ALBION FINANCIAL GROUP

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GUIDING CLIENTS TO A LIFETIME OF GOOD DECISIONS

THE SEARCH FOR INVESTMENT INCOME: CAN YOU SAFELY EARN 8% INCOME PER YEAR FROM YOUR PORTFOLIO?

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It is no secret that interest rates are low and have been for a long time. For nearly five years, many respected professionals have incorrectly predicted an imminent rise in rates. "They can't go much lower", "rates haven't been this low since World War II", and "printing money will cause runaway inflation and higher interest rates" have become such commonplace quotes that most listeners have simply tuned out. The public has accepted that interest rates are low and may very well stay low for the foreseeable future. In this regard, The Fed has won; investors have quit waiting for rates to rise. They have acquiesced, cashed out their CDs, and are now willing to take on additional risks in the quest for higher yields and returns. But care is warranted. That warm feeling of consensus – others agreeing with your point of view - often comes at a high price. Wall Street is all too happy to profit by creating and selling products to meet this surging demand for yield. Caveat emptor – it was just five short years ago that subprime loans and mortgage backed securities were Wall Street's product du jour. This doesn't mean it is too late to look for yield, but it does indeed suggest caution. The purpose of this paper is to discuss several of the investment tools that Albion has used to help clients increase their portfolio cash flows.

Let's begin with the question posed in the subtitle: Can you safely earn 8% income per year from your investment portfolio? The short answer is "not easily and not without taking some risks."

The benchmark of a completely "safe and liquid investment" is a short term U.S. Treasury Bill. A three-month treasury bill yields 0.036% year or just $360 a year on a $1 million investment. By contrast, a portfolio with an 8% yield generates $80,000 per year -

a material difference for anyone, whether you have $1 million, $100,000 or $10,000 to invest.

It is possible to construct a diversified portfolio that has a reasonable likelihood of delivering 8% cash flows per year. But be forewarned; this portfolio is not without risks and it is certain to experience volatility along the way. In other words, this is not a "risk free" portfolio. Whether the resultant level of risk is suitable for you depends on your personal situation.

Any balanced discussion on investments should include a candid dialog on risks as well as potential rewards. Therefore, this paper begins with a candid discussion of risk and why it matters. Then, to illustrate the risk-return tradeoff, we review five investment choices along the risk-return spectrum and discuss some of the risks and benefits associated with each.

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WHAT IS RISK? / WHAT IS A "SAFE" INVESTMENT?

Ultimately, the true measure of risk is not the stock market's daily price movement that we hear about on the nightly news. Rather, it is the risk of not achieving one's financial goals. Most people fail to meet their financial goals for one of three reasons: 1) They did not save enough money, 2) Their investments lost money, or 3) Their rate of investment return was simply too low. The impact of reasons 1 and 2 are self-evident. The impact of #3, returns being too low, is less apparent. Like failing to eat well or exercise regularly, the consequences of low investment returns are easy to miss day-by-day but become alarmingly clear over the long-term.

Viewed in this light perhaps the risk-free U.S. Treasury is not so risk-free after all. If an investor needs a 5% portfolio return to achieve their goals, the Treasury's meager 0.04% yield guarantees this investor will fall short. That is the challenge with "safe" investments - you sleep soundly each night as you drift further and further away from reaching your goals.

It is tempting to define risk this simply - the likelihood of not achieving your financial goals. Unfortunately, this definition is incomplete. If only investing were

this easy … determine what return you need to achieve your goals, build a portfolio likely to achieve those returns over an investment cycle and wait. Voila'! In 10 or 20 years you are done.

What this measure of risk misses is the very essence of what it means to be human – we have emotions. Not just emotions that make life richer – love, gratitude, empathy - but also negative emotions – fear and greed. We all have these negative emotions; Mother Nature and evolution made sure of it. See something scary, like a lion, and we run for safety (fear). See something pleasurable – food, shelter or a beautiful car - and we run towards it (greed).

While fear and greed were useful emotions for cavemen fighting for survival, they are treacherous for investors. Because of this, we ourselves are often the biggest risk factor to our own long-term investment success. But there is hope.

By redefining how we look at risks and by refocusing on the true objective – achieving our reasonable investment goals – we can dramatically increase our likelihood of success. Some people are able to do this on their own; others benefit from working with an unbiased financial advisor to help them make good decisions and to keep their financial journey on course.

CASH FLOW INVESTMENT CHOICES:

The following investment choices fall along a risk-return continuum where we define risk as the probability that the investment loses money over a full investment cycle (typically 5-7 years). While there are thousands of investments that can create yield in your portfolio, this paper focuses on five – chosen because they illustrate different tradeoffs between yield and risk and because we have used each of them, to some degree, in client portfolios.

1. Short Term, High Quality Corporate Bonds (Yield: 1-2% per year)

Bonds are simply an alternative form of debt capital. As companies get larger, they can bypass banks and raise debt less expensively directly from the public. For instance, Apple Computer recently raised debt by selling bonds. Their short-term bonds pay investors less than one-half of one percent more than the equivalent short term U.S. Treasury security. Why? Because investors are willing to accept lower interest rate payments from financially strong companies such as Apple.

What is the risk of loss in short-term, high quality corporate bonds? Pretty low. It is unlikely that companies such as Apple, Walmart or Kraft Foods will go bankrupt in the next 2-4 years and not pay their bond obligations. The bigger risk to most investors is that, after taxes, the yield on high quality, short-term bonds likely will not keep up with inflation. While these types of bonds serve the role of providing stability to one's investment portfolio they do so while providing a rate of return less than the rate of inflation. It is very difficult to meet long-term goals with returns that make your dollars less valuable each year.

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2. High Quality Dividend Paying Stocks (Yield: 2%-4% per year)

We like quality dividend paying stocks, in part, because they tend to increase their dividend payments at a rate faster than inflation. Over the past 10 years, inflation has averaged 2.35% per year. Dividend paying stocks in the S&P 500 have increased their dividends by 6.5% per year during that same time period – more than double the

pace of inflation. Thus, a retiree living off of dividends from high quality stocks has seen the purchasing power of his dividend checks actually increase over time.

What is the risk trade-off with dividend stocks? Volatility. Like all stocks, dividend-paying stocks are subject to swings in their share price, possibly substantial swings. Many investors were shocked to see just how volatile their "safe" dividend stocks were in 2008 and 2009. Yet what is the true long-term risk to investor capital? How likely is it that companies such as Coca-Cola, Procter & Gamble, and Verizon will be permanently hurt by a recession? We think the probability of permanent damage to these companies is low. The global economy would have to get pretty bad before people give up 50-cent soda, toothpaste, or their cell phones.

For many investors, a combination of short term, high quality bonds and dividend paying stocks offer an attractive overall yield and an acceptable level of risk. For these investors, going beyond bonds and dividend stocks may not be worth the increased risks – the pain of loss outweighs the joy of gain. The investment choices that follow take a meaningful step along the risk-return spectrum, both in potential return (good) and risk (bad).

3. Master Limited Partnerships, MLPs (Yield 5-7% per year)

MLPs are tax-favored investments that typically involve the transportation, processing or storage of energy products such as oil and gas. A classic example of an MLP company is a gas pipeline firm. One of the advantages of MLPs is single taxation. In a typical company, the firm's profits are taxed and then after-tax cash flows are used to pay dividends to shareholders, which are then taxed again on the shareholder's personal tax return. As long as certain restrictions are met (such as pay-out of at least 90% of income to shareholders), MLPs are not taxed at the

corporate level, thus avoiding double taxation. More importantly, transportation MLPs such as pipelines tend to be relatively immune to price swings in the energy market. They function more or less as a toll road and are indifferent to the price of the material they transport. That said, they are impacted by supply and demand. If either drops, so will revenues – reducing cash flows available to investors and negatively impacting the firm's stock price.

What is the risk level of MLPs? Over an investment cycle, fairly modest. Month-to-month or quarter-to-quarter the price of an MLP stock will certainly fluctuate; perhaps substantially. But, if supply and demand stay healthy, the regulatory environment remains friendly and management runs the company well, strong MLPs should exhibit long-term price stability.

4. Private Debt Business Development Companies, BDCs. (Yield 8-10% per year)

Investments in private debt funds are typically limited to accredited investors1 . The BDC structure offers these funds the ability to raise money from the general public via the stock market (as long as the BDC is registered in compliance with Section 54 of the Investment Company Act of 1940).

BDCs are publicly traded on exchanges such as the NYSE. BDCs that loan money to privately held

companies are called “private debt BDCs.” Privately held companies typically pay higher interest rates on their loans, which is why some investors like private debt BDCs - they want the opportunity to earn higher interest rates than those offered by publicly traded bonds.

But take care. Unlike MLPs that typically target investments in stable, recurring revenue businesses, BDC investments can include a wide range of businesses from risky start-ups to safer, more mature companies.

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We prefer BDC’s that provide floating rate loans because payments to the BDC will increase if benchmark interest rates increase. Further, we prefer BDCs that loan to higher credit quality companies which generally means loans to larger, more mature businesses in stable industries.

Most private debt BDCs use outside debt to leverage returns to their shareholders. How this outside debt is structured is critically important to the inherent risk of the BDC. Simply put, you don’t want the BDC’s debt to come due before their loans are paid back to them. For example, if a BDC provides a 3- year loan to a company, you don’t want that BDC leveraging their fund with debt they must pay back in 90 days. Private debt BDCs that address the five criteria below have the potential to deliver strong returns while remaining first in line, ahead of other investors, in the event of a default. Most BDCs carry too much risk for our comfort. However, the Albion research team has successfully identified a few BDCs that meet our investment criteria. Challenging to find, yes, but they do exist.

Five important aspects to consider when evaluating private debt BDCs include:

1. Proprietary deal flow
2. Proven track record of performance and credit management (low default rates) through various economic cycles
3. Portfolio primarily of floating (not fixed) rate loans
4. Diversified portfolio across industries and geographies
5. Intelligent use of leverage

5. Alternative Investments. Accredited Investors1 Only. (Yield 10-12% per year)

Alternative investments are simply investments that do not trade on public exchanges such as the NYSE. Broadly defined, these investments include venture capital, private equity, real estate, oil & gas, private debt, and others. For this paper, we focus solely on private debt funds, real estate funds and cash generating private equity funds.

Private Debt Funds: The increased regulatory environment and the need to rebuild their own balance sheets has forced many commercial banks out of historically profitable markets. The effect for private debt funds has been reduced competition, better quality borrowers and the ability to charge higher interest rates. This is a nice combination for lenders. Private debt funds generally target 10-12% annual yields and are similar to the BDCs discussed earlier. In fact, several private debt funds also offer publicly traded BDCs. BDCs have the advantage of immediate liquidity as they trade on public exchanges (you can easily sell the fund if you want). Unfortunately, as of this writing, most private debt BDCs trade at a 10-20% premium to their net asset value. This means investors are paying up to $1.20 for each $1.00 loaned by the firm. It takes nearly three years for a 7% loan to merely cover that premium. While private debt funds are illiquid (hard to sell), there is typically no premium associated with them and, consequently, they offer the investor a higher yield than available in the publicly traded BDC.

Real Estate Funds: Most readers are likely familiar with the basics of real estate investing. In most positive economic cycles, real estate investments tend to do fairly well. Done wisely, real estate produces reasonable cash flows and the opportunity for capital appreciation. Where investors tend to get hurt is when they overleverage their properties or when they get overly optimistic on their ability to make a quick profit ("flip" the property). One of the major challenges with real estate investments is that they tend to be fairly active. It can take a fair amount of the investor's time. Real estate funds are nice as they eliminate the time consuming aspects of this investment. Unfortunately, the fund managers also tend to take much of the economic upside as well. These funds take as much as 50% of the profit on top of annual fees. The least friendly deal terms we have seen are from real estate funds and oil & gas partnerships. The mentality of these managers towards investors seems to be "...well, I don't see you doing any of the work." Finding strong real estate funds with reasonable investment terms is challenging at best. They do exist but investors will likely need to conduct an extensive search to find one that meets their investment criteria and has reasonable terms.

Cash Generating Private Equity Funds: These funds typically target yields of 8-12% per year. They invest in recurring revenue industries such as landfills, frozen food storage and land leases under cellphone towers or billboards. Privately held companies in these industries tend to sell for 5 - 8 times free cash flows. For example, a company with sales of $10 million and $1 million a year in free cash flow would likely sell for $5M - $8M. If a buyer paid $7M for this company, he would earn a yield of 14% a year on his investment ($1M/$7M = 14.3%). Some may consider "stable and recurring revenue businesses" boring, but to income investors, these companies are captivating. Alternative investments have the greatest yield potential of the five asset classes discussed in this report, but how risky are they? In a word, risky. Yet there are several steps an investor can take to reduce the risk and make these have the greatest yield potential of the five asset classes discussed in this report, but how risky are they? In a word, risky. Yet there are several steps an investor can take to reduce the risk and make these investments appropriate in a portfolio. Investors should be proactive in investment selection, forward looking in investment analysis, critical in due diligence, and they should diversify, diversify, diversify.

Investors are locked into these investments for the life of the fund, which is often around 10 years. Because of this, it is imperative that investors be diligent and patient. You don't want to be "sold" an

alternative fund. Rather, you want to seek out and find the very best funds for a given investment style. The secret to investing successfully in this space is to proactively choose strategies that are likely to benefit from current and future trends. Don't be lured into the trap of "rearward thinking." Your success is much more dependent upon trends that will develop over the next 5-10 years than those that have already come and gone. Admittedly, this is difficult.

Once you have identified the strategies that you like (e.g., private debt, low-mid market buyout, late stage venture capital, etc.) then seek out the very best managers within this small subset of strategies. While effective, this approach requires a great deal of time, resources and effort. Albion estimates that there are over 12,000 alternative investment funds. But, as most readers would guess, only a small subset of these managers is best in class. Finding the best managers is critical to the success of any investment strategy but even more so with alternative assets. The vast majority of returns in this space come from the top-quartile managers.

Diversifying among 8-12 funds, each of which likely has a $1 million minimum investment (or more), is a high hurdle for most of us. One effective way to solve this challenge, while also addressing the need to perform time-consuming due diligence, is to invest in a "fund of funds" (FOF). Under this structure, the FOF manager leads the research efforts and selects the underlying funds that become part of the FOF's portfolio. By accepting commitments from a multitude of investors, the FOF can meet the relatively high minimums of most funds and still provide a diversified portfolio to each investor in the FOF. For example, each of Albion's fund of funds has a minimum investment size of $250,000 and gives investors exposure to several underlying funds diversified across a variety of strategies. While there is no way to entirely eliminate risk with alternative assets, a well-designed fund of funds offers a degree of due diligence and diversification that helps reduce the overall risks.

IN SUMMARY

So, can you safely generate 8% cash flows a year from an investment portfolio? With the right investment tools, adequate diversification, and good decision making along the way, we believe it is possible to create a portfolio that generates an 8% income stream. What about risks? For some investors, but

certainly not all, a portfolio like this has a level of risk (defined as the likelihood of losing value over an investment cycle) that is acceptably low. Such an investment portfolio would likely include:

- A well-constructed fund of funds that targets current income investments (accredited investors only).
- High quality dividend paying stocks and MLPs.
- Private Debt BDCs that have proven credit management skills, low default rates, sensible leverage and that primarily offer floating rate loans to higher credit quality companies.

The final allocation amongst these asset classes is critically important to an investor's success. Unfortunately, this topic is outside of the scope of this paper. It should also be clear that the ultimate yield of the portfolio will vary based on the allocation amongst the various assets. Albion Financial Group has a great deal of expertise in this area and is happy to discuss this topic in greater detail if the reader is interested.

Please note that the 8% portfolio would likely not include the "safest" options as outlined earlier in this report - no short term, high quality corporate bonds or U.S. Treasury securities whose interest rates are simply too low. Without bonds and Treasuries volatility will be higher. However, there is some level of perceived price stability (less volatility) provided by the fund of funds allocation. This is because the values of its underlying investments are calculated using metrics such as revenues and cash flows - not on the volatile emotions driving prices on the publicly traded financial markets. While not as effective as bonds at buffering volatility, a FOF's formulaic calculation of value does offer some perceived price stability for the portfolio.

But let there be no doubt - this is not a "risk free" portfolio. From a volatility standpoint, this portfolio will likely see a fair amount of price movement quarter-to-quarter and year-to-year. Yet for an investor with a long-term focus and comfort with volatility, this portfolio could be a powerful tool for generating income.

The search for yield is growing increasingly difficult for all investors. But today's low rate environment does not mean investors are powerless to produce an attractive level of income from their portfolios.

The investment tools discussed in this paper gives investors the ability to create portfolios best suited for their unique situation. For some, that may mean a portfolio of high quality dividend paying stocks and bonds. For others, it may mean a more aggressive portfolio that generates higher income but that also has higher risks.

Creating the right investment portfolio to achieve your financial goals is challenging. Candidly, it always has been and likely always will be. But, it is a worthy and important goal – one that all of us on the Albion Team are proud to devote our professional careers to helping clients attain.

— FOR MORE INFORMATION —

about Albion Financial Group's investment strategy and portfolio models, please contact your financial advisor or visit AlbionFinancial.com.

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