Episode Title: New school passive income strategies

Episode Description: Passive income isn't just rental properties and bond ladders anymore. There are plenty of modern, innovative opportunities out there and available to everyday investors. We break down what they are, how they've performed so far, and ways you can get involved.

Transcript:

Alex Lieberman (00:04):

Hey, everyone. I'm Alex Lieberman, co-founder and executive chairman of Morning Brew. This is Season 3 of Fresh Invest, your favorite investing podcast sponsored by Fidelity Investments and powered by Morning Brew. This season we're getting you the answers that can help you and your finances navigate through volatile market conditions. Last week, we broke down what passive income is and what it isn't, the traditional methods of earning it, and what to do with your capital once this revenue stream starts flowing in.

(00:33):

Now that we've covered the old school style of earning passive income, today we're talking about some new school strategies, what these modern methods are, how they've performed, and which ones are best poised to hedge against inflation. There are a number of innovative new ways investors can earn passive income. From democratized alternative investments to real estate crowd funding, technology has helped create a ton of exciting opportunities for generating this type of income.

(01:00):

We're here with Jonathan Lord to lay out what you need to know about these opportunities and how you can get involved. Jonathan is part of Fidelity Strategy Desk, which assists investors with developing and implementing more informative trading strategies. Jonathan, great to have you on the show. Thanks for joining.

Jonathan Lord (01:19):

Hey, happy to be here. Thanks, Alex.

Alex Lieberman (01:22):

Let's start by laying the groundwork. Can you tell us a little bit about yourself and what you do at Fidelity?

Jonathan Lord (01:27):

Yeah, absolutely. So my name's Jonathan Lord. I'm a Certified Financial Planner, and I work with the Trading Strategy Desk at Fidelity. We're a small group of industry veterans, traders, investors, and we kind of run our own little universe of trading and investing education. So going through Zoom webinars, we talk a lot about technology today. But really technology has brought us together with a lot of people who want to learn about things like options, technical analysis, even market analysis, fundamentals, and a lot of the tools that we use here at Fidelity.

Alex Lieberman (01:57):

Love it. So for those listeners of Fresh and Fast to have heard some of the episodes from this season, you know that we asked members of the Morning Brew community how they felt about financial topics that we're discussing this season, and then they shared whether they're bearish or bullish. I would love to get your take on whether you are bearish or bullish on building passive income streams.

Jonathan Lord (02:19):

Yeah, so definitely cautiously bullish, I would say, especially with the technology that's coming out, the due diligence that needs to be done on some of these new products and ideas. It's really important. But it's really an exciting time for finance, technology, earning passive income, and sort of transforming maybe some of those more class methods. It can feel really tempting to kind of chase into some of these newer, higher yields. We just need to make sure we're weighing some of that risk along the way. Longer term, you need to be keeping an eye on these things and focusing on them. It should kind of feel like watching paint dry. It shouldn't be exciting, get rich quick type strategies. It's going to be slow. But at the same time, you should be actively looking at these things. So it's a passive investment, but you also need to be active in terms of being often looking at researching, doing that due diligence all the way through, and even after you've entered into that investment.

Alex Lieberman (03:11):

Some of these passive investing strategies are things you're super deep in, but potentially a lot of retail investors and those folks listening to this podcast are not. Can you share what are some budding passive income strategies that you consider to be both lucrative as well as long lasting?

Jonathan Lord (03:28):

Yeah, absolutely. The way that you have to think about these is how traditional passive income, you had some of these assets in the past. So you have savings at a bank. The bank then does what? Well, it loans those out. So it's utilizing that, and you see this sort of economic growth spurred from that. It's having a need and an asset kind of mixing them together.

(03:49):

Some of these new concepts with technology are allowing you to do that. So think of peer to peer lending, sort of these crowd funding ideas, and then eventually, maybe, where some of these new technologies like crypto and DeFi will fit into that. Now that's obviously down the line. You need to do that research and understand what you're getting into beforehand. But those are some things that we're really excited about looking forward into the future.

(04:11):

Again, if you have something like an asset. Think about a car that you're not using. It's an asset, right? It's just sitting there and for many years, and you're not actually using it. Somebody else might be able to get something out of that, and then maybe you can generate some income instead of having it sitting there doing nothing. So that's sort of that idea of technology now, is bringing people together, finding ways to use technology to your advantage to build some of these passive income streams.

Alex Lieberman (04:34):

Let's zoom in on just one asset that is clearly an important asset for many Americans, and that's real estate, specifically real estate investing trust or REITs. Can you share for the audience, what are REITs, and what do investors need to know about this approach to investing?

Jonathan Lord (04:52):

So REITs, kind of interestingly, kind of in that same realm, but this is going back to 1960s when they created these to give regular investors access to income producing properties. That was technology in sort of saying, "Hey, we could build a product that puts together investments." So real estate properties.

(05:09):

For instance, let's use an example of this. There may be a company that owns, for instance, the Empire State Building. And that Empire State Building does what? Collects rents for offices, may have retail, may have restaurants, there may be, I don't know if they do, but a residential property in some of these, maybe they have storage that's there. So these are all styles of income producing properties. I'm not really sure that me and you would have the capital or the time or energy to own a skyscraper, but it's just part of that REIT that allows you to have access to that style of income coming in.

(05:42):

One of the nice things about the structure of REITs is certainly that they, through their structure, have to pay out 90% of their taxable income. This is created and sent to you via dividends. Comparing that to maybe something like a gross stock where they can reinvest and retain that income, it does have to come back to you. It's again, a longer term type trade. You do need to keep in mind it can be susceptible to business cycle moves, and there may be rate sensitivity there depending on what style you're trading, so if it's a mortgage or if it's one of those equity REITs. And certainly as well, we've seen big shifts in recent years.

(06:15):

So this may be an opportunity, and it may be costly to you depending on which way you go, if there's some kind of big changes such as we've seen with baby boomers and millennial habits, we've seen with malls and shopping, some of these big shifts with where these REITs have been getting their income from. Not all of them have that same approach. You need to make sure you've done the research and kind of know, again, what area you may be able to get the most impact out of going forward.

Alex Lieberman (06:39):

Got it. So to surmise, it's important to know where we are in the cycle. It's important to understand the differences between the REITs that you can invest in. It's important to understand the value of how REITs work, and the fact that 90% at minimum of taxable income needs to be paid out. And also, just how sociographic trends impact the value of REITs over time. You had mentioned, obviously the difference in habits between boomers and millennials.

(07:05):

Now let's talk about a different asset class. So we talked about real estate, let's talk about equities. Looking into dividend stocks can be exciting for people. It can also be wildly overwhelming. What should retail investors be looking for when searching for yield, specifically with dividend stocks?

Jonathan Lord (07:21):

Yeah, this is a great question. It's something we do a lot on our desk, where we will run these sort of sessions and walk people through something called a screener. So you have this universe of stocks that are available to you. There's some of course that are, like I mentioned, growth or value type stocks. But one of the things you can search for is dividend yield. And inevitably we will pull that up and what will be there is some really high yield that's showing up there. That can be really based off of what you think about the calculation of yield, which is price. And then you have dividends paid. So it could be that the price is dropping down.

(07:54):

We want to make sure we're understanding the sustainability of that, so we have some metrics that we can use. One of the things we can do in screen four is dividend pay out percentage to validate that, right? Or dividend pay out ratio, saying how much of those profits is being used to pay for it. So that's one thing we could use to make sure that.

(08:13):

We also want to look at prior history of dividends. There's a really extreme example, something called a dividend aristocrat. You have to have a top hat and monocle to buy one. But they have over 25 years of history of increasing their dividend. That's a long time, right? 25 years of doing this. And so you find there's funds and ETFs that, again, gravitate towards these type of securities. But that sort of long term growth in dividends, and also you may be getting that capital appreciation.

(08:40):

Those are things we might want to focus on, just sort of make sure that you aren't chasing some kind of yield there. So again, just comparing those things, comparing the price of a dividend stock versus a growth stock. You want to make sure you're looking at those things comparatively, so we might also use something called total return as a way to do that. If you're just looking at price return, you're not seeing some of those dividends that were being paid out and reinvested, and that can skew those results to a degree. You may be, again, looking at some tech stock, and not realizing that it's actually not as far apart versus some of these dividend stocks that have had huge distributions consistently over their lifespan.

Alex Lieberman (09:15):

So it's super important to treat dividend stocks and gross stocks apples to apples, because if you're not taking into account obviously the cash flow that dividend stocks are paying out over time, the return profile can look very different. When in fact, it may not be as different as investors may think upon first look or first glance.

Jonathan Lord (09:33):

Exactly.

Alex Lieberman (09:34):

Let's talk about things that investors may not be aware of or thinking about when it comes to passive income strategies. Are there any innovative or emerging passive income strategies that you've seen, that you've spent time researching, that say the typical retail investor may be sleeping on?

Jonathan Lord (09:53):

Yeah, this is where I get really excited if we're talking about options specifically. It's not that innovative or emerging, but per se, right? It's really come into the retail sphere lately that, "Oh, there is this product that you can use that might be sort of that missing link for some of that active trading that creates this more passive type yield." So you got to keep in mind, of course, there's a lot of risks here, in terms of understanding what it is. There's also a lot of uncertainty when trying to trade these. We'd spend a lot of time working with clients on how to select the strikes and all the explorations that are available to you.

(10:28):

But once you figure that out, you could effectively create your own style of dividend. You can create some yield based off of uncertainties in the marketplace. Though again, it may take a little bit more of actual work and sweat in order to make sure that when managing it correctly, understanding it and keeping that income stream flowing here.

(10:49):

But it is a really interesting thing that we've seen in the past couple years of retail really picking up on that. Maybe can use an example of this from a defined risk standpoint. We do have what we call a covered call, which is where you would own a hundred shares of a stock or ETF, and you would be, again, selling or receiving some income or premium for the right to deliver your shares at a given price. So you can receive some premium, and you will also, can, possibly, again, get some appreciation, if that stock even if you go sideways or up a little bit towards that strike.

(11:23):

This is all ways to create some of that income, and say that long term, be able to continue to kind of turn this out and continue trading and creating that income over and over again. We have many types of strategies like that. So a covered call is usually the most basic one. We also have cash-covered puts, or we've now talked about this strategy called the wheel strategy, which is combining those two together. Again, it's very important that you understand the risks inherent to these types of trades before you get into them. But they can be lucrative, they can be long lasting, they can be a very important part of your portfolio if done correctly and utilized to your advantage there.

(11:58):

Again, those are just two strategies. We often use this phraseology for your options give you options. There are just tons of different types of income type strategies you can use and combined together. Even for myself trading for many years now, I have just continued to learn more and more about and have found some just interesting opportunities out there. There's just not a lot of real shortcuts to it, and you do need to make sure, again, it's done properly, and those risks are being managed.

Alex Lieberman (12:22):

Yeah, I mean, I feel like we could do an entire episode on option strategies and how you can structure options in a way to effectively act as a passive income generator. Could do a whole nother episode just on the naming conventions of these options, because they are everything from hilarious to borderline ridiculous. Wheel strategies, iron condors, butterflies. I want to meet the person who named these strategies. But let's talk now about thinking about passive income in the context of inflation, right? Inflation is top of mind probably for any retail investor. We've seen CPI prints above 8% basically since March of this year. Are there certain passive income strategies that you believe are well positioned to hedge against inflation moving forward?

Jonathan Lord (13:09):

We've already talked about a few of them to a degree, but we always want to kind of start with that clarification, and those numbers that you put out there, right? They're extremely high. So typical inflation we always think of as, actually it's a good thing, right? Economy's expanding, companies growing, hiring, we'll see wages kind of increasing as well. What we might see shine within that in terms of the passive income strategies goes back to that real estate that we talked about. So it could be the REITs, it could be finding ways to own that property.

(13:37):

Now it's important to also understand extreme inflationary pressures or extreme rate moves can be a problem, and also keep in mind the risk of leverage here. You don't want to be leveraging to get in too high with a lot of these products. But that's really going to be in a great spot over the long term. Though again, we all know recently to an eight obviously had its issues there, and sort of a bit of people, especially with that leverage aspect.

(14:03):

Historically, we have seen real estate as an asset class outperform usually within these and sort of inflationary environments. There's also other types of trades we can get into, but we're hearing a lot, of course, about getting into just bonds because of the rising rate environment, and also specifically with regards to inflation, some tips in I bonds. Again, probably another entire podcast could be done on those individually. But those are things that, again, if you want to do more research on them, certainly Fidelity has a lot to talk about with regards to those things right now.

Alex Lieberman (14:34):

Yeah, I think you've given listeners just a really good appreciation for how, even in the context of passive income strategies, there's the 101, the 201, and the 301. Obviously as we start talking about more sophisticated option strategies, or things such as ladders or tips, you start getting into 201 or 301. But for new investors who are exploring passive income strategies for the first time, what's the 101? What do you see as the best place for them to start?

Jonathan Lord (15:02):

I think you got to kind of go back to the tortoise and the hare, right? Where, again, we got to keep remembering that this is a long term slow strategy. If you just buy into something, you may see, I mean the hare running past you, right? And some of these double digit, triple digit returns, and everybody's posting these on social media. You want to be reminding yourself about that. That's what this is. It's a slow build, and it can have a very nice long term effect if done properly.

(15:28):

Some ways you could do this, of course, would be going towards the managed products. We always want to make sure we focus on that. There are ETFs, mutual funds, that do this. You get that professional management. You can even go in and look and read their perspectives and see what they hold. That's another way to kind get a look under the curtain there.

(15:43):

Also, I mentioned already some of the stock screeners. Of course, they already have some pre-built screens for this for dividends, for reads. So you can go in and also see some of those parameters, too, like we mentioned earlier, dividend payout ratio, making sure that it's a sustainable type thing as you're getting into them. But again, we want to be careful about chasing. We want to make sure your best arm is going to be that education and knowing and looking at, again, what's out there, and understanding the product before you dive in.

(16:11):

But really again, also just to talk up our own book. Of course we have our webinars, we talk about a lot of these things. We do a lot of the coaching and of course the learning center. Join us at fidelity.com/coaching, fidelity.com/classrooms. Trading Strategy Desk sessions that we run on a lot of these topics. We'd be happy to have you there. Of course, we're also doing these Reddit AMAs now that we have on Fridays. But again, really excited about the technology and how that's gotten us together with a lot of different traders. So happy if you'll join us there. So a lot going on with the Trading Strategy Desk and Fidelity. The Learning Center will be your best friend there.

Alex Lieberman (16:43):

Love it. Jonathan Lord, thank you so much for providing us a really good foundation for understanding passive income strategies. Appreciate you joining Fresh Invest.

Jonathan Lord (16:52):

Thanks for having me.

Alex Lieberman (16:58):

Thanks everyone for tuning in to Fresh Invest today. I hope you all feel like you have a strong understanding of your options when it comes to earning passive income, and hopefully you feel confident and ready to explore some of these opportunities. What's exciting about passive income streams today is the wide number of options everyday investors have. Between concerns over market volatility and inflation, a lot of folks are looking to establish a stronger foundation for building wealth with secure successes. And the opportunities to do that, they're abundant.

(17:28):

Thanks again for listening, and make sure to join us again next week to learn about a popular alternative to the traditional investing approach, thematic investing. We'll discuss what exactly this strategy is all about, how it works, and the ways it differs from the traditional route. It's a pretty intriguing approach, so be sure to tune in. I'll see you then.

Alexandra Bass (17:48):

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(19:25):

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(19:45):

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