in performance along with broader energy, midstream yields remain well above historical averages and are more generous than other income-oriented equity sectors. The chart on the following page shows that current yields for midstream, represented by the Alerian MLP Infrastructure Index (AMZI) at 10.4%, the Alerian Midstream Energy Dividend Index (AEDW) at 9.6%, and the Alerian Midstream Energy Index at 7.9%, exceed the smaller 3.5% yield of the FTSE NAREIT Real Estate 50 (FNR5) and the 3.4% yield of the S&P 500 Utilities Index (S5UTIL) as of December 31. Notably, each of the midstream index yields is 130 basis points or more above its five-year average, while REITs are 50 basis points below and utilities are 10 basis points under their five-year averages.

Midstream Yields Remain Above Long-Term Averages and REITs/Utilities



Source: Alerian, Bloomberg as of December 31, 2020

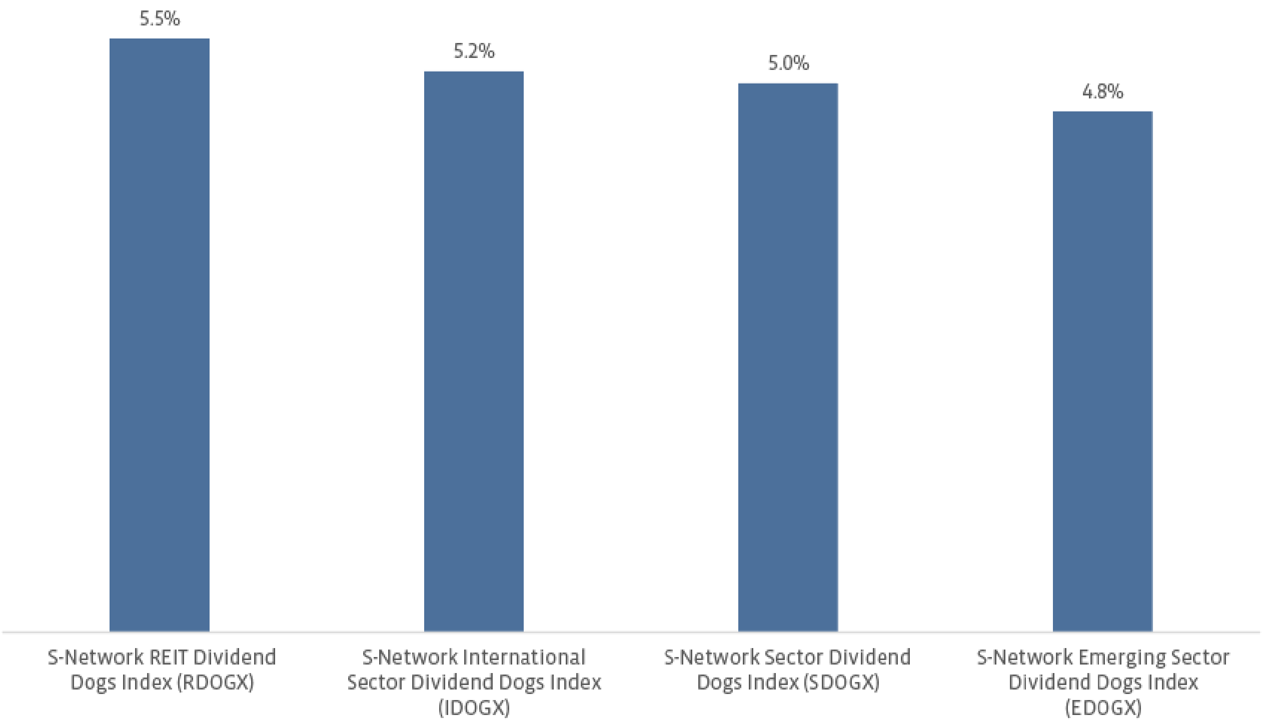
AMZI is the underlying index for the Alerian MLP ETF (AMLP) and the ETRACS Alerian MLP Infrastructure Index ETN Series B (MLPB). AEDW is the underlying index for the ETRACS Alerian Midstream Energy High Dividend Index ETN (AMND) and the Alerian Midstream Energy Dividend UCITS ETF (MMLP). AMNA serves as the underlying index for the ETRACS Alerian Midstream Energy Index ETN (AMNA).

