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Searching for income focus:

Exploring the bigger picture

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What lies ahead?

Mike Brooks looks at what's in store for those searching for income across asset classes

For those that invest with the aim of generating an income, the last year provided a unique set of challenges.

After years of declining yields on government debt, bond investors suffered some heavy capital losses after Donald Trump's surprise election victory led to concerns his fiscal plans could result in extra bond issuance and higher inflation. Over the fourth quarter of 2016, investors in 10-year Treasuries suffered losses of nearly 7%.

Similar concerns have spread to the UK bond market. There is increasing talk about a move towards fiscal policy to help stimulate the economy, and a reduced focus on monetary policy. Although UK interest rates will probably be kept on hold in the coming year, concerns about rising government spending have contributed to a sell off due to worries about higher issuance.

Inflation – the scourge of bond markets due to the fixed nature of bond coupon payments – is also on the rise. UK inflation recently picked up sharply to 1.6%, its highest reading since July 2014. The effects of sterling's recent decline suggest inflation will breach 2% shortly.

Meanwhile, commercial property, which had been the asset class of choice for the previous three years, came off the boil as valuations continued to climb and investors became nervous about life after Brexit. Offering an initial yield of 5.3% as at the end of 2016, the payouts from commercial property compare favourably to bonds. However, uncertainty and investor nervousness seem likely to cast a cloud over the property market in 2017.

What the last year has provided was a useful reminder that no one, be they pollsters or investors, can predict the future, or indeed the effects of such events on markets. The falls in bonds and property markets caught many investors on the hop. To time markets and to bet successfully on their direction on a consistent basis is nigh on impossible.

For the majority of investors, a better approach is to invest in a diversified portfolio of shares, bonds, property, and alternative investments. The advantage of this approach is that it smooths out the peaks and troughs, leading to far more consistent returns.

This approach could also help protect investors from bouts of market volatility,

which seem likely to prevail in coming months. Brexit negotiations, elections in Europe and Trump's first months in office will be closely followed and influence investor sentiment day in, day out.

Meanwhile, the pace of US rate rises seems likely to escalate as the economy continues its long-awaited recovery following the global financial crisis, bringing inflationary pressures.

"[A diversified approach] could also help protect investors from bouts of market volatility, which seem likely to prevail in coming months"

Equities should have another reasonable year, despite hitting new highs in 2016. As sterling weakness continues, many FTSE 100 companies are benefiting from the rise in the value of all their non-sterling revenues.

Looking globally, there are some encouraging trends for equity income investors. Managements across the world are increasingly realising that dividends, and the discipline to pay them, tells investors something about the quality of the company. Hence in Europe and in the United States companies are paying more attention to investors' dividend requirements. And even in Japan, not previously thought of as a happy hunting ground for income investors, dividends are now seen as part of the evidence that companies are more focused on their shareholders.

In contrast, the outlook for other mainstream asset classes (bonds and commercial property) is far from inspiring, making equities the least-worst major asset class.

Despite the recent sell off, we think developed market bonds offer little value. However, other forms of debt are more attractive and offer the potential to produce returns similar to equity markets, but with lower volatility. This includes high-yield bonds, emerging market bonds and corporate loans.

Some of the most interesting opportunities will come from niche asset classes, which many investors may not have previously considered. Examples include renewable infrastructure, social infrastructure, peer-to-peer lending, insurance-linked securities and aircraft leasing. These asset classes are capable of providing sources of income, which are often uncorrelated to mainstream investments, such as equities and bonds. As such, they also provide excellent sources of diversification and can help smooth investment returns. While not all will flourish, I predict we will see much increased interest in these 'alternative' assets during the coming year.

My predictions for 2017 may turn out to be wide of the mark and – as ever – we should be prepared for the unexpected. But by sticking to our principles and investing in high-quality assets within well-diversified portfolios, it should be possible to continue generating for investors, whatever 2017 has to throw at us.

Written by Aberdeen Asset Management head of diversified multi-asset strategies Mike Brooks

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Summary
• Official interest rates in the major economies remain stuck at unprecedentedly low levels. Central banks have made vigorous attempts to dislodge them, including through special liquidity schemes, asset purchases and forward guidance. The yield on a typical gilt today is 1 per cent, but the long term average was 5-6 per cent.
• This is a challenge for pension funds, particularly those defined benefit schemes that are closed to new members and need income to cover their liabilities.
• Emerging market government debt is becoming more commonplace as there is no default risk, but much higher yields.
• Asset-backed securities and infrastructure are also proving popular, with listed infrastructure funds on the market that invest in a portfolio of windfarms, paying yields of 5-6 per cent.

Searching for the right answer

Sandra Haurant looks at the structural and demographic challenges currently affecting global interest rates and how pension funds can diversify to boost incomes

Back in 2015, the chief economist of the Bank of England, Andrew Haldane, began a speech to the Open University with the summary of a children's story. *Stuck*, written and illustrated by Oliver Jeffers, "tells the story of a boy whose kite becomes lodged in a tree. The boy makes vigorous attempts to dislodge the kite by throwing up objects, including a cat, a gorilla and an ocean-liner. (The story is fictional.) Yet the kite remains stuck," explained Haldane.

And so it is, he went on, for global interest rates. "Central banks today can sympathise with the boy's dilemma," he said. "Official interest rates in the major economies remain stuck at unprecedentedly low levels. Central banks have made vigorous attempts to dislodge them, including through special liquidity schemes, asset purchases and forward guidance. (This story is factual.) Yet interest rates remain stuck."

They have been for some years now. Indeed, when the press talks of interest

rates, the phrase "historically low" can often be found nearby. Haldane confirmed in his speech that, having been challenged on his assertion that rates were at their 'lowest-ever' levels, he finally had proof. "Several exhausted research assistants later I can report that, luckily, I was on safe ground. Interest rates appear to be lower than at any time in the past 5,000 years."

