This article, written by an RII officer, recently appeared in *On Wall Street* magazine, and appears here by permission.

HIGH YIELD: A PERPETUAL FLAME DRAWING INVESTOR MOTHS

Americans culturally believe more is better. Some burger chains label soft drinks no longer small/medium/large but instead large/super/giant. In income investing, however, yield reaching predictably produces lower returns or net losses.

High yield is simply easier to sell, and for self-directing investors to sell themselves, than low yield. Investment professionals and academics understand that apparent higher returns mean shouldering elevated risk. But investors, and unfortunately some relied-on investment helpers, focus on today and overlook tomorrows.

Years back, as an analyst covering utilities for a retail-oriented sell-side firm, I recommended selling two electrics whose dividends were facing imminent omission. On the squawk box ,I mentioned they yielded about 13-14% *in hindsight* -- numbers probably unsustainable. Shockingly, several brokers actually called their income-seeking clients and *bought* the stocks at tempting yields. It was simply a really easy ticket to write, despite predictable longer-term consequences. Brokers well know it is easier to sell a higher-yielding REIT, utility, or bond fund than a safer one with lower yield.

Reaching for yield is an understandable temptation. As consumers we want more term insurance for our premium dollar, a higher CD rate at the bank, and so on. The idea that accepting -- ;let alone seeking – lower anything (*lower yield?!*) is so jarring as to be rejected out of hand. Beyond the intuitive sense that more must be better, at least two psychological reasons make higher yield easy to sell investors.

First, humans focus most on what's clearly visible because of proximity. Things in the distant future are more nebulous and uncertain. So we mentally downgrade or outright ignore them, a pattern behavioral economists call hyperbolic discounting. With high-yield fund investments, the cash flow expected next quarter/year is a powerful purchase inducement, whereas unknown chances of distant future reductions are difficult to envision and so downplayed. Markets are fairly efficient, explaining why shares of the larger competitor Verizon trade to provide lower dividend yield than others like Qwest: risk is the reason. Long-term bonds and bond funds holding them carry higher yields for involving greater inflation and principal risk. Non-FDIC banks' CDs yield more because they're uninsured.

Second, people actively dislike focusing on risk and loss, which explains holding losing stocks irrationally, and postponing writing wills. Here, again, considering risk gets short shrift.

The sub-prime mortgage morass is the latest example of yield reaching. Banks and mortgage brokers wrote higher-interest mortgages to ever-less-qualified borrowers. By great irony, the Street actually *bought* some of the rancid product that it would normally sell to yield-reaching buyers for commissions. Famous houses reached for high yield, assuming nothing would go wrong: hey, those loans were written on government-mandated standard forms! After multiple re-packagings and layers of derivatives/leveraging, no one yet can quantify the price for this chasing of yield. Prudence by those who eschewed high yield is being rewarded.

Sometimes risk is invisible; occasionally not yet conceived of. Munibonds are suffering because some AAA insurers' guarantees became suspect. Closed-end income fund managers using leverage were recently shocked to learn that ARPs they've routinely counted on for 20 years do not renew100% dependably. The apparently free ride of enhanced yield and the pricing that came with it evaporated.

A 2005 Lipper study documented that over long periods total returns on high-yield bond funds topped those on U.S. Government funds by a mere 20 BPs/year. Investors in the former bought the palpable current cashflow but ignored the historically demonstrated principal risk. Sadly, a lot of product sellers blithely abetted that error. Default rates in junk bonds were historically low at under 1% in 2007, not long after stunning consecutive 12%s in the last recession. Early in this recession, with even venerated banks in questionable shape, now is hardly a time to reach for yield in such bonds and funds!

A significant component of the total risk in any investment, especially volatile ones, lies in investors' brains and bellies: many holders predictably panic and sell when spooked. Investment sales people and money managers should take the long view and refrain from tempting innocent investors with yield reaching. As 78 million Boomers hit retirement and look for income, this becomes a moral obligation of high order.