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Income focus:

The search for steady returns

Aberdeen Asset Management senior investment strategist Craig Mackenzie

An alternative look

Craig Mackenzie explains why a more diversified approach to income is necessary in a low-yield world

For decades, income investors have relied on government bonds and investment-grade corporate bonds as the mainstay of their income portfolios. These assets have provided a relatively high income: a typical UK gilt index has offered an average income of 5.3 per cent over the past 20 years. These bonds are relatively low risk, which is also an attraction for risk-averse income investors.

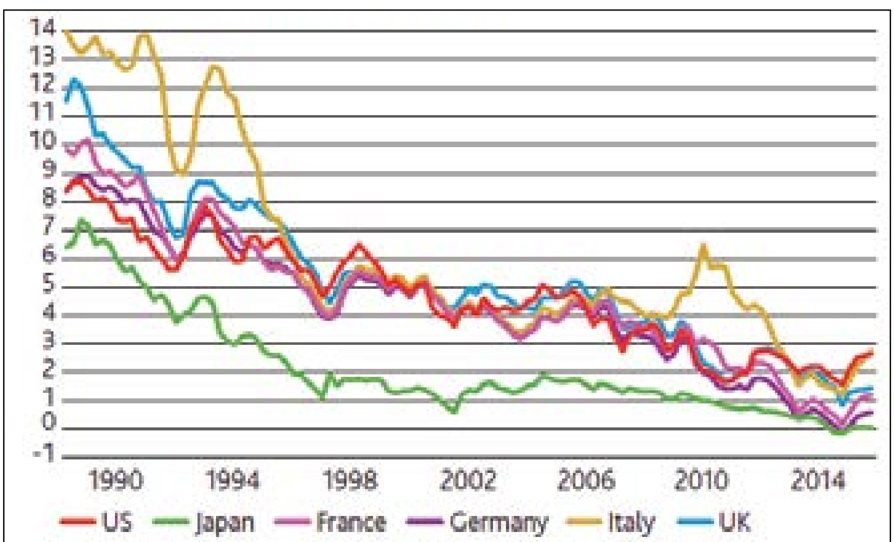
But during the past few decades, bond yields have declined steadily – as the chart below shows. Hitherto, this has not been a problem for investors. While the income provided by bonds has declined, this has been handsomely offset by the boost to capital return as yields have fallen (yields and prices always move in the opposite direction).

Unfortunately, now that yields are close to rock bottom, the income return bonds offer is very low – but with little prospect of capital gain to compensate. So our expected total return for a standard UK government bond index is just 1 per cent per annum for the next 10 years. The picture is not much better for investment-grade corporate bonds (2.8 per cent pa).

We suspect that while yields might rise a little, they are likely to remain unusually low for an extended period. This is because today's low interest rates are a function of a global 'savings glut' caused by slow-moving demographic trends. Eventually, these trends will reverse, but not any time soon. Accordingly, low government bond yields will probably be with us for some time.

Rather than accept a low income from government bonds, many investors have sought yield from riskier sources of income like high-yield bonds and high-dividend equities. Such assets can offer higher incomes, as the table opposite shows. It is a strategy that has worked well in recent years, with capital appreciation adding to income to generate good returns. But equities and high-yield bonds are relatively risky assets whose returns are also highly correlated (i.e. they tend to fall in value at the same time). So this approach is not ideal for more risk-averse investors, particularly now that equity and high-yield valuations are looking stretched.

Many investors may be better served by diversifying their portfolios across a much wider range of 'alternative' income sources.



Source: Oxford Economics, February 2017.
Note: Chart shows yield on 10 year maturity government bond in each country.

Income return: forecasts vs history	3 year forecast	Historical average	Difference
UK Gilts	1.9	5.3	-3.4
Global govt bonds	1.5	2.9	-1.4
UK Investment grade bonds	3.9	5.9	-2.1
Global investment grade bonds	4.1	5.2	-1.1
UK cash 3M LIBOR	0.5	3.7	-3.2
US High yield bonds	6.5	8.5	-2.0
Global equities	2.4	2.3	0.2
EM Debt (hard currency)	5.9	6.0	-0.1
EM Debt (local currency)	6.1	7.1	-1.0
Senior secured loans	5.8	5.8	0.0
UK infrastructure social	4.6	5.1	-0.5
UK infrastructure renewables	5.6	5.4	0.2
Asset backed securities (mezzanine)	4.5	5.0	-0.5

July, 2017. Historical averages are based on 20 year histories where available. Income forecasts are based on house long-term expected return models. Total returns are often different from income returns because changes to capital values can add or subtract return.

This serves three purposes. First, the income available from these alternatives is often higher than that offered from equities and high-yield bonds; second, investors can rotate away from high yield and equities when they are expensive; third, the underlying cashflows that drive these alternative sources of income have a low correlation with one another (unlike equities and high-yield bonds). If one asset class crashes, the others may not be as badly affected. This means that by combining several diversified sources of income one can achieve a lower overall volatility.

What are these alternative sources of income? There is a wide variety: emerging-market debt (EMD), social and environmental infrastructure funds, asset-backed securities (ABS), insurance-linked securities, litigation finance, health care royalties and many more. Our three largest portfolio allocations are to EMD, infrastructure and ABS.

• **Emerging market local currency debt.** These are bonds issued by emerging market governments in their local currencies. Yields are much higher than in developed markets, currently averaging 6 per cent. While there have been defaults in the past, lessons have been learnt in recent decades and these bonds are now safer. Our approach is to hold bonds issued by more than a dozen different governments, and this further mitigates the risk.

