Q&A

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American Century Investments®

INVESTING FOR SUSTAINABLE INCOME

Diversification Matters

We discuss how a mix of investments may help boost return potential while helping to temper overall volatility.

Since the 2007-2008 financial crisis, unprecedented accommodative monetary policies and low interest rates have created challenges for investors seeking income from familiar sources, such as bonds and dividend-paying stocks. Despite recent Federal Reserve rate hikes, interest rates and dividend yields remain low by historical standards. Outside the U.S., including in Europe and Japan, yields are even lower, as central banks maintain aggressive easing programs.

We believe investing for income in today's low interest rate environment requires a broadly diversified strategy with a goal of providing sustainable income. Senior Client Portfolio Manager Nancy Pilotte recently spoke with Portfolio Manager Radu Gabudean about income diversification and professional management and how they can help investors achieve the competing goals of income, total return, and risk management.

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Q Where can investors find the most attractive income opportunities in today's rate environment?

A We believe investors should consider a range of sources to achieve their income, total return, and risk goals. Along with the familiar sources—bonds and dividend-paying stocks—investors have other options. High-yield bonds, convertible bonds, preferred stocks, REITs, and others offer excellent income-generating potential, but they also may be difficult to access, combine into a portfolio, and manage. This underscores the value of professionally managed income portfolios.

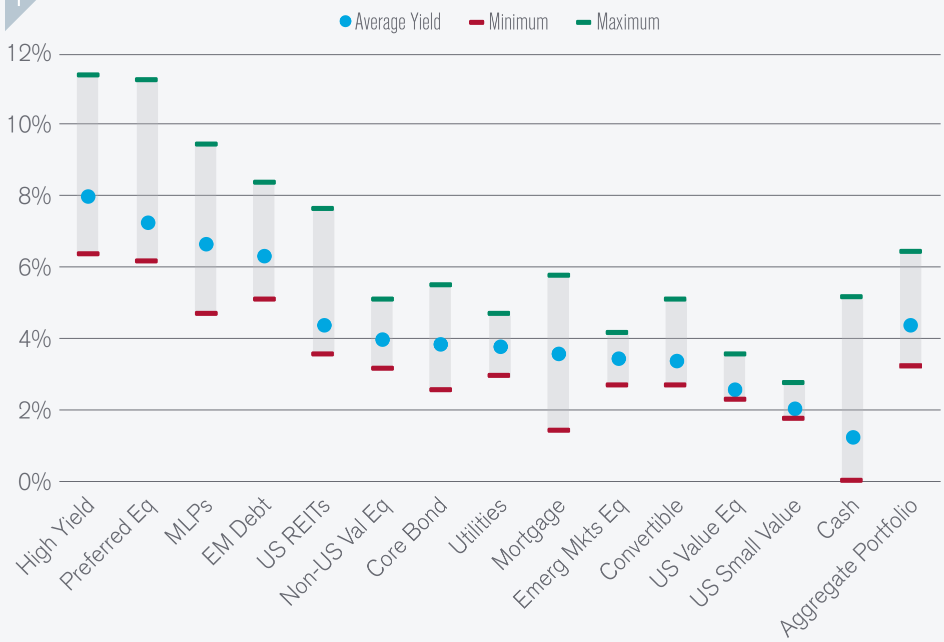
When constructing an income portfolio, should investors focus on the asset class that has provided the highest yield?

In our view, that strategy is shortsighted and risky. Income-generating securities not only vary in their average yield, they also vary in income consistency. That is, the level of income can fluctuate in response to risk and changing market and economic conditions. So the highest-yielding security today may not be the highest-yielding security tomorrow.

Income investors need a steady stream of income, which is why yield stability is an important consideration. A portfolio of different types of income-generating securities may help provide a smoother, more consistent level of regular income than a single asset class whose yield may vary widely. The aggregate portfolio in **Figure 1** illustrates this concept.

FIGURE 1

Yields Vary Widely Over Time



Source: FactSet, Bloomberg. Data from 10/31/2004 – 6/30/2018. See p. 4 for the representative indices for each asset class.

Are there other potential benefits to investing in different sources of income?

Yes, it has the added important benefit of diversifying the sources of return and risk, which may lead to a better risk/return trade-off over time. With a mix of investments, each asset class may respond differently to market and economic factors. This diversity aims to boost return potential while tempering overall volatility.

Is the relationship between income and risk similar to the relationship between return and risk?

It's not. Unlike the positive relationship between risk and return—essentially, more risk equals more return potential—our research shows that increasing risk beyond a certain level actually reduces income potential. This represents a conundrum for income investors. Specifically, to effectively generate income over the long term, a portfolio needs more than income—it also needs total return. If total return falls below income, then income comes at the cost of diminishing capital. But, at the same time, focusing on earning higher returns has generally led to lower income and higher risk. We believe a sustainable income portfolio must balance three distinct goals: stable income, total return, and risk management.

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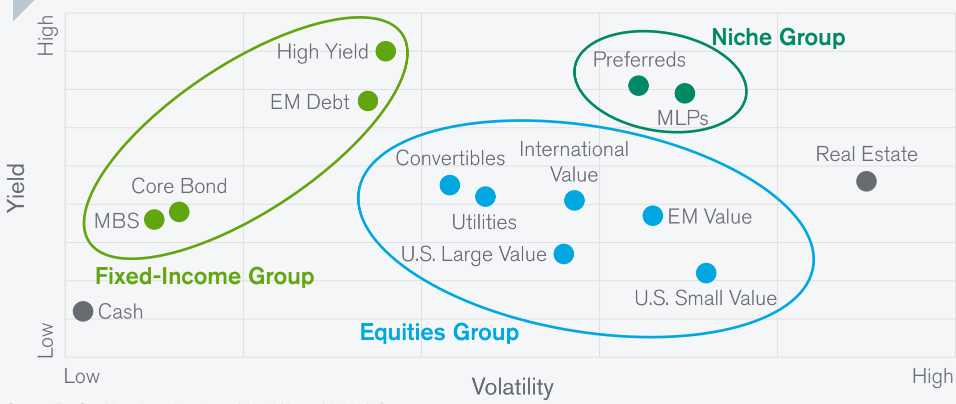
Figure 2 plots the average yield of various income-generating asset classes versus their volatility. With the fixed-income group, income moves higher as volatility increases. With the equities group, volatility is higher, which also means return potential is higher, but income is much lower. What we've identified as the niche group of securities is characterized by high income and high volatility. Exposure to niche areas of the market means these securities are vulnerable to specific risks, such as oil prices or tax regulations. Because of this, we believe the niche group should complement an income portfolio, rather than comprise a significant allocation.

FIGURE 2

Higher Volatility Doesn't Always Equate to Higher Yield

Yield vs. Volatility for Income-Oriented Asset Classes



Source: FactSet, Bloomberg. Data from10/31/2004 to 6/30/2018.
Asset classes represented by the following indices: Real Estate: MSCI USA Real Estate, MLPs: Alerian MLP, Utilities: Russell 3000 Utilities, U.S. Large Value: Russell 1000 Value, U.S. Small Value: Russell 2000 Value, International Value: MSCI EAFE Value, EM Value: MSCI Emerging Markets Value, Core Bond: BbgBarc U.S. Aggregate, High Yield: BbgBarc U.S. Corporate High Yield - 2% Issuer Cap, EM Debt: BbgBarc Emerging Markets Aggregate, MBS: BbgBarg U.S. Agg Securitized MBS, Convertibles: BbgBarc U.S. Convertibles, Preferreds: S&P U.S. Preferred Stock, Cash: BbgBarc U.S. Treasury Bills (1-3M).

How should investors pursue the combined goals of consistent income, attractive total return, and risk management?

Even though it's tempting to equate total return with income, these goals are separate, which means investors often trade one for the other. Therefore, investors must remain mindful of both goals and should consider strategies that pursue those goals simultaneously.

The three hypothetical portfolios in **Figure 3** demonstrate this. Portfolio A maximizes return, Portfolio B maximizes income, and Portfolio C balances income and return. All three have similar risk profiles. Portfolio A offers a strong return, but its income is low. Portfolio B delivers high income, but it gives up total return. Portfolio C offers decent levels of both—while maintaining the same risk exposure as the other portfolios. Along with a significant level of income, Portfolio C's total return is higher than its income, which is key to preventing the depletion of capital. This portfolio represents our approach to income diversification.

We believe investors must remain mindful of both goals—income and total return—and should consider strategies that pursue those goals simultaneously.

FIGURE 3

Striking a Balance Between Income, Total Return and Risk

Total Return and Yield for Three Hypothetical Portfolios with Similar Risk

Source: FactSet, Bloomberg. Data from 10/31/2004 - 3/31/2017. Historical risk of portfolios was 8.8% annualized.

To sum up, what should investors consider when investing for sustainable income?

To achieve sustainable income, we recommend investors strike a balance among income, return potential, and risk. This is a complex undertaking, but professionally managed solutions exist to help investors meet the challenge in a single, well-diversified portfolio. Our approach includes researching and analyzing a range of income-generating asset classes and sources of risk. Based on this work, we invest dynamically across a range of income sources, with the goal of creating a sustainable income stream and attractive risk-adjusted returns over time.

Asset classes represented by the following indices: High Yield: Bloomberg Barclays US Corporate High Yield - 2% Issuer Cap; Preferreds: S&P Preferred Stock Index; MLPs: Alerian MLP; EM Debt: JPMorgan Corporate EMBI Broad Diversified Composite Index; Real Estate: MSCI/USA Real Estate - IG; International Value: MSCI EAFE Value Index; Core Bond: Bloomberg Barclays US Aggregate Bond Index; Utilities: Dow Jones US Total Market Utilities Index; MBS: Bloomberg Barclays US Mortgage Backed Securities Index; EM Value: MSCI EAFE Value Index; Convertibles: Bloomberg Barclays US Convertibles Composite Index; U.S. Large Value: Russell 1000 Value Index; U.S. Small Value: Russell 2000 Value Index; Cash: Bloomberg Barclays US Treasury Bills 1-3 Mo. The Aggregate Portfolio is an equal-weighted portfolio including the same allocation (~7%) of all 14 asset classes.

Past performance is no guarantee of future results.

Diversification does not assure a profit nor does it protect against loss of principal.

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