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The High Income Factor

Unlocking Powerful Strategies to Achieving Superior Returns

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Don't Be a Victim of Bernanke's Low-Rate Gamble . . . Exploit It

I recently flew from my home in frigid New Jersey to warm Palm Beach, Fla., to address a group of private investors on the economy.

They were shocked by what I had to say. And most made immediate changes to their investment portfolios. I'll tell you exactly what I told them in a minute . . .

But first, I need you to know that rock-bottom interest rates don't have to be a disaster for those who need to generate income. Understanding one particular aspect of the current environment can save you from missing out on a huge investment opportunity that's literally right under the nose of every American.

As I mentioned to these investors, the United States is not financial healthy. We are in perhaps the worst economy of our lifetimes. It's certainly the worst I've ever seen.

Here's why . . .

This is the longest period of sustained high unemployment since the Great Depression, averaging more than 9 percent for the past two and a half years.

After the near financial collapse in 2008, the economy has only sprung back with a whimper and job creation has been almost nonexistent. We won't have a sustainable recovery until we're putting more Americans to work.

How lame has this "recovery" been? Economic growth, as measured by the gross domestic product, has averaged less than 2.5 percent in the nine quarters since the recession, one of the weakest recoveries on record — especially coming off such a severe downturn. The first half of 2011 posted almost recessionary GDP growth of less than 1 percent. Meanwhile, the government is drowning in unsustainable debt, desperate for strong economic growth to increase tax revenues and reduce unemployment.

Because our elected officials in the White House and Congress have been impotent in providing meaningful solutions to these problems, the Federal Reserve System has been forced to do most of the heavy lifting. In doing so, it has pulled out just about everything from its bag of tricks.

A hyperactive Fed on steroids has put up trillions of dollars in backstops and bailouts through the Troubled Asset Relief Program and other plans. It also lowered short-term interest rates, operated two rounds of quantitative easing, and recently announced "Operation Twist." But now the central bank is running out of bullets.

When the economy again sputtered after the second round of quantitative easing (QE2) this spring, the Fed did something highly unusual. Unable to lower interest rates further, the central bank did the next best thing and announced it would keep short-term rates at "current levels" until mid-2013.

This is the most impactful announcement from the Fed that I have ever seen in my 20 years on Wall Street.

While the Fed's intention was to keep rates low to encourage borrowing and stimulate the anemic economy, it also delivered a blockbuster that can be parlayed into double-digit income *for those who know where to look.*

Let me explain . . .

High Rates in a Low-Rate World

At first glance, it certainly seems as if the low interest rate environment is a curse for those who need to generate cash flow. Here's a table of current yields on several traditional investment staples that most investors buy:

10-Year Treasury	1.9%
Three-Year CD	1.2%
S&P 500 Average Dividend Yield	2.1%
Investment-Grade Corporate Bond Yield	4.5%
AAA 10-Year Municipal Bond	3.8%

Most of these securities are actually losing money after factoring in the cost of inflation and taxes. (The official inflation rate is about 3.6 percent year over year). But given the current sorry state of the economy and the volatile market, some might think that just losing a little bit isn't a bad deal these days.

Don't be fooled by all the pessimism because if you look beneath the surface, huge yields can actually be found today. Sure, the general economy stinks. But there are niches in which business is booming.

Just as certain businesses benefit from high oil prices, more infrastructure spending, or increased consumer demand, there are businesses that benefit from low short-term interest rates. The pocket of prosperity for these low interest rate beneficiaries creates opportunity. While business is terrible for some, it is absolutely booming for others — and yields spun off by these companies are easy, ripe, and double digit.

Ironically, the very fact that interest rates are unusually low creates an opportunity to earn yields that are unusually high.

The Low-Rate Opportunity: Clarity for Investors in an Uncertain World

The federal funds rate (the rate set by the Fed that major banks charge each other to borrow money) is a bellwether for short-term rates.

Right now, the federal funds rate is 0 to 0.25 percent, the lowest it's been in modern times. As you can see from the chart below, interest rates are normally very tricky to predict beyond the immediate or foreseeable future — but these aren't normal times.

Again, the Fed has announced that it will keep short-term rates at current levels until at least mid-2013 — more than a year and a half from now! That's clarity that I've never seen in my time on the floor of the New York Mercantile Exchange or my 15 years as a financial adviser.

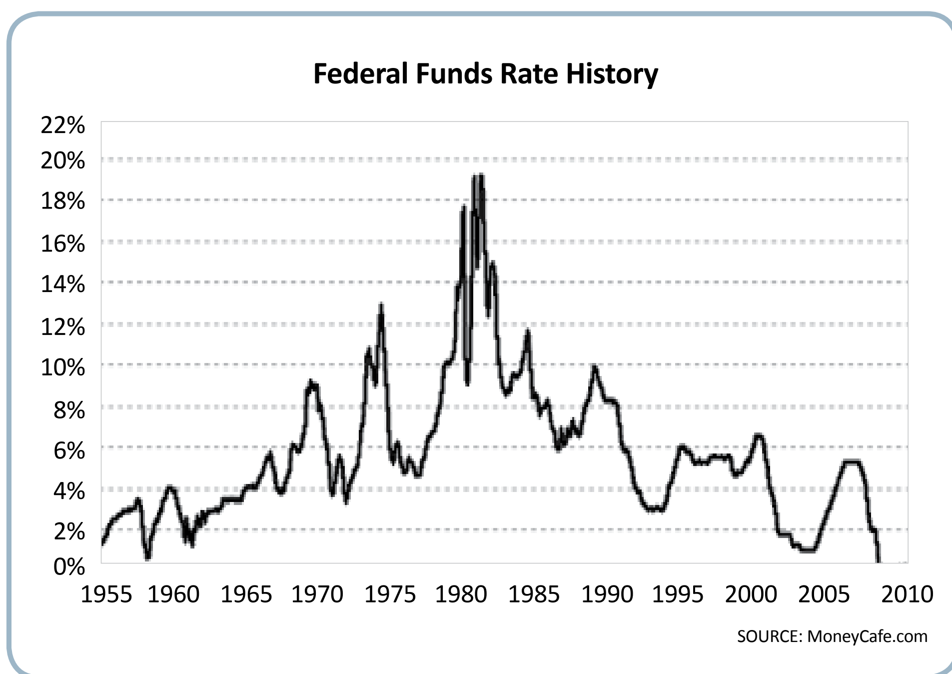
This highly unusual commitment creates a fantastic opportunity to earn high dividends from companies and funds that use leverage.

Leverage: Multiplying the Opportunity The Fed's Providing

Leverage is a term loosely defined as any technique that multiplies gains and losses. For most investments, leverage is borrowing money at low short-term interest rates and using that money to invest in higher-return investments, thus earning additional money on "the spread."

This process increases risk by amplifying potential losses and also increases potential return by amplifying potential gains.

The primary problem in using this type of



SOURCE: MoneyCafe.com

leverage is rising interest rates or, more specifically, rising short-term interest rates. However, because Fed Chairman Ben Bernanke has guaranteed that these rates will not increase until mid-2013, we know that the bulk of risk has been eliminated. In addition, given the likelihood of a continued weak economy, it is highly doubtful that Bernanke will be in any hurry to raise rates in 2013.

The unusual clarity on short-term rates creates opportunities in certain parts of the market to get a high income while maintaining and possibly even growing principal. This is precisely the point I made to the private investors in Palm Beach: You can grab high income, even though we live in Bernanke's low-yield world.

And as I explained to them, there are two great ways to take advantage.

ADVANTAGE NO. 1

The Easy Way to Manage a Rewarding Bond Portfolio

Sure, short-term federal funds rates are near zero. But as one investor recently complained to me, "That doesn't do me any good!" He's right. Try to get a loan for less than 1 percent. If you want to borrow on margin in a brokerage account, chances are you'll pay at least 6 or 7 percent.

These rock-bottom rates are the domain of big banks and huge multinational corporations that have the money to take advantage of sophisticated financial instruments like overnight repurchase agreements and the like.

The good news is that you can piggyback off these large organizations that have powers and abilities far beyond those of mortal men. And you don't need hundreds of millions of dollars to benefit from near-zero short-term rates.

Closed-end funds offer benefits normally reserved for "fat cats" and organizations with incredible amounts of doe to throw around. First, you own a share of a huge portfolio of securities, providing a level of safety through diversification that you can't get yourself. Second, funds have the resources and expertise to scour the markets on a continuous basis for the best opportunities.

But these investments also use something else — leverage. CEFs often borrow money against the fund's assets (usually up to 35 or 40 percent) at these rock-bottom short-term interest rates and reinvest the money in their higher-yielding securities, thus juicing the distributions with extra income. The additional spread earned enables investors to enjoy a higher income than the regular portfolio generates. In certain times, this practice can be quite risky. But, as I mentioned earlier, these times are special.

Right now, there are 59 leveraged closed-end funds paying distribution rates of 8 percent or higher, of which 32 pay at least 9 percent. These funds come in all different sectors of course, including high yield (junk bonds), preferred stock, international, and tax free.

Right now, there's one fund that I think offers the best opportunity in this environment. Best of all, it'll put cash in your pocket each and every month. I can't think of a better fund to start you on the path of lifelong dividend investing.

This fund is the Pimco Income Opportunity Fund (PKO).

This multi-sector closed-end bond fund has the flexibility to invest in any kind of debt security any place in the world with a goal of total return

FIRST PICK AT A GLANCE

PIMCO INCOME OPPORTUNITY FUND (NYSE: PKO)

SECTOR/TYPE: Closed-end fund, multi-sector bond
PRICE: $25.31
52-WEEK RANGE: 23.57 - $29.54
YIELD: 9.0%
PROFILE: This multi-sector closed-end bond fund can invest in any type of bonds anywhere in the world.

POSITIVES

- The fund has the flexibility to seek out the best opportunities and shift gears if the markets change.
- The use of leverage is timely in this environment.
- PKO has a solid track record, and it is earning the high monthly dividend.

RISKS

- The fund uses an unusually high amount of leverage that could amplify losses.
- PKO has a big part of the portfolio in uninsured mortgage securities.

through income and capital gains. PKO attempts to put Pimco's best income ideas in a single fund.

Flexibility is the key to this fund. Most funds specialize in one area of the market like high yield, emerging market debt, or investment grade. But things can change fast in today's markets, and the ability to move in and out of different debt sectors and seek out the best values anywhere on the planet can provide a strong income and a level of diversification found in few income funds.

In taking advantage of the current situation, this fund uses a high degree of leverage — about 49 percent. That means the fund borrows money on 49 percent of the fund's assets at low short-term rates and reinvests that money in higher-yielding securities, thus making extra income on the spread. Given the low current short-term rates and the clarity in time frame discussed earlier, high leverage is a timely way to generate higher income.

As of Aug. 31, top holdings included mortgage securities (101 percent), investment-grade corporate bonds (31 percent), high-yield bonds (15 percent), and emerging market securities (7 percent). The largest sector holding was finance (which includes mostly banks and insurance companies) at 25 percent, and the next largest were utilities (4 percent) and integrated oil (4 percent). As you can see, because of the company's leverage, its top holdings exceed the fund's total size. The fund is 17 percent short government bonds and 51 percent short cash.

The average maturity in the portfolio is about 8.45 years, and the average rating is a slightly below investment grade BB- (as of July 31).

Now, I can almost hear you saying, "Whoa, how much is in mortgage securities?"

Yes, PKO holds a high percentage of mortgage bonds, which can naturally be a cause for alarm. After all, lower-rated subprime mortgages were primarily responsible for the financial crisis. However, most of PKO's investments are in commercial (not residential) mortgages that management considers solid credit. There is tremendous opportunity in this market, and the fund manager, Dan Ivascyn, has a long experience in asset-backed securities and is the portfolio manager on Pimco's mortgage and asset-backed securities team.

Because this type of fund has a tremendous amount of flexibility, management's aptitude is especially important.

> "The key to any closed-end fund is the ability of the managers that construct and re-balance the portfolio."

This is a lesson that I learned firsthand during my years as an investment adviser at UBS. The key to any closed-end fund is the ability of the managers that construct and re-balance the portfolio. I have analyzed funds for decades and personally met with many fund managers. The experience has taught me to spot the telltale signs of superior management.

First, the managers need to show a track record of being ahead of the curve, anticipating the next strong performing sector of the market rather than just reacting. Second, the fund needs to perform strongly in bad markets as well as good markets. And finally, the fund needs to have top-notch resources and expertise.

Not only is PKO managed by an expert in the lucrative mortgage market, but the fund also can access Pimco's debt research, which I consider the best in the business. The fund's track record proves it can correctly anticipate market moves and perform in tough markets.

Since its inception in 2007, PKO has blown away the competition, outperforming the multi-sector leveraged fund group with an average annual return of 11.7 percent compared to just 3.7 percent for the group. Also, PKO has significantly outperformed its peer group in rough times. In 2008, PKO lost -24 percent compared to a 40 percent drop for the group, and so far this year, the group is up less than 2 percent, while PKO is up nearly 11 percent.

On the next page, you can see a snapshot of how PKO's total returns stack up to the largest of its peers and the multi-sector leveraged fund group as a whole over recent tumultuous markets and the

past several years: It's a clear cut above the rest.

The best thing about this fund is that it pays distributions every month. The current monthly distribution has been $0.19 since March when it was raised from $0.17. The current dividend translates to a stellar 9 percent yield at today's price.

Pimco's also a good dividend because it's all paid out from net investment income with no return of capital. In fact, the fund had $0.69 per share in undistributed income as of July 31.

PKO does currently sell at a 5.25 percent premium to net asset value compared to an average 1.67 percent premium over the past three years. However, that's because the fund is in demand thanks to the great opportunity in leveraged funds following the market sell-off this summer.

▸ Conclusion: PKO has used its flexibility and leverage well. The fund is also not bound by any one asset class and has the ability to shift the portfolio if circumstances change. The solid monthly income juiced by leverage is a timely opportunity.
Buy shares of PKO under $26.00.

ADVANTAGE NO. 2

Grab Higher Yields by "Being the Bank"

Let's face it, being a banker can be a sweet deal.

Banking's primary business of borrowing money cheap and lending it out at a higher rate built capitalism and built this country. The problem is that most regular people are on the wrong side of the scheme. That is, we're the ones who pay the bank higher rates for loans while they get rich.

Well, there is way you can be the banker. Through ownership of certain securities, you can take advantage of the profitable practice of borrowing money for virtually nothing and lending it out to people at higher rates. This opportunity exists in mortgage real estate investment trusts (REITS).

As the name implies, mortgage REITs invest in loans secured by mortgages rather than property like traditional REITs. Today, many people hear the word "mortgage" and run the other way. This fear is understandable because, as I said before, mortgages are what caused the financial crisis. But amid this perceived crisis is really a secure opportunity.

You see, those were *subprime* mortgages that didn't have a government-guaranteed backing. Many mortgage REITs invest *only* in mortgages guaranteed by U.S. government agencies (Fannie Mae, Freddie Mac, Ginnie Mae). Because the government has taken over these organizations, they are obligations of the U.S. government with essentially zero credit risk.

REITs enjoy a huge tax advantage that enables them to pay much higher dividends than regular companies. They pay no income tax at the corporate level, provided that 90 percent of the net income is paid out in dividends. So money normally lost to taxes is available to pay higher dividends.

But mortgage REITs pay huge dividends even for tax-advantaged investments because they use leverage more than any other securities on the market. The bulk of profits are generated by simply borrowing money at low short-term rates (obtained through repurchase agreements and other vehicles available to large organizations) and reinvesting this money in higher-yielding mortgages — thus earning money on the "spread."

By owning these securities, you earn money just like a banker does, and because these securities pay out 90 percent of profits to shareholders in the

COMPARATIVE BOND FUND RETURNS

FUND	YTD	2008	3 years
Pimco Income Opportunity Fund (PKO)	10.94%	-24.40%	27.17%
Calamos Convertible and High Income Fund (CHY)	-0.36%	-27.07%	21.61%
Nuveen Multi-Strategy Income and Growth Fund (JQC)	2.59%	49.30%	32.63%
GROUP	1.82%	40.35%	26.61%

form of dividends, you get paid like one.

Low short-term interest rates make this business model profitable because the cost of capital is so low. The clarity given by the Fed regarding these rates makes mortgage REITs especially desirable now. However, mortgage REITs have not been soaring in price recently as one would reasonably surmise.

In fact, these securities have seen prices fall in the last several months. FTSE NAREIT Mortgage Plus Capped Index Fund, which measures performance of residential and commercial mortgage REITs trading on U.S. exchanges, has fallen about -13 percent in the past several months.

What's going on?

There are two primary risks to mortgage REITs. One is interest rate risk. As short-term rates rise, the cost of capital rises and directly affects the spread earned and profits. But, as I mentioned earlier, that risk is all but eliminated for the next year and a half thanks to the Fed.

The other risk is prepayment risk. Prepayment can be a problem because when longer-term interest rates decrease, people refinance mortgages at the lower rates. The higher-paying mortgages in a REIT's portfolio are prepaid and can only be replaced with lower-paying mortgages — thus reducing the spread and profits.

Prepayment risk is being exacerbated by numerous recent government interventions. The Fed's recent "Operation Twist" involves the central bank selling short-term bonds and buying long-term bonds in order to drive down long-term rates to stimulate borrowing and activity.

Also, the government announced plans to expand the Home Affordable Refinance Program, the goal of which is to encourage more borrowers to refinance at lower rates.

In addition, mortgage REITs have been pressured by worries that the European debt crisis could erupt and send credit markets reeling, affecting the ability of REITs to obtain short-term financing.

Also, the Securities and Exchange Commission recently made announcements concerning mortgage REITs that raised concern that they could lose their status as REITs (and be taxed) or that there could be a restriction on the amount of leverage allowed.

However, my sources in Washington and on Wall Street believe strongly that new rules won't come to fruition anytime soon.

All this makes mortgage REITs even more attractive. Despite the fact that the current environment is ideal for these securities, recent concerns have kept prices from running away, and they are still relatively cheap. Certain well-chosen REITs are largely unaffected by the latest headlines, and the opportunity couldn't be better.

American Capital Agency Corp. (Nasdaq: AGNC) is a mortgage REIT established in 2008 that invests exclusively in mortgage securities guaranteed by U.S. government agencies (Fannie Mae, Freddie Mac, Ginnie Mae).

As of Sept. 30, AGNC's portfolio consisted of 91 percent fixed-rate mortgages (52 percent 15-year, 2 percent 20-year, 37 percent 30-year) and 8 percent adjustable-rate mortgages. In the most recent quarter, the REIT reported a 1.00 percent cost of funds and a portfolio yield of 3.14 percent, for a spread of 2.14 percent, down from last quarter.

SECOND PICK AT A GLANCE

AMERICAN CAPITAL AGENCY CORP. (NASDAQ: AGNC)

SECTOR/TYPE: Mortgage REIT
PRICE: $27.65
52-WEEK RANGE: $22.03 - $30.76
YIELD: 20.2%
PROFILE: This company invests in government-backed mortgages.

POSITIVES

- The company benefits greatly during times of low short-term interest rates
- The use of leverage is timely in this environment.
- AGNC has an excellent track record and it is able to pay investors a 20% return thanks to today's interest rate environment.

RISKS

- The company could see losses if short-term rates rise or if long-term rates come down.
- The company must issue new shares to make acquisitions, which is dilutive to existing shareholders.

While most REITs pay a higher dividend than regular corporations, AGNC's dividend is stratospheric even for a REIT. AGNC has paid a dividend of $1.40 per quarter for nine consecutive quarters, even throughout the financial crisis. That translates to $5.60 per share, a staggering 20 percent yield at today's price.

The dividend is high because business is good. Mortgage REITs flourish when the yield curve (the difference between long and short interest rates) is steep because they earn a higher spread. Because AGNC only invests in mortgages guaranteed by the U.S. government, there is essentially zero credit risk.

But there are still two primary risks: interest rate risk (which I examined at length earlier) and prepayment risk. Prepayment risk for mortgage REITs has increased because of "Operation Twist" and the HARP program, as I previously mentioned.

However, in a demonstration of prudent and effective management, AGNC anticipated prepayment risk increasing and rearranged its portfolio over the past few quarters. The portfolio now has only 5 percent pre-2009 mortgages and therefore only 5 percent that is potentially vulnerable to HARP refinancing.

Strong management is the main reason I favor AGNC over the other Mortgage REITs (along with the huge dividend). While management has decreased prepayment risk, it has also increased leverage.

In other words, AGNC has reduced the risk that is potentially harmful in the current environment and increased the risk that is worth taking. Also, the REIT has shown its ability to quickly maneuver as the markets change.

AGNC has outperformed the competition since its inception in 2008, and it has been able to maintain the dividend while many REITs have cut theirs. The table below shows how AGNC stacks up to some of the largest mortgage REITs that invest in agency securities: In addition to its large yield, the company has also outperformed its peers in capital gains, a trend I expect to continue.

As you can see from the chart, not only has AGNC had better performance, but it's also selling at a cheaper valuation and pays a higher dividend. That's a winner in my book.

▸ **Conclusion: Mortgage REITs are securities that most investors don't understand and shy away from. That presents a fantastic opportunity in Bernanke's low-yield world.**

The unusual degree of interest rate clarity over the next 12-18 months (and possibly beyond) should make this investment a winner for yield-hungry investors. Recent overblown concerns regarding mortgage REITs have kept prices relatively cheap during a golden period for earnings.

AGNC's massive 20 percent should be safe for at least the next year or so. The REIT is an excellent yield generator for the aggressive portion of an income portfolio.

Buy shares of AGNC under $28.00. ◻

Tom Hutchinson at a Glance

I've worked in finance my entire career, from the back office of a Wall Street firm to the floor of the New York Mercantile Exchange learning how markets work. Eventually, I became a financial adviser where I met with thousands of investors and managed the portfolio of hundreds over the course of about 15 years.

I left my career as a financial adviser, writing for The Motley Fool as well as StreetAuthority LLC, researching companies, industries, and markets.

In The High Income Factor, I can bring you the full benefit of my years of investing experience.

AVERAGE ANNUAL RETURNS

	Leverage	PE Ratio	YTD	1-year	3-year	Div Yield
American Capital Agency Corp. (AGNC)	7.9X	4.2	10.33%	15.61%	32.90%	20.30%
Annaly Capital Management Inc. (NLY)	5.5X	6.3	4.46%	9.50%	20.65%	14.10%
Anworth Mortgage Asset Corp. (ANH)	7.2X	7.0	2.57%	5.56%	17.84%	14.10%

The
High Income Factor

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Closing Thoughts

When I told a private group in Palm Beach about these two investments, they were quick to react. I hope you are, too.

Rates are low, and they're going to stay that way for a while. The Fed will continue to punish income investors in the hope that their gamble will stimulate the economy.

The markets are volatile, and economic data hints that we could see a lot more substantial market moves — both up and down. Reading the headlines and watching the news, you're always hearing about the next crisis and how all hell can break lose.

Meanwhile, you can't put your money in traditional safe investments without watching your buying power evaporate as the Fed punishes investors with low rates.

Yet this environment is spawning opportunities that can give you double-digit incomes in some cases. There's no reason to think that you have to settle for the paltry returns offered at your local bank or watch your investment principle swing wildly every time a new scary headline pops up. The High Income Factor will continue to find investment opportunities that many thought existed only in the very best of times.

You can take advantage of the opportunity that today's low interest rates offer with two plays. The first is Pimco, which offers a leveraged way to earn 9 percent from a diversified portfolio of bonds. The second is American Capital, a mortgage REIT that enjoys fat profits during periods of low interest rates.

Let the Fed flog some other poor sap. You and I can exploit his guarantee to keep rates low for another two years.

If you're looking for additional income-producing investments, be sure to log on to the website to read the special reports: "A New Golden Age of Dividends," "Conquer the Commodities Boom," and "Income Strategies for Today's Market." They'll point you to the basics of income investing.

In closing, it's my absolute pleasure to welcome you to The High Income Factor.

Sincerely,

Tom Hutchinson

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