Retirement Income
JOURNAL

Retail investors reach for income when interest rates fall

By Editorial Staff *Thu, Mar 7, 2019*

A one percentage point drop in the federal funds rate is associated, over the following three years, with a five percent increase in the inflows to stock mutual funds with high income yields, according to a new paper from the National Bureau of Economic Research.

Standard theories in financial economics hold that Investors shouldn't care whether they receive income from dividends or from capital gains, assuming that there are no tax differences and or capital market frictions that favor one over the other.

But that's not how real people—retirees in particular—actually behave, according to "**Monetary Policy and Reaching for Income**," a recent working paper from the National Bureau of Economic Research (NBER Working Paper No. 25344).

The paper shows that when interest rates fall, as they might after a relaxation I the federal funds rates, some interest-and-dividend investors adjust the amount of high dividend paying stocks in their portfolios.
Authors Kent Daniel and Kairong Xiao of Columbia and Lorenzo Garlappi of the University of British Columbia analyzed individual portfolio holdings at a large discount broker over the period 1991-96 for 19,394 households.

They merge the portfolio data with the CRSP (Center for Research in Security Prices) stock database, and determine income and pricing for the stocks in each individual portfolio. The average dividend yield of the stocks in the sample was 2.1%. "High income yield" stocks were defined as those with dividend yields above the 90th percentile, or 5.7%.

Using the CRSP Survivor-Bias-Free US Mutual Fund Database, which provides mutual fund income yields, asset flows, returns, size, expenses, and volatility from January 1991 to December 2016, the authors analyze rotations of fund flows following a decrease in the federal funds rate. The average yield of equity mutual funds was 1.3% and the yield at the 90th percentile was 2.8%.

In the six months after a one percentage point drop in the federal funds rate associated with accommodative monetary policy, households raise the share of their portfolio in stocks paying high dividends by 0.95 percentage points.

Over the following three years, the researchers find a 5.2 percentage point increase in inflows to equity mutual funds with high income-yields. An accommodative monetary policy appears to reduce portfolio diversification and increase the value of high dividend stocks relative to low dividend stocks.

To disentangle monetary policy changes from other economic changes, the researchers compare changes in holdings of individual stocks by households in different Metropolitan Statistical Areas. The demand for dividends was negatively related to local area bank deposit rates, suggesting that local bank deposit rates "provide a more accurate measure of available sources of income for local investors than the Fed Funds rate."

The researchers suggest that reaching for income can be an optimal investment strategy if investors try to discipline themselves by restricting their spending to the income from their portfolios. The investors who reach for income are disproportionately those with low labor income, such as retirees.