And many argue that they will not be rising any time soon. "The consensus view, and we subscribe to this, is that interest rates have fallen to these lows due to structural, demographic factors; this isn't just a cyclical thing, this is a structural change in economies," Aberdeen Asset Management senior investment strategist Craig Mackenzie says.

"It is to do with the ageing population and the need for the baby-boomer generation to save much more for retirement. The emerging world is also saving far more, and essentially there is what is called a global savings glut." The equilibrium, he says, has been knocked off kilter by this imbalance between savings and capital investment.

"What drives all interest rates is a function of the amount of savings there are in the world and the uses of those savings for capital investment etc, and what we have seen over the last 20 years is a huge savings glut with too much capital out there chasing too few opportunities to invest that capital. And that savings glut has depressed interest rates. The yield on a typical gilt today is 1 per cent, but the long term average was 5-6 per cent. So the structural demographic changes are what is holding interest rates forgovernment bonds and corporate bonds at such historically low levels."

The challenges

All of which constitutes something of a challenge for pension funds, particularly those defined benefits schemes that are closed to new members and need income to cover their liabilities.

GSAM head of the global portfolio solutions group for EMEA and Asia Pacific ex-Japan Shoqat Bunglawala says: "The current low-yield environment poses a number of problems for pension schemes. Low interest rates have driven up liability values, meaning that for many scheme funding levels have fallen or failed to improve. As funding positions have stagnated, schemes have continued to mature with annual pension payments steadily increasing. This means that investments must now both generate return, to help close deficits, while

generating income to pay benefits as they fall due."

Traditionally, pension funds have relied upon fixed interest assets such as government bonds and investment grade corporate credit, which for a long time provided perfectly respectable income with low risk to capital. But the world has changed, and what worked for decades is now in need of a rethink.

It is a slow process, though. "Pension funds still have a significant amount of assets invested in traditional fixed income and they are likely to continue to be a major source of demand for index-linked and conventional gilts for liability hedging purposes," JLT Employee Benefits senior investment consultant David Will states. "However, pension funds are increasingly making allocations to non-traditional fixed income strategies."

One of the first ports of call for income is often equities or higher yielding corporate bonds, says Mackenzie, and in particular "high dividend companies and corporate high yield debt, both of which pay significantly higher yields, maybe 4-5 per cent".

"So that is great from a yield point of view, but the problem is those assets are pretty risky, and actually the more we go through the cycle, the more equities are getting expensive, valuations are more stretched, so the risk is growing." They are, he says, "essentially risky forms of income, quite volatile, and will crash in a recession." Not ideal for a pension fund wanting to preserve capital. "They might be part of your mix, but on their own they are a fairly risky alternative," Mackenzie adds.

One lower-risk option is emerging market government debt, says Mackenzie. "Governments tend not to default, even emerging market governments, so you don't have a default risk here, but you have much higher yields. Emerging markets pay around 6-8 per cent, even 10 per cent in some cases," he says. "If you have a diversified pool of these emerging market government bonds, say you have Brazil, India, Indonesia, Poland, Hungary, for example, you reduce your risk but still get much higher yields."

Infrastructure and asset-backed securities

Another area is infrastructure, which can cover anything from airports to wind farms. Pension funds and consortiums can and do invest directly in infrastructure projects, but access is also possible through funds that offer greater liquidity. For example, says Mackenzie: "There are listed infrastructure funds on the market that invest in a portfolio of windfarms, and they pay a yield of 5-6 per cent."

Asset-backed securities are also worth a look, says Mackenzie. Here, retail mortgages are packaged together in their hundreds and thousands and a bond backed by those loans is issued. Of course, for anyone with memories of the 2008 financial crisis, this is an area that may seem unappealing. "The spark that lit the taper that led to the financial crisis was mortgage-backed securities," admits Mackenzie. "Asset-backed securities were a huge problem, but because this was at the epicentre of the financial crisis, everybody has become profoundly interested in ensuring that those mistakes don't get made again. The quality of credit is far higher than it was before and the process of scrutiny and assessment is far better." What's more, because of a reticence to invest, he says, these come with a yield that is perhaps higher than they would otherwise.

Property

Another familiar income source making its way into pension fund portfolios is property. Real estate, whether in the private residential sector, hotels or commercial, has not perhaps been a mainstay for pensions in the past, but it is increasingly playing an important role, particularlywithin the context of liability-driven investment (LDI) strategies. Invesco Real Estate managing director, client portfolio management, Europe, Simon Redman explains: "We have been developing property strategies that are linked directly to the liability matching part of a pension fund's portfolio, rather than a more traditional property mandate, where you are trying to manage against, say, a property benchmark. It gives us greater latitude in terms of what we can invest in but the return profile is very much based on liabilities."

But while pension funds are increasingly inventive in their search for income, care needs to be taken. "The key is not to put all your money in one basket, but to have a portfolio across all of these different sources of income," says Mackenzie. Crucially, it's important to ensure that separate asset classes have little or no correlation, so that when one comes down in value, another will be going up. "For example, the income you get from emerging market debt has a very low correlation with the income you get from infrastructure."

Will adds: "There are a number of multi-asset income strategies available to UK pension funds. These strategies typically aim to provide a stable, sustainable level of income without the need to take excessive risk, from a diverse portfolio of income generating assets, including gilts, index-linked gilts, corporate bonds, high yield and emerging market debt, as well as assets such as equities, infrastructure, and real estate."

The structural and demographic challenges facing global interest rates may mean they will remain stuck for some time to come. But with a bit of novel thinking and plenty of diversification, pension funds should be able to keep their income portfolios moving.

Written by Sandra Haurant, a freelance journalist

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