Finding income today

By: Babak "Bob" Zenouzi, *Senior Vice President/Chief Investment Officer, Delaware Investments*

With 10-year Treasury yields at approximately half of what they were just five years ago, some income investors have begun buying alternative investments, often based on yield alone. In the following notes, Bob Zenouzi, chief investment officer of the Delaware Investments® Real Estate Securities and Income Solutions (RESIS) group, addresses his thoughts on the dangers of an income-only strategy, as well as his team's current views of traditional income-producing assets, such as dividend-paying stocks, real estate investment trusts (REITs), and high yield bonds.

On valuations for dividend-paying stocks

We believe that certain sectors of the high yield equity market are expensive, such as utilities, telecommunications, and consumer staples. In our opinion, these areas are generally overextended in terms of valuations, relative to their rate of dividend growth.

However, we believe that other sectors — such as healthcare, energy, and industrials — are currently undervalued, and generally provide better dividend growth. In all, we believe discerning investors can still find solid income-oriented opportunities.

We believe it's important to own companies that do not necessarily have the highest dividend, but rather, have a current and sustainable dividend that can grow in any environment. Holding these sorts of companies is important, particularly in today's low-growth environment, because we believe the market will capitalize on those stocks to a higher level than those stocks that have a higher dividend and no growth. There is no guarantee, however, that dividend-paying stocks will continue to pay dividends.

Current conditions within the REIT market

We still like the fundamentals in the REIT market — such as a lack of supply — but REITs are another area in which we are wary of valuations at the moment. In the last few years, for example, Japanese investors have increased fund flows in REITs from zero to $40-45 billion based on the belief that mutual funds will deliver strong returns (source: Citi Investment Research & Analysis. March 2012, most recent data available). Given that sort of dynamic, we remain cautious on REIT holdings within the portfolios we manage.

High yield bonds: Relatively strong fundamentals

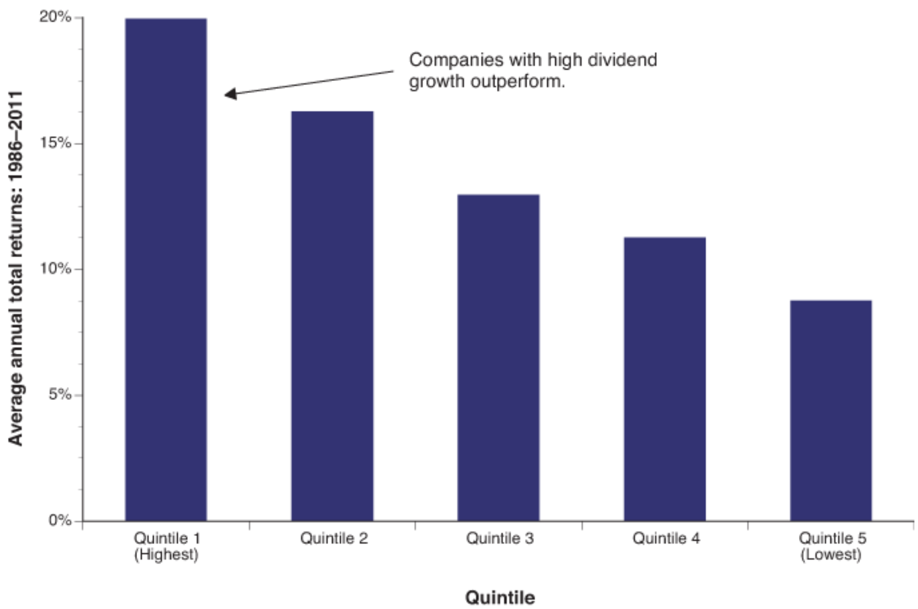
What interests us about high yield bonds is how much more yield they offer than Treasurys. We feel there's a nice spread between high yield bonds and the Treasury rate, which yields currently less than 2% (source: Bloomberg), and fundamentals among issuers of high yields bonds are currently pretty strong, in our view.

That said, we are keeping an eye on fund flows into high yield bonds because the lowest potential yield possible without the issuer defaulting remains at historically low levels.

Emphasizing total return potential over yield alone

We believe investors should consider an investment's total return potential, rather than just its yield. When considering stocks, for example, those with sustainable dividend payouts have historically outperformed those with the highest yield, as noted in the chart below.

Total returns historically driven by dividend growth, not current yield



This chart looks at companies within the S&P 500® Index, grouping them into quintiles based on rates of dividend growth. As shown, companies with the highest rates of dividend growth (those in the higher quintiles) historically have generated the strongest overall returns. *Data: Compustat, Deutsche Bank*

Chart is for illustrative purposes only and is not a representative of the performance of any specific investment. Past performance does not guarantee future results.
Investors are reminded that different types of investments involve varying degrees of risk.

We believe investors should also be cautious about chasing the highest yield possible for another reason — yield rates are currently highly correlated to Treasurys; and if Treasury yields rise, investors could suffer significant capital losses.

The views expressed represent the Manager's assessment of the market environment as of October 2012, and should not be considered a recommendation to buy, hold, or sell any security, and should not be relied on as research or investment advice. Views are subject to change without notice and may not reflect the Manager's views.

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IMPORTANT RISK CONSIDERATIONS

Investing involves risk, including the possible loss of principal.

Fixed income securities can lose value, and investors can lose principal, as interest rates rise. They also may be affected by economic conditions that hinder an issuer's ability to make interest and principal payments on its debt. Bonds are also subject to prepayment risk — the risk that the principal of the bond is prepaid prior to maturity, potentially forcing the investor to reinvest that money at a lower interest rate. High yielding, noninvestment grade bonds (junk bonds) involve higher risk than investment grade bonds.

Narrowly focused investments may exhibit higher volatility than investments in multiple industry sectors. REIT investments are subject to many of the risks associated with direct real estate ownership, including changes in economic conditions, credit risk, and interest rate fluctuations. A REIT's fund's tax status as a regulated investment company could be jeopardized if it holds real estate directly, as a result of defaults, or receives rental income from real estate holdings. "Nondiversified" Funds may allocate more of their net assets to investments in single securities than "diversified" Funds. Resulting adverse effects may subject these Funds to greater risks and volatility.

While dividend payments can provide an important income cushion, they should not be construed as having the same level of risk as interest payments received from bonds. Generally speaking, dividend income can be more volatile than interest income. What's more, the principal portion of a stock allocation can be more volatile than a bond allocation, because prices for stocks tend to move less predictably than prices for bonds.

The S&P 500 Index measures the performance of 500 mostly large-cap stocks weighted by market value, and is often used to represent performance of the U.S. stock market. An index is unmanaged and one cannot invest directly in an index.

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About the Author

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Bob Zenouzi is the lead manager for the real estate securities and income solutions (RESIS) group at Delaware Investments, which includes the team, its process, and its institutional and retail products. He also focuses on opportunities in Japan, Singapore, and Malaysia for the firm's global REIT product. Additionally, he serves as lead portfolio manager for the firm's Dividend Income products, which he helped to create in the 1990s.

About Delaware Investments

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