SPECIAL REPORT
July 2015

Finding Income in the 'Year of No Return'

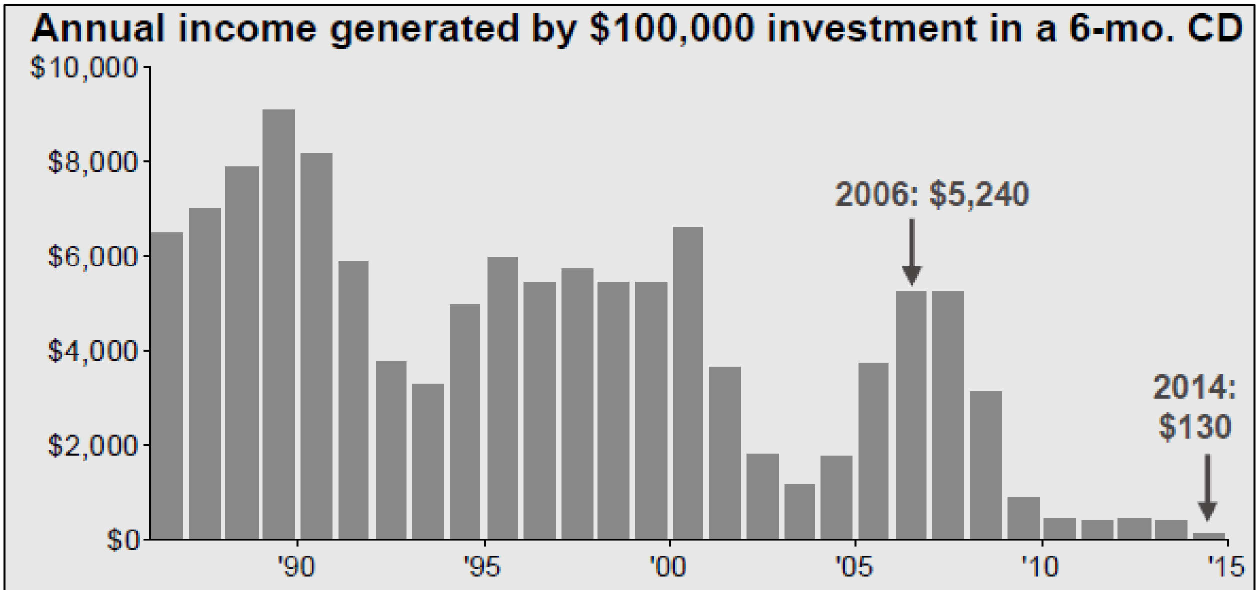
Investing for income is harder than ever in 2015. At the year's halfway mark, few areas have generated positive total return in income-oriented investments. Stocks have fared poorly as well, with the S&P 500 total return up slightly over 1% and the Dow Jones Industrial Average almost flat over the same period.

Rock-bottom interest rates and global market turmoil certainly make this a challenging environment in which to generate sustainable income. Even so, at Kenjol we still see opportunity in carefully selected market niches. This report discusses the challenging environment as well as some areas of opportunity today.

Challenging Times for Income Investors

U.S. investors are now in the seventh year of the Fed's near-zero interest rate policy. The Federal Reserve under Ben Bernanke and now Janet Yellen has obviously been in no hurry to change; they spent over two years making up their minds whether to "taper" off the quantitative easing program before actually doing it.

Now the Fed may be near a decision to lift rates slightly above zero. The timing of the rate increase, which at the beginning of 2015 was expected to take place in June, is now expected to occur in September if not later. Even when the Fed does begin raising rates, any increases will likely be small and slow. We are still years away from seeing bank deposit or Treasury bills above 1% yields. As the following chart shows, the return on “risk-free” investments, represented by certificates of deposit (CD’s), has been minimal. In 2006, $100,000 invested in a 6 month CD generated $5,240 in income. Under current Fed policies, that same $100,000 has generated significantly less income (only $130 income in 2014).



Source: Bankrate.com, Federal Reserve, St. Louis Fed, J.P. Morgan Asset Management.

At the same time, positive economic signs have raised inflation expectations despite plunging oil prices. Inflation serves to reduce the “real” yield on income-producing assets. If inflation reaches the 2% target the Fed thinks possible, then even a 3% nominal bond yield would be only 1% in real terms.

In our past communications, we have made it clear that **<u>we believe that Barclays Aggregate Bond exposure should be avoided</u>**. This includes many of the popular core or total return bond funds, including the Pimco Total Return fund. The index, which has significant interest rate risk, posted a slightly negative return for the first half of the year (not even taking into consideration any inflation).

Corporate and foreign bonds have offered little additional help. Investment-grade corporate bonds delivered negative returns in the first half as businesses wrestled with lower energy prices and economic uncertainty. Overseas, even long-term rates were close to zero in much of Europe even before the Greek crisis intensified in recent weeks. Japanese rates are near zero, too.

Some would say to look for income, or dividend, paying stocks including utilities and REITs. However, given market expectations of higher interest rates, these have struggled as well.

Consider the year-to-date total returns as of 6/30/15 for some notable dividend oriented equity ETFs, all with yields over 3%:

- iShares Cohen & Steers REIT (ICF) -6.07%
- SPDR Utilities (XLU) -10.70%
- iShares Select Dividend (DVY) -3.82%

Desperate for yield and price stability, some investors turned to other instruments that looked superficially attractive. Tax-free municipal bonds looked safe (and many are), but some of the highest yielding muni funds padded their returns with bonds from Puerto Rico, Illinois and other troubled local governments. The tax benefit of municipal bonds isn't much help when their principal value is falling.

"Stretching for yield" can amplify your risk in unpredictable ways. This makes the task of earning attractive income even more difficult. Fortunately, a few niches exist that we believe offer good prospects even in this year's difficult environment.

What's Working in 2015

We currently identify a number of income-oriented investments, which deliver attractive yield with acceptable levels of volatility.

Structured Credit

Since fear of rising interest rates is behind much of this year's income challenge, it makes sense to use income vehicles that are less rate-sensitive. "Structured Credit" is one such category. This group includes Agency and Non-Agency Residential Mortgage Backed Securities, Commercial Mortgage-Backed Securities, Collateralized Loan Obligations, and Asset-Backed Securities.

Many of these securities feature a "floating rate" design, meaning their interest rates adjust at regular intervals. If you have an adjustable rate mortgage on your home, it may well be part of a mortgage-backed securities issue. "RMBS" notes are simply big packages of mortgages like yours. The lender has less risk because the mortgage rates will adjust upward if interest rates rise.

The returns in Structured Credit vehicles react to other factors, like supply and demand in the housing market or changes in consumer credit usage. Their low correlation to traditional fixed income assets makes them very attractive in today's environment. One fund we currently own will earn positive returns if rates rise (based on 3/31/15 interest rate scenarios) and only a slightly negative return even if rates rise 2% (which we consider to be unlikely for some time).

Tactical High Yield Strategy

Our Kenjol tactical high yield strategy also has the ability to make money in periods of rising rates. Overall, the high yield sector is one of the few fixed income sectors that has actually delivered positive returns over previous periods of rising rates.

Like structured credit, high yield is less sensitive to interest rate changes. The key factor is default risk of the issuing companies. We use high yield funds with diversified portfolios so occasional defaults will have minimal impact.

To further control risk, Kenjol utilizes a tactical overlay. Our strategy remains invested when prices are rising, but can move to the sidelines and sit in cash if yields rise enough to generate negative price movement.

Spreads (compensation for risk) over Treasury yields are currently quite attractive. As of June 30, the spread was +5.5% versus a current default rate of 1.9%. The historical spread is +5.9% with a 3.9% default rate.

High yield has been one of 2015's best-performing fixed income sectors. Through June 30, the U.S. Corporate High Yield Index rose 2.5%.

Alternative Investments to Consider

At Kenjol, we're not afraid to look "outside the box." While many advisors restrict themselves to some combination of stocks, bonds, and cash, we monitor and use "alternative investments" when appropriate. They are proving very helpful this year.

Alternative investments that currently look attractive include private real estate, privately traded business development companies, and absolute return funds, among others.

One distinguishing factor in alternatives is they don't always have daily liquidity like mutual funds and ETFs. If you aren't actively trading and don't need instant liquidity, you can many times earn higher returns in exchange for foregoing it.

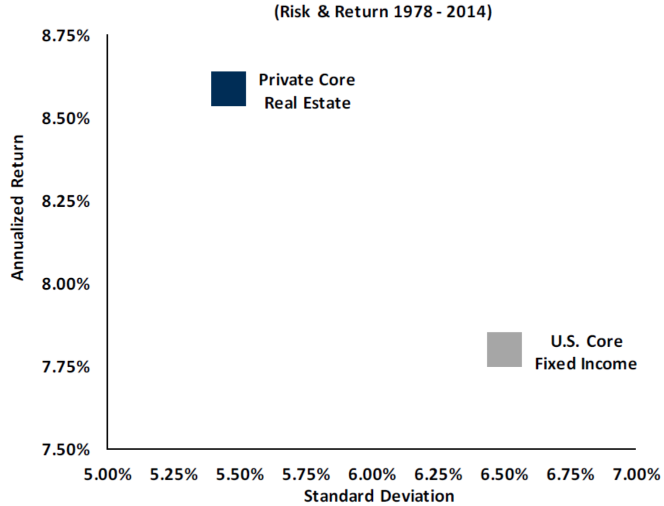
Private Real Estate

Most investors are familiar with public Real Estate Investment Trusts, or REITs. These pools of property trade on an exchange like company stocks. They are often very useful but we find privately offered real estate is more attractive in the current environment.

Private real estate often holds similar types of assets to REITS you see listed on exchanges, but most are at an earlier stage of their lifecycle. Others intend to stay private and offer liquidity in other avenues, such as quarterly redemptions.

Opportunities in this space include both privately-traded REITs and multi-manager vehicles. Multi-manager REITS offer diversified access to a portfolio of privately held real estate, most of which have very high barriers to entry by individual investors. In this structure, the overall manager makes smaller investments in various private REITs and the pooled vehicle is offered to individual investors.

Private Core Real Estate vs. U.S. Core Fixed Income[1]
(Risk & Return 1978 - 2014)



[1] Private Core Real Estate is defined as the NCREIF – NFI ODCE Index.
U.S. Core Fixed Income is defined as the Barclays U.S. Aggregate Bond Index.

Individual privately-traded REITs invest in more narrow opportunities, which typically bring greater risk but also the potential for greater return. Examples include a healthcare REIT, a grocery store REIT, a REIT investing in hotels, and a multi-family REIT, to name a few.

Private real estate is an excellent income alternative because it can generate higher returns with lower risk than public REITs, while also exhibiting an uncorrelated performance cycle.

Business Development Companies (BDC)

We see another very useful alternative investment in Business Development Companies, or BDCs. These specialized investments combine high dividend payouts with potentially favorable tax treatment and reduced interest rate risk. This combination makes them ideal in the current environment.

BDCs make loans to small and midsize businesses (the "middle market") and pass the interest on to shareholders as income, similarly to real estate investment trusts (REITs) and master limited partnerships (MLPs). Like those vehicles, BDCs are "flow-through" vehicles for tax purposes. They pay no corporate taxes as long as they distribute at least 90% of annual income to shareholders as dividends. Many distribute an even higher percentage. Distributions can be ordinary income, qualified or non-qualified dividends, return of capital, or a combination of these tax categories.

The middle market that BDCs serve is huge, comprising approximately 200,000 businesses with $10 trillion in gross revenue. If this market were a country, it would be one of the world's largest economies.

We typically utilize non-traded BDCs which bring liquidity restrictions but also help minimize volatility. We rely primarily on investments who partner with large private-equity firms including Apollo, GSO Blackstone, and KKR.

		Potential Effects On:	
	INTEREST RATES	VALUE	INTEREST INCOME
Floating Rate Investments	↑	Stable	Increase
	↓	Stable	Decrease
Fixed Rate Investments	↑	Decrease	Fixed
	↓	Increase	Fixed

Most BDCs take advantage of a floating rate structure that, like structured credit, protects against rising interest rates. The effect of rising rates on both floating rate and fixed rate investments is shown on the chart above. They also tend to invest on the highest end of the capital structure, which helps enhance recovery prospects if a borrower defaults.

Absolute Return Funds
Most traditional stock and bond funds tie themselves to a benchmark index, like the S&P 500 or Russell 2000 Small Cap Index. Their goal is to beat the index, not necessarily earn positive returns. If the benchmark drops 20% and a fund loses only 15%, the fund manager will consider it a victory because the index did even worse.

Absolute Return Funds target positive returns without regard to benchmarks. The goal is to deliver a reliable, consistent return in all market environments. To do this, they combine the conventional asset classes with others like currencies and commodities. They may also use "non-directional" methods that involve short-selling and other active trading strategies.

Adding one or more absolute return funds to an overall portfolio can have real, measurable benefits over traditional strategies alone. They tend to perform best when stocks and bonds are at their worst. This low correlation helps cushion losses in bear markets and deliver more stable performance over time.

Other Alternative Investments
Kenjol also looks to other alternative investments we won't detail at this time. These include private equity investments that take equity stakes in non-public companies. These investments have the opportunity to generate attractive income and / or capital appreciation depending on the specific investment.

Another investment vehicle we utilize is "life settlements" or life insurance contracts. By investing in a large enough pool, the investment attempts to take advantage of actuarial statistics to generate uncorrelated returns.

Conclusion

As you can see, while today's environment is challenging, opportunities exist to investing outside of core or total return fixed income, which we believe to be risky and offer flat or negative real returns over the coming years.

If you want to learn more about any of these opportunities and whether they may be appropriate for your financial situation, please contact us at any time by phone at 512-506-9395 or e-mail at discovery@kenjol.com.