Has income investing had its day in the sun?

Steven Andrew explains why pension funds are turning to multi-asset investments for their income needs

Income investing generated strong returns in the years following the financial crisis. However, today's low yields and the potential threat of rising interest rates could represent a challenge to many traditional income-generating assets. As UK DB pension schemes focus ever more on generating income from their assets, flexible income strategies that seek relative value from a wide range of assets globally should be best placed to adapt to the changing environment to meet these needs.

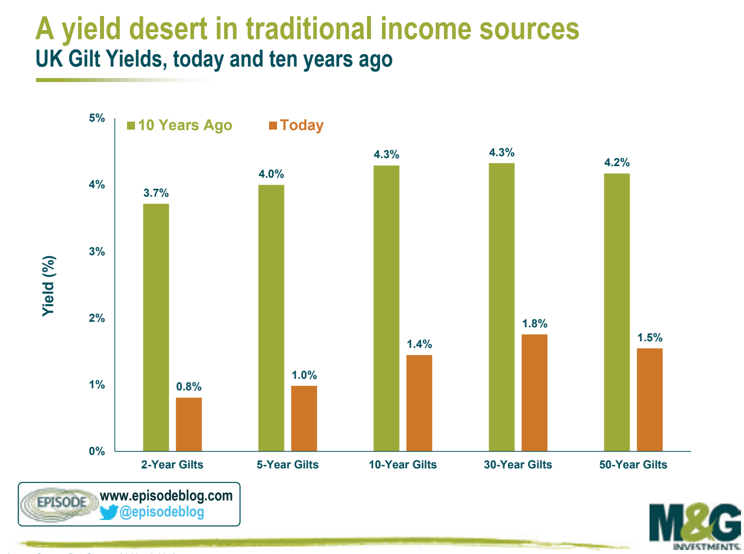
Income investing: A turning point?
In the aftermath of the financial crisis, traditional sources of income such as gilts, bonds and dividend-rich stocks generated strong capital returns against a background of falling interest rates. At the same time, pessimism about the growth outlook and an aversion to short-term volatility made near term return of capital a greater concern than longer-term return on capital.

However, the environment no longer looks supportive for delivering income via some traditional means. Falling interest rates have reduced the return available on many assets; even gilts with a maturity of 30 years and beyond are priced to deliver yields lower than 2 per cent (which, should CPI resemble most of recent history, would represent a negative real return).

A yield desert
Moreover, should the Western world begin to follow the US in meaningfully tightening policy, traditional income sources that have benefited from a low-rate environment could be vulnerable to material capital loss. Not only are low yielding bonds vulnerable, but rising rates can pressure a wide range of other assets.

In February 2018, threats of increasing US rates prompted material volatility in equity markets, while in the UK the underperformance of UK stocks with a history of growing dividends (as reflected in the S&P 'Aristocrats' index) began as UK yields began to rise in the latter part of 2017.

As rising rates pressured assets across the investment universe, correlation patterns changed during this phase. Government bonds, which had previously been seen as 'safer' sources of income, acted as a source of volatility, rather than a protection against it. Multi-asset income strategies can be flexible in responding to these dynamic diversification properties. For example, the volatility of February offered the opportunity to add exposure to US Treasuries at more attractive yields, and to areas of the equity market that should be less sensitive to interest rates over the longer term.

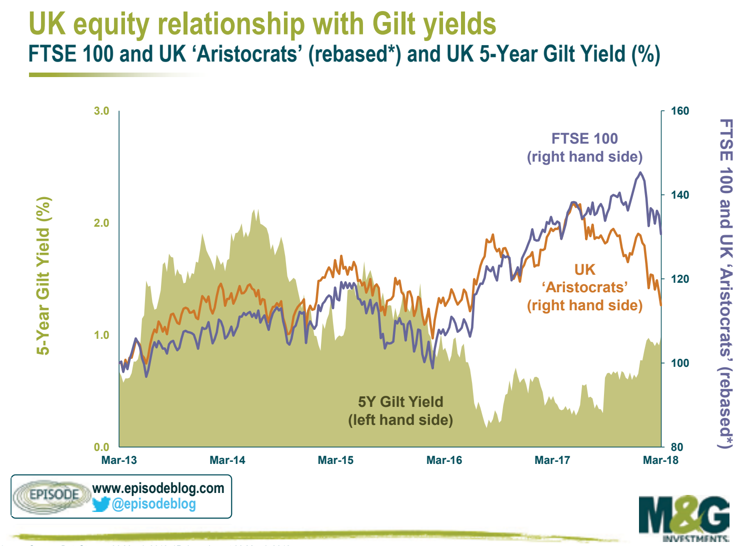


Pension funds' need for income
Pension schemes invest widely in asset classes ranging from equities and corporate bonds to real estate and infrastructure with the aim of generating diversified income as well as opportunities for capital growth. These assets complement their matching asset portfolios for contractual cashflow.

Maturing schemes need to meet increasing cashflow requirements:
Mercer's latest *European Asset Allocation Report* found that in 2017 for the first time over half of UK defined benefit schemes were cashflow negative (55 per cent of schemes versus 42 per cent the previous year) and this share is set to continue growing.

Regular income delivery can help pension schemes delay or even prevent having to liquidate assets in order to meet these cashflow needs – it can also partially mitigate the risks associated with forced liquidation. Divesting in periods of market stress can result in losses being crystallised (particularly when less liquid assets are involved) and could damage the prospects of an asset base delivering returns in line with long term expectations. Managing the process of forced selling can also create administrative challenges, particularly for smaller schemes.

Pension fund trustees will need to consider the various trade-offs in achieving their income goals, or seek external actively managed portfolios whose objectives are compatible with the overall scheme. Multi-asset solutions are useful in this respect, offering a transparent means of delivering income in different market conditions.



1 Source: DataStream, 26 March 2018. *Rebased as at 22 March 2013

Multi-asset solutions: Selectivity and dynamism

The clear benefit of multi-asset solutions for income delivery is that they are not bound to any single asset and are able to capture the best opportunities from around the world, while avoiding those areas where prospective returns are low.

Falling interest rates were a boon to a wide variety of assets, but the flipside of this is that many of the greatest beneficiaries could be the most vulnerable to a reversal in that trend. Selectivity therefore becomes increasingly important to avoid losses and manage short term volatility.

Fortunately, a growing global universe of income-bearing assets means that multi asset managers with an income objective have far more avenues to pursue today than in the past. The corporate bond market has become broader and deeper in the UK and overseas, more global companies are focusing on returning cash to shareholders via dividends and buybacks, and both alternative and emerging markets have also matured significantly.

This means that delivering income does not necessarily mean 'reaching for yields' in ever more risky assets, so long as investors are willing to look across financial markets to source assets offering attractive value. For example, although gilt yields are low, US treasuries offer more attractive yields of above 3 per cent from 10 year maturities out to the long-dated end of the curve and so offer the potential for diversification, which was less evident at lower yields.

Similarly, in equities, though 'bond proxy' stocks as described earlier have offered little value until recently, European banks have offered comparable income yields at far more competitive pricing. The ability to seek value across a far broader opportunity set can enable a manager to build a more resilient, diversified portfolio.

Multi-asset solutions also offer the advantage of being able to manage short-term volatility in capital and income payment by maximising diversification across a broader range of exposures. Single-asset income strategies on the other hand are likely to be more beholden to shorter-term swings in capital values, particularly if they are being relied upon to deliver a natural income.

Conclusion

Pension schemes' need for income is intensifying as if the market environment enters a new phase in which asset prices may change significantly.

A regular, stable and growing income stream is a useful tool for schemes managing cashflows, while the commensurate need for stability and growth in the capital base of many income funds mirrors the requirements of schemes that need to improve funding levels.

We expect investors to have to look across a diverse investable universe for attractive income sources to support their goals. However, targeting a constant yield level should not incentivise chasing yields in ever riskier assets, simply because traditional sources are unavailable. Instead, taking advantage of the diversification benefits that come with a wider universe and considering risk management tools such as active currency and duration management allows multi asset approaches greater scope to deliver the return and volatility profiles that could once be expected from single assets.

This is especially important today, as a potential end to an era of ultra-easy policy in the developed world creates challenges to both prospective returns and correlation patterns across global assets, as demonstrated by market behaviour so far in 2018. Navigating such shifts will likely involve both selectivity and an ability to be dynamic as return and correlation patterns change.

For more information please visit www.mandg.co.uk/multiasset

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