As discussed in our 2021 Midstream Outlook video and summarized in this recent piece, the investment thesis for midstream does not stop at income alone. The industry's financial footing improved in 2020 as management teams prioritized reduced leverage, lower capital spending, and cost cutting, and in some cases, companies cut dividends to amplify financial flexibility during the downturn. Since 1Q20, midstream has delivered largely steady payouts, adding confidence to the safety of these income streams. In addition to attractive yields, midstream is likely to increasingly reap the benefits of free cash flow generation this year, which is evident in the six buyback authorizations announced since November. In combination with generous income, midstream's discounted valuations, free cash flow expectations, and buybacks make for a compelling total return opportunity in 2021. These positive factors could be further enhanced by potential tailwinds from a broader recovery in energy as the distribution of COVID-19 vaccines supports improving oil demand.

Exploring diversified equity income solutions.

Given their propensity for steady dividends, some investors look to large-cap stocks as another source of income, or investors may gravitate to certain equity sectors known for dividends, such as utilities. Equity income strategies can often lack diversification or offer modest yields as only blue-chip dividend payers with long track records are considered. Optimism around vaccines has led to improved performance over the last few months for high-yielding companies that could carry over to 2021. The S-Network Sector Dividend Dogs Indexes, linked to the ALPS Dividend Dogs ETFs, provide a large-cap bias with a differentiated approach to equity income by including companies with the highest yields across ten sectors. The construction of the indexes helps to maximize yield without sacrificing quality by leveraging strong starting universes, such as the S&P 500 for the S-Network Sector Dividend Dogs Index (SDOGX), and utilizing an equal weighting scheme to ensure sector diversity (read more). In addition, the annual reconstitutions for the index series were recently completed in December, replacing existing constituents with higher-yielding names. In effect, this process allows for the index's Dogs of the Dow strategy to be reset at the beginning of each year and results in an increase in yields for the indexes. For example, following the annual reconstitution in mid-December, the yield of the S-Network Sector Dividend Dogs Index (SDOGX) increased from 4.6% on December 15 before the reconstitution to 5.0% on December 31 afterward as estimated by Bloomberg. As shown in the chart below, the dividend dogs are each yielding near or above 5.0% as of December 31. For comparison, the S&P High Yield Dividend Aristocrats Index (SPHYDA) and the S&P 500 Index (SPX) yielded 3.3% and 1.5%, respectively, as of the end of 2020.

Dividend Dogs Indexes Yielding Near 5% Following Annual Reconstitution



Source: S-Network Global Indexes, Bloomberg as of December 31, 2020

RDOGX serves as the underlying index for the ALPS REIT Dividend Dogs ETF (RDOG). IDOGX is the underlying index for the ALPS International Sector Dividend Dogs ETF (IDOG). SDOGX is the underlying index for the ALPS Sector Dividend Dogs ETF (SDOG). EDOGX is the underlying index for the ALPS Emerging Sector Dividend Dogs ETF (EDOGX).

Yield-oriented CEF indexes provide outsized income.

Closed-end funds (CEFs) provide another alternative for investors looking for income because they frequently offer attractive yields. In addition, CEFs are actively managed, which may be preferred by some investors given current uncertainty, and fund managers often use leverage to enhance returns. With a yield-oriented focus that includes some of the top funds and managers across the CEF landscape, the S-Network Closed-End Fund Indexes reflect a substantial income opportunity. The methodology of the CEF indexes results in considerable yields through a smart beta approach that exploits CEF discounts (read more). This smart beta approach results in a greater weighting for the CEFs trading at larger discounts, which helps drive attractive index yields. As of December 31, the S-Network Composite Closed-End Fund Index (CEFX), which includes CEFs focused on generating high taxable yield, had a yield of 7.9%. Similarly, the S-Network Municipal Bond Closed-End Fund Index (CEFMX), which is comprised of CEFs focused on tax-exempt yield, was yielding a robust 4.4% as of 12/31. CEFMX benefits from the tax advantages of municipal bonds since they generate interest income that is exempt from federal taxes.

CEFX serves as the underlying index for the Invesco CEF Income Composite ETF (PCEF) and the ETRACS 1.5x Closed-End Fund ETN (CEFD). CEFMX is the underlying index for the VanEck Vectors CEF Municipal Income ETF (XMPT).

Bottom Line

Despite a market environment that remains starved for yield, investors have several options for income in 2021 that still provide attractive yields. Midstream may prove an intriguing opportunity this year given the potential for oil demand to noticeably improve as we approach the end of the pandemic, with a more constructive macro backdrop enhancing positive company-level developments. Diversified equity income strategies and closed-end funds also represent attractive income opportunities in today's low-rate environment.

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