• **Infrastructure funds.** These funds own social infrastructure assets (such as schools and hospitals) with government-backed inflation-linked income, or renewable energy assets (such operational solar or wind farms) that earn a reliable cashflow stream from a mix of government subsidies and power contracts. These funds have proven to be resilient in volatile equity markets.

• **Asset-backed securities.** These are pools of securitised mortgages and corporate loans. ABS offers higher yields than corporate bonds of the same credit quality, with a lower volatility and lower risk of default.

By combining a range of these diversified income sources with more conventional income assets, this approach can generate an income of around 5 per cent. This is a fair bit higher than the traditional bond-based income portfolio of government bonds and investment grade credit. But volatility, on the other hand, is only a little higher. In an age of low government bond yields and expensive equities, we think this is an attractive proposition for income investors.

For more information on Aberdeen's long term asset allocation forecasts see chapter three of Aberdeen's 2017 Long-term Investment Outlook, which can be downloaded at aberdeen-asset.co.uk

Written by Aberdeen Asset Management senior investment strategist Craig Mackenzie

The hunt for income

Summary

- The hunt for income has become a new theme as UK pension funds grapple with cash negativity.
- The number of UK DB pension funds that are cash negative has increased to 55 per cent from 42 per cent last year, according to Mercer's latest *European Asset Allocation* study.
- Larger institutions are combining standalone strategies themselves, while smaller funds are looking at diversified-growth funds with an income twist or multi-asset income funds.
- In the future, cash-driven investing is expected to gain momentum to provide a framework along the same lines as liability-driven investing.

Lynn Strongin Dodds explores the investment trends occurring for pension funds to receive a steady income stream

Although the search for yield is a well-worn trend, the hunt for income has become a new theme as UK pension funds grapple with cash negativity. They are not only exploring a wider range of asset classes to invest in but also looking at developing cash-driven investment (CDI) frameworks similar to the established liability-driven investment (LDI) structures.

"The desire for income has become one of the key investor objectives in the current environment," says Aviva's head of investment strategy, global investment solutions, John Dewey. "One of the main reasons they are moving towards a cash-negative position is the closure of European and UK pension schemes to new accruals. The other is the low interest rate environment, which remains a fundamental issue not just because of the problems of generating returns but also in meeting short-term income needs."

Dewey notes that, overall, recent studies show that around 75 per cent of UK DB plans are allocating to alternative income asset classes with funding from selling equities and bonds. About 62 per cent of them will replace equities and 52 per cent will replace bonds with these strategies. "We are still at the very early stages because of that figure, 58 per cent are first-time investors but we see the allocations increasing."

The challenges are highlighted by a recent report by The Pensions Regulator. It showed that just 15 per cent of defined benefit (DB) schemes remained open to new members, while active memberships dropped to 1.65 million from 2.42 million people in 2010. This dwindling number combined with current market conditions has meant that the coffers are being emptied at a faster rate than expected.

Selling

Mercer's latest *European Asset Allocation* report brings the picture into even sharper focus by revealing that around 55 per cent of the 600 UK DB schemes canvassed lack sufficient income from investments and contributions to pay members, up from 42 per cent last year. The remaining 45 per cent with relatively healthy positions should not be complacent, as 85 per cent of them are expected to follow suit over the next 10 years.

One of the main issues is that the majority, 88 per cent, in the Mercer study have been closing the gap by selling assets, with only 29 per cent changing the investment mandate to accommodate an income element. A perfect storm for a cashflow-negative scheme with a material holding in equities, illiquid assets and making use of leverage would be a situation in which yields rise and equities sell off, requiring assets to be sold at depressed prices in order to meet collateral requirements and cash outgo.

Newton Multi-Asset Income Fund portfolio manager Paul Flood also warns about the dangers of being a forced seller at the wrong time in the market cycle. He believes that pension funds should avoid sequencing risk and build a portfolio that not only delivers sustainable cashflows but also provides inflation protection because in today's low-yielding environment, there are many parts of the bond market that cannot offer that protection. These include long-lease properties or infrastructure assets, such as operational renewable energy assets, which have strong contractual ties and are less sensitive to the vagaries of the economy.

Control

As with many investment solutions, schemes are forging their own path depending on size, objectives and funding positions. "Smaller pension funds are typically looking at one diversified solution that throws off cashflows and targets a return of around gilts plus 3 per cent while the larger schemes prefer to piece together the underlying building blocks themselves that can seek cash plus 4-5 per cent," says Schroders portfolio solutions strategist Alistair Jones. "Both though want certainty of delivery because pension funds are maturing and their time horizons are shortening. Equities can't provide this but if you are 50-60 per cent funded they become attractive because you will want a certain level of growth."

Natixis Global Asset Management head of institutional sales Lucas Crasborn also believes that larger funds want to be in greater control, given the regulation and greater accountability they are now faced with. "If they outsource asset allocation within illiquid assets to a third party they may be taking more risk than they thought," he says. "In general it has taken longer than expected for pension funds to look at income-generating strategies because they are traditionally more conservative and want to have the comfort and understanding before they move into the more illiquid asset classes."

While there are a variety of options already in the market and being developed, one popular route for those at the smaller end of the scale are diversified-growth funds (DGFs) with an income twist. "Many pension schemes have appreciated the value of the DGF in generating diversified performance and we believe that the same philosophy and processes can be applied to the demand for income," says Aberdeen Asset Management senior investment specialist Simon Fox. "Our products sit as sister funds with the same multi-asset team managing them both. They have leveraged their experience in DGFs but have made adjustments to include asset classes that are more income generating."

Fox notes that the mix is far reaching and encapