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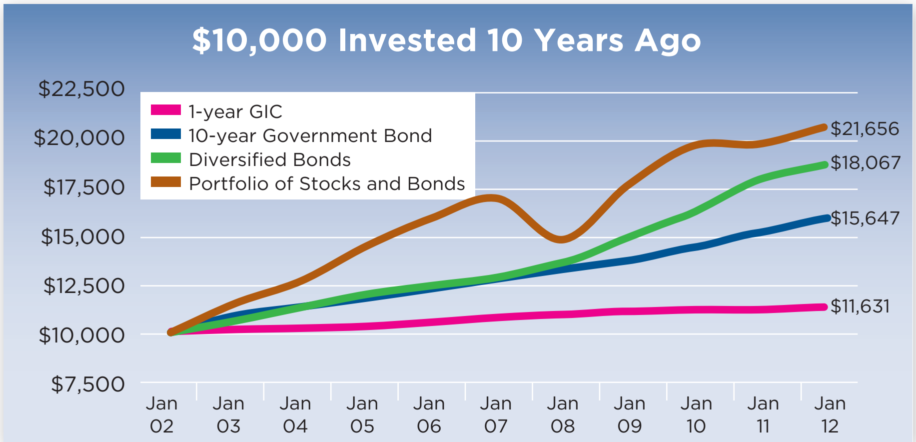
# Generating Income in a Seemingly Income-less World

A look out across 2013 shows a balance of risk and opportunity for investors. Economic indicators suggest the economy is likely to continue on a path of slow growth, which should support reasonable growth in corporate earnings. This, along with healthy dividends, bodes well for positive market performance and equity returns over time. But sizable risks to the economy and markets remain, including the ongoing debt and economic struggles in Europe, U.S. fiscal policy uncertainties and a sluggish global economy – all of which are likely to prompt episodes of elevated market volatility.

## Yield of Dreams? Look beyond Present Rates

This volatility has caused some investors to seek short-term refuge in government bonds, which – along with policy stimulus efforts from many central banks around the world – has pushed interest rates to historically low levels. With monetary policies from the Bank of Canada, the U.S. Federal Reserve and others likely to remain geared toward promoting economic expansion, interest rates have the potential to remain low for some time. Fortunately, low rates don't mean you can't generate income in your portfolio. Nor does it mean low investment returns are inevitable. Looking beyond short-term interest rates and building a diversified portfolio of bonds along with stocks can help you generate income while keeping you on track toward your long-term financial goals.




Source: Ibbotson, Bloomberg, Edward Jones calculations; 12/31/2002–12/12/2012. 10-year Government Bond assumes coupon payments are reinvested in 1-year GIC at the end of each year. Diversified Bonds = DEX Universe Bond Index. Stocks and Bond portfolio = 50% S&P/TSX Composite Total Return Index and 50% DEX Universe Bond Index. 2012 year end value as of 12/12/12. The S&P/TSX/DEX Universe Bond Index are all unmanaged indexes that cannot be invested into directly.

## Diversify Investments to Generate Long-term Income

- A balanced portfolio of bonds and stocks (including those paying dividends) produced an average annual return of 8.0% over the past decade.[1]
- Diversifying fixed-income investments by issuer and maturity can help you generate more reliable income over time. Over the past 10 years, the average return on a diversified bond portfolio was 6.1% per year versus 4.6% for a 10-year Government of Canada (GoC) bond.[2]
- Dividends can be a powerful driver of investment returns. Over the past 10 years, dividend income from stocks has accounted for roughly 36% of the return.[3] Right now, stocks are yielding more than 10-year GoC bonds for only the second time in more than 50 years.

## Action for Investors

Low interest rates don't necessarily mean you need less income, but it's important to consider the current environment as well as the longer term. While it's tempting to shift more of your money toward higher yields in junk bonds, long-term bonds or preferred stocks – or toward the perceived safety of cash or short-term guaranteed investment certificates (GICs) – we think now is the time to rebalance your portfolio to prepare for varying conditions.

Where appropriate, we think you should consider opportunities to generate steady income and the potential for rising income in the following ways:

- **Don't own too much cash and short-term GICs –** Although these types of investments are key components of a diversified portfolio, too much can limit your income given their current low yields. After accounting for inflation, the actual yield on many short-term GICs is zero or even negative. While short-term investments can provide price stability and steady income for the near term, owning too much can prevent your portfolio from earning an appropriate return over the long term. As such, we recommend no more than 35% of your fixed-income portfolio be invested in short-term investments.
- **Create a laddered bond portfolio –** Rates are low now, and while we can't predict exactly when they will change, we think the next sizable move will be higher. As a result, we believe you need to ladder your fixed-income holdings across maturities and make sure you don't own more than 30% in long-term bonds or preferred stock. We believe intermediate-term bonds currently offer an attractive income option given the trade-off between income today and the possible impact of rising interest rates in the future.
- **Optimize your mix of bonds and dividend-paying stocks –** If appropriate for your situation and income needs, we believe now is a good time to buy stocks and stock mutual funds that offer the opportunity for rising income over time. To complement your portfolio's income, many quality stocks currently offer attractive dividend yields above 3% as well as the potential for rising dividends and stock price appreciation.

## Generating Income in the Current Rate Environment

**Low Rates Can Mean Higher Returns –** Just because interest rates are low doesn't mean your investment returns have to be. For many investors, yields on fixed-income investments are only a portion of their portfolio return. Historical periods of low rates have often been followed by strong investment returns, in part because low interest rates can help foster economic growth and rising corporate earnings. In fact, over the past 20 years, in periods where interest rates hit short-term lows, the annual return in the stock market over the next 24 months averaged 23%, including 3% annual dividend income.[4] While we're not forecasting a return of that magnitude over the next year, we do believe the current environment presents investors with compelling reasons to remain invested in a diversified portfolio of quality investments.

**Position Yourself for Higher Rates in the Future –** Current rates may make it tempting to reach for yield in lower-quality bonds or move a larger portion of your money into long-term fixed-income investments. With the potential for longer-term rates to rise, we believe now is a good time to ensure your portfolio won't be substantially impacted if rates rise. Your goals in owning bonds are to provide stability to your overall portfolio value as well as generate reliable income over time, and we believe a laddered portfolio of quality bonds is the best way to do this. In our view, a laddered portfolio can help you:

1. Generate reasonable income amid current conditions
2. Better weather changing interest rates
3. Position your portfolio to take advantage of higher rates in the future

**Equities Can Offer You a Pay Raise –** Build a mix of stocks that can help prepare your portfolio for up and down markets. In particular, look to augment your income, where appropriate, by adding stocks with the potential for dividend increases over time. Companies are sitting on near-record cash levels, which we believe will be partly directed toward dividend increases moving forward. Since 2001, companies in the TSX that have increased their dividends for 10 years have delivered an annual return of 14%, roughly double the return of the TSX and far better than the 4% return for non-dividend payers.[5] Adding the potential for rising income can offset the impacts of inflation over time, as dividend growth has outpaced inflation by nearly 2% since 1960.[6]

Generating income is challenging in the current rate environment, and there's no one-size-fits-all process. The best approach, in our view, involves owning a broad range of investments that provide income in varying ways and in varying conditions. It's important to ensure that your portfolio remains aligned with your long-term financial goals and not simply designed with today's volatile market and low interest rate environments in mind. Your Edward Jones advisor can help you design an investment strategy to help meet your income needs and keep you on track toward your long-term financial goals.

Diversification does not guarantee a profit or protect against loss.

Dividends may be increased, decreased or eliminated at any point without notice.

Sources:

1. Ibbotson, Bloomberg, Edward Jones calculations; 12/31/2002–12/12/2012. Balanced portfolio comprises 50% DEX Universe Bond Index and 50% S&P/TSX Composite Total Return Index.
2. Ibbotson, Bloomberg, Edward Jones calculations; 12/31/2002–12/12/2012. Diversified bond portfolio represented by the DEX Universe Bond Index.
3. Bloomberg.
4. Bloomberg, Edward Jones calculations. Interest rates based on 10-year Government of Canada bond yield. Market return figured on average of |TSX and S&P 500 total return and price appreciation over 24 months after the following dates: 1/27/94, 10/5/98, 6/13/03, 9/2/05, 1/14/09.
5. FactSet, 10/31/2001–12/31/2011. Highest yield = the top 10% of all stocks ranked by yield.
6. Bloomberg.

**Craig Fehr, CFA**
Investment Strategist