Generating Portfolio Income

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Most people think of investment income solely as the cash flow they receive from bond coupons and stock dividends. However, this is an incomplete view. We encourage investors to consider both cash flow and growth in the value of their investments. By adopting a total return approach, one that generates income from **both cash flow and capital growth, investors can optimize their spending rate from a portfolio across market cycles to align cheap and expensive investments to their goals.**

Investors should consider multiple sources of portfolio income: bond coupons, stock dividends, financial strategies and capital growth. Individually, each source offers some degree of cash flow and opportunity for capital appreciation, and poses some risks from liquidity, volatility and growth. For example, in today's low-yield environment, investors relying excessively on cash flows are squeezing their bond portfolios harder than ever for that last bit of current income, and as a result venturing into riskier areas they normally might not consider. A diversified approach can help mitigate some of these risks.

SUMMARY

In a goals-based approach to wealth management, income is key to an investor's ability to fund *essential goals*. Investors should consider funding these goals through multiple sources of income, including coupons, dividends, financial strategies and capital growth. Given the current low rate environment, certain sources of income have become quite expensive and may not yield enough to meet spending needs. However, by drawing income from many sources at a sustainable rate and in a tax-efficient way, investors may be able to meet their goals while balancing risks.

The Wealth Allocation Framework

The Wealth Allocation Framework helps you put your goals and aspirations at the center of decisions about allocating your financial resources. **This paper focuses on strategies that may be appropriate for Personal and Market asset categories.**

Personal: Individual investors have a desire for safety and personal financial obligations they want to meet regardless of market conditions. To safeguard essential goals, investors can hold lower-risk assets—but they have to accept lower returns in exchange.

Market: When we invest, we strive to capture market growth most efficiently. Today, access to a broadening array of asset classes and types makes diversifying beyond stocks and bonds easier than ever before.

To learn more, read the whitepaper, *Investing in a Transforming World: The Wealth Allocation Framework*

Exhibit 1: Many sources to meet an investors income needs

- Equities are favored over bonds but come with higher risk of losses
- Sustained and growing dividends preferred

- Cash flows paid at discretion of firm management

- Bonds are expensive
- Yields are not enough to meet most income needs

- Cash flows are contractual

- Portfolio gains may be harvested adding to current income
- Prudent for retirees to trim profitable positions for income

- Less certain and subject to price fluctuations

- Annuities may provide retirement income
- Option overlay strategies augment equity income

- Annuities are contractual. option strategies that include principal risk

Source: ML GWM Investment Management & Guidance. As of May 2015.

We recommend investors start by using the Wealth Allocation Framework to help set realistic goals and determine specific income needs, taking into account individual risk tolerance, time horizon and liquidity needs. **We believe that drawing income from multiple sources, at a sustainable withdrawal rate and in a tax-efficient way, can provide an investor with a more optimal income portfolio** (see Exhibit 1).

MULTIPLE SOURCES OF PORTFOLIO INCOME

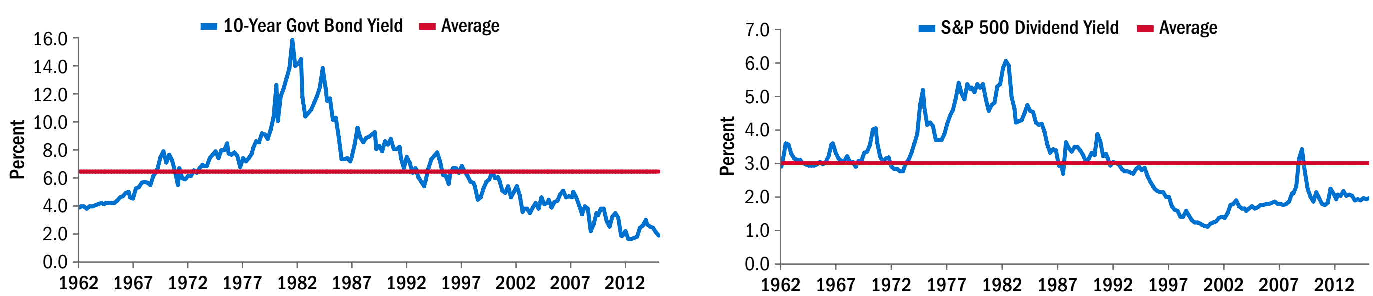
Once an investor has determined the income needed for systematic withdrawals, he or she should consider multiple sources of portfolio income. Bonds have traditionally been the main source of portfolio income for individuals. However, after a 30-year bull market and ultra-accommodative central bank policies, **bonds have become richly valued and generally don't yield enough to meet income needs** (see Exhibit 2). Dividend-paying stocks are the natural next step for income-seeking investors, though they come with a higher risk of losses, and currently also look somewhat expensive.

The next source involves certain specialized approaches that provide income solutions to address specific goals. For example, annuities can provide retirement income and certain options may help generate income and manage risks. Finally, an investor should also consider harvesting capital growth by selling portions of appreciating assets to enhance an income-generating portfolio. These capital gains are taxed at a lower rate than other types of income such as equity dividends.

BOND INCOME IS A GOOD FOUNDATION

Bond income typically comes in the form of coupon payments – contractually guaranteed streams of interest income paid at predictable intervals. With many kinds of bonds available to generate income, investors must choose between limiting risk and stretching for a higher yield. All bonds are not equal, and the biggest variables are credit risk and interest rate risk. Credit risk is the risk that a bond issuer fails to meet its contractual obligations to pay coupon interest and repay the principal to an investor. It can be minimized by selecting the relative safety

Exhibit 2: Both bond coupons and equity dividends are low and expensive



Sources: FactSet, Haver Analytics and ML GWM Investment Management & Guidance. Quarterly data as of 1Q 2015. **Past performance is not indicative of future results.**

of Treasuries and high-quality municipal bonds, with the latter being an attractive choice for taxable investors. Alternatively, investors can select riskier bonds that pay higher coupons to compensate for the potential for default. Investment-grade corporate bonds, high-yield bonds and emerging market bonds carry varying degrees of credit risk.

Another way to get a higher yield is to invest in longer maturity bonds as they pay higher coupons to compensate for longer holding periods. However, they also have greater interest rate risk (also called duration risk), which is the risk that a bond's value declines as prevailing interest rates rise.

Laddering is a popular strategy in this environment that enhances cash flows while helping to reduce long-term interest rate exposure. It involves building a portfolio of bonds with staggered maturities where cash flow from currently maturing bonds is reinvested at regular intervals in new ones with higher interest rates.

To balance the risk and return of a fixed income portfolio, investors also can apply a core/satellite portfolio construction approach. In this strategy, the core is made up of Treasuries, municipals and high-quality corporate bonds, while the satellite consists of the more risky varieties. The core typically makes up the majority of the portfolio, and the size of the "satellite" varies depending on the risk tolerance of the investor.

EQUITY DIVIDENDS OFFER BOTH CURRENT AND POTENTIALLY GROWING INCOME

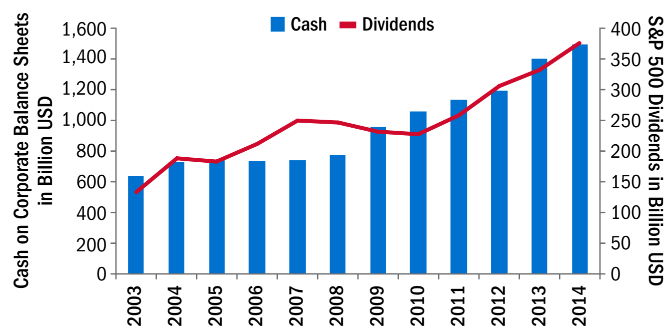
Dividend-paying equities or funds can play an equally important role as a source of income in a diversified portfolio. Dividends are regular, often quarterly, payments by companies or funds to shareholders. However, unlike coupon payments on bonds, dividends are not contractually guaranteed and can fluctuate over time.

High-dividend equities can typically be found in more mature industries, such as utilities and telecom, or issued by low-growth firms where profits do not need to be reinvested into the company. Dividend-growth stocks offer the advantage of expected increases in dividends, and therefore greater income for the investor over time. While rising dividends can be attractive, they can also be very popular and consequently the stocks can be expensive. However, the risk this poses can be mitigated by diversifying across various sectors.

In addition to stocks, there are other sources of dividends though they may not be suitable for all investors. Other types of equity instruments that pay dividends include Master Limited Partnerships (MLPs) and Real Estate Investment Trusts (REITs). It also may be worthwhile to look abroad for dividend income opportunities. Global markets can provide relatively attractive options for further diversifying an income-generating portfolio. Suitable global opportunities for an investor's specific goals can be identified through advice from a Financial Advisor.

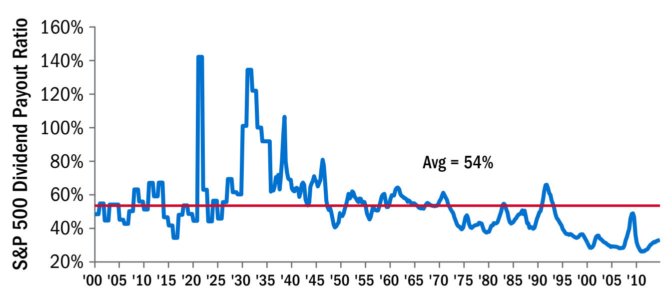
Like coupons, dividend income is also relatively expensive at this time, although given the accumulation of cash on corporate balance sheets (see Exhibit 3), it may be set to grow (see Exhibit 4). Even with a portfolio of coupon and dividend income, the yields still may be in the range of only 2% to 3%. Investors can accept the market rate and move on, or, as we suggest, consider diversifying into additional sources of income.

Exhibit 3: Corporate cash and dividends



Sources: FactSet, Haver Analytics and ML GWM Investment Management & Guidance. Quarterly data as of 1Q 2015. **Past performance is not indicative of future results.**

Exhibit 4: Dividend payout ratios low but likely to rise



Source: S&P, BofA Merrill Lynch US Equity & US Quant Strategy. Data as of April 2015. **Past performance is not indicative of future results.**

FINANCIAL STRATEGIES SUCH AS ANNUITIES AND OPTION OVERLAYS

Financial strategies encompass a potentially broad range of income solutions. These include investments such as annuities, market-linked securities and options, among others. **Often income from these sources depends not on a dividend or a coupon, but on something else such as the creditworthiness of an insurance company. Yet these strategies can be valuable to investors in diversifying the sources of income.** Owing to their somewhat more complex nature, these forms of income generation often offer higher rates of return than coupons and dividends, but also carry special risks.

An annuity can complement a traditional investment portfolio as a financial instrument that could provide lifetime income.[1] Numerous research studies have shown that allocating a portion of investors' portfolios to annuities could help them reduce the risk of outliving their retirement assets. Income annuities convert assets into lifetime income commencing immediately or at a defined point in the future. Deferred fixed or variable annuities with optional living benefit riders (available for an additional cost) can help protect retirement income regardless of how the annuity investment performs. There are specific risks unique to different types of annuities that a Financial Advisor can help explain.[2]

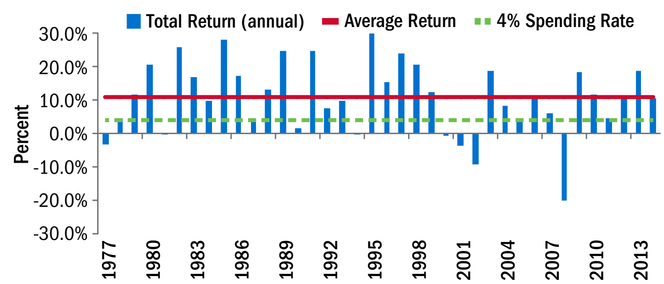
Selling options also presents an opportunity to generate income in a portfolio. Typically, an investor seeking income will sell an option to collect the premium, generating income. A classic example is selling covered calls. In this case, an investor sells an option to buy equities he owns. The investor earns the premium and has limited principal risk if the option is exercised given that he already holds the stock. Selling covered calls on securities that appear susceptible to short-term declines may be a smart strategy, as the premiums earned can help offset any volatility. As always, the use of derivatives requires a complete understanding of the risks and limitations of a particular strategy, and can benefit from the guidance of a Financial Advisor.

Market Linked Investments (MLI) can also generate portfolio income. Certain structures such as STEP Income Securities (STEPS) can provide an investor with regular income in addition to growth potential. However, these are unsecured securities of an issuing company and should be used appropriately.

HARVESTING CAPITAL GROWTH: SELLING SOME PORTION OF A PORTFOLIO TO PROVIDE INCOME

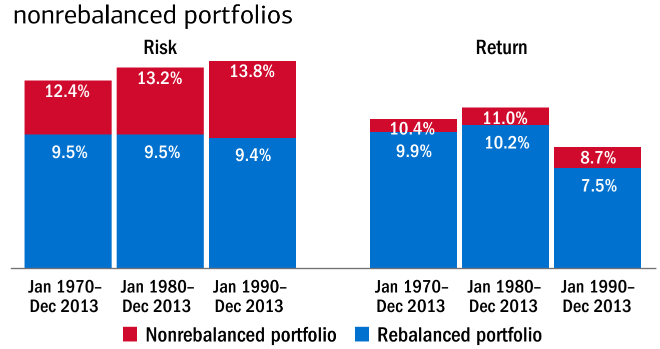
Most investors only consider the cash flows like dividends and coupons when planning for income. However, this approach is incomplete. **Investors should also consider the capital appreciation of investments in their portfolio as a source of income.** By harvesting capital gains in addition to relying on cash flows, the investor can work toward a total return strategy. The simple approach is for the investor to generate income by selling a portion of the portfolio at regular intervals to meet liquidity needs. Historically, total returns have varied over time, so an investor should maintain a spending rate below the average total return of the portfolio to avoid unintended shortfalls (see Exhibit 5). While there are potential tax and fee implications with this approach, the simplicity and ability to tie asset sales to a consistent portfolio rebalancing process are key to success. An added benefit of this portfolio rebalancing as part of an active management approach is mitigating the risk that the portfolio drifts from strategic allocations to ones with a different risk profile (see Exhibit 6).

Exhibit 5: Average portfolio return should exceed an investor's spending rate



Source: ML GWM Investment Management & Guidance and Consolidated Investment Analytics. Annual data as of 2014. Note: 60% / 40% - Indices are represented as 60% S&P 500 Index and 40% Barclays U.S. Aggregate Index. Rebalancing is done annually. **Past performance is not indicative of future results.**

Exhibit 6: The risk and return of rebalanced versus nonrebalanced portfolios

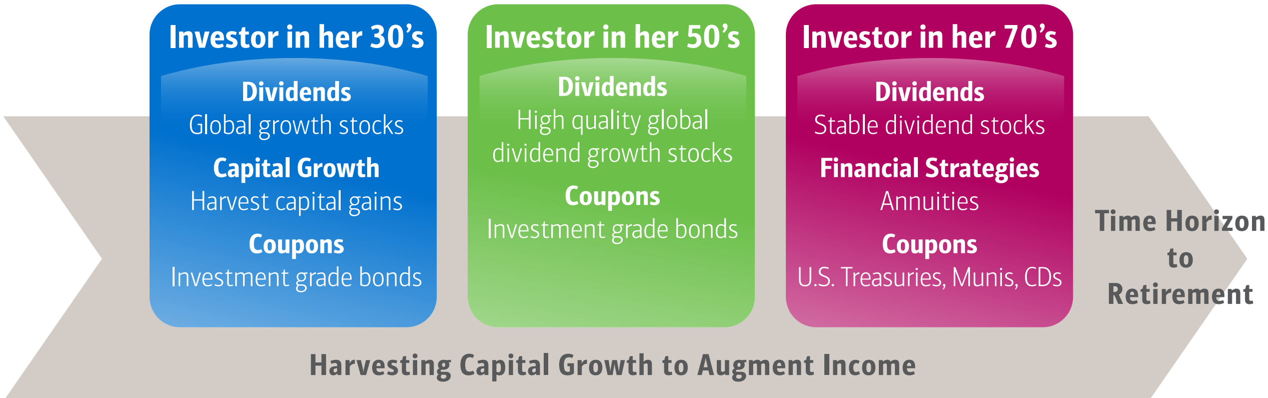


Sources: Morningstar. *For further explanation please see the appendix on page 7.

[1] All annuity guarantees and payout rates are backed by the claims paying ability of the issuing insurance company.

[2] Please see the appendix on page 7 for note detail.

Exhibit 7: Stylized lifecycle timeline of income-generating investments



Source: ML GWM Investment Management & Guidance.

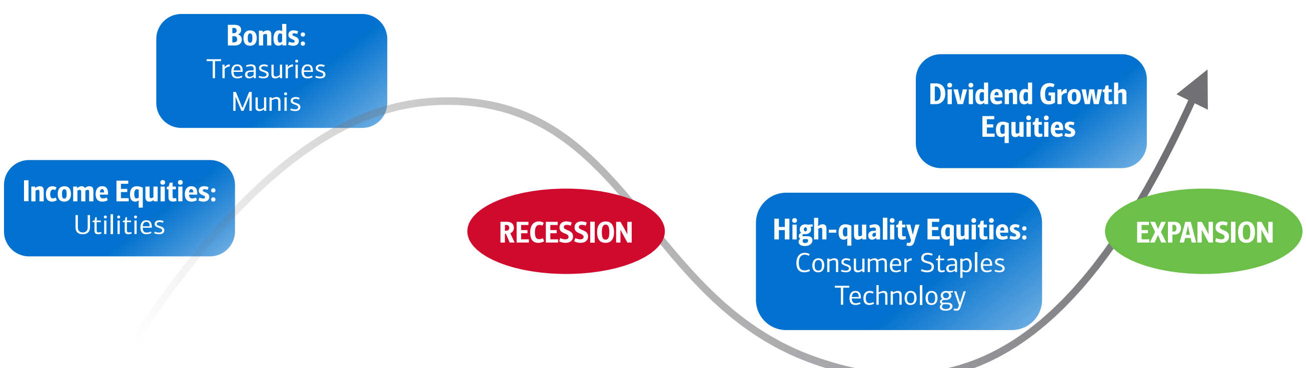
PERSONAL GOALS AND THE BUSINESS CYCLE MATTER TOO

While we recommend assembling a well-diversified portfolio of income-generating investments consistent with one's investment objectives, **it is important to consider how well each instrument aligns with an investor's goals within the Wealth Allocation Framework.**

For example, in the case of retirement income, a natural tendency would be to consider relatively secure strategies such as government bonds. However, retirees in their 70s also may need to invest in dividend-paying equities that can provide growth of capital (see Exhibit 7). By contrast, an income-seeking investor in her 30s may favor much higher allocations to dividend-growth stocks and capital appreciation.

In addition, the optimal allocation of income investments can change with the business cycle. For example, in an economic expansion, a balanced menu of income-generating investments may call for greater emphasis on dividends from sectors that do well in the early phase of an economic expansion—Consumer Discretionary and Staples as well as Technology and dividend-growth stocks. By contrast, if the economy is approaching a recession, an investor might emphasize income sources from coupons with lower credit risk, such as Treasuries and municipal bonds (see Exhibit 8). When interest rates rise, as we expect in late 2015, it could be prudent to avoid extended interest rate risk by selecting bonds with shorter maturities, higher coupons or variable rates, and to favor blue-chip dividend-paying equities. Rising rates may also present headwinds to equity price appreciation.

Exhibit 8: Select income-generating options along a stylized business cycle



Source: ML GWM Investment Management & Guidance.

CHOOSE WISELY AMONG INCOME INSTRUMENTS

Income instruments offer different combinations of risk and reward and various levels of liquidity. Working with a Financial Advisor can help you choose wisely among them based on the following considerations.

- **Loss of Capital:** Investors who may have an imminent need for the capital in a portfolio may want to take less capital risk as the impact of a market selloff can be long-lasting. While yields on Treasuries are generally unattractive compared to other classes of fixed income, they continue to help diversify portfolios and principal repayment is virtually guaranteed. **Risk-averse investors with a focus on capital preservation may have to be content with investments offering a lower yield.**
- **Greater Volatility and Correlation:** Certain instruments may offer higher income but also inject more volatility into a portfolio, which may not align with an investor's risk tolerance. In addition, some income instruments may be relatively safe on their own but their price movements can be highly correlated with those of other investments, making an overall portfolio more vulnerable to broad changes in value.
- **Income Stability:** Counting on income from equity or bond instruments is not always reliable as the cash flows from coupons and dividends can be cut if the issuer runs into financial difficulties.
- **Liquidity:** In certain cases, income-generating investment vehicles, such as closed-end funds (CEFs), may be infrequently traded (or "illiquid"). They may also trade at a price different from the collective value of the underlying holdings.
- **Concentration Risk:** Many equity income products have a high proportion of their assets allocated to a few sectors (such as Utilities and Telecom), which may increase the risk in a balanced portfolio from those sectors experiencing a downturn. The concentration of risk can come in several forms—country or style, for example—and investors must be aware of the unique issues associated with those investments.
- **Unintended Risks:** Equity segments that have recently become favorite sources of income have a greater sensitivity to interest rates. REITs and MLPs have historically underperformed broad equity markets in rising rate environments, and have exhibited greater volatility relative to fixed income.
- **Tax Implications:** Of all of the variables that could affect investment income in the years ahead, we believe one of the most certain is rising taxes. Neutralizing taxes at the investment level is a proven strategy, but requires attention to all applicable tax laws and a thoughtful approach that combines active tax management of positions with overall risk management of the portfolio. We strongly urge investors to consult with advisors and tax professionals for specific advice on their individual situation.

PORTFOLIO STRATEGY

The quest for income is unlikely to end soon as Fed policy is expected to remain accommodative even after the first rate increase, keeping government bond yields low for longer and valuations unattractive. Beyond bonds, high-dividend equity valuations remain elevated relative to history, limiting the capacity for dividend yields to increase. A blind reach for an income target pushes investors further out on the risk spectrum.

We encourage investors to adopt a more holistic, total return approach to generating income to meet sustainable spending needs. To this end, we believe that an optimal portfolio should include many income sources that can provide **both cash flow <u>and</u> capital growth**. The appropriate blend must be tied to one's overall financial goals, taking into consideration an individual's risk tolerance, time horizon, income and liquidity needs with a spending rate that sustains the investor's wealth.

SOURCES, REFERENCES AND FURTHER READING

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APPENDIX

Note (from page 4):

All contract and rider guarantees, optional benefits and any fixed subaccount crediting rates or annuity payout rates, are backed by the claims paying ability of the issuing insurance company. **They are not backed by Merrill Lynch or its affiliates, nor do Merrill Lynch or its affiliates make any representations or guarantees regarding the claims paying ability of the issuing insurance company.**

It is possible to lose money in a variable annuity purchased with an optional protection rider. Variable annuities have holding periods, limitations, withdrawal charges, exclusions, termination provisions, and terms for keeping them in force. Optional riders may be irrevocable and expire without use.

Exhibit 6 Details:

Each portfolio consists of 60% stocks, 30% bonds, and 10% cash at the portfolio begin date. The 60% stock allocation consists of 30% large, 15% small, and 15% international stocks at each portfolio begin date. The bond allocation consists entirely of five-year U.S. government bonds, while the cash allocation consists of 30-day U.S. Treasury bills. The portfolios have been rebalanced annually.

Large stocks in this example are represented by the Standard & Poor's 500®. Small stocks are represented by the fifth capitalization quintile of stocks on the NYSE for 1970–1981 and the performance of the Dimensional Fund Advisors, Inc. (DFA) U.S. Micro Cap Portfolio thereafter, international stocks by the Morgan Stanley Capital International Europe, Australasia, and Far East (EAFE®) Index, government bonds by the five-year U.S. government bond, and cash by the 30-day U.S. Treasury bill. The data assumes reinvestment of income and does not account for taxes or transaction costs. Risk and return are measured by annualized standard deviation and compound annual return, respectively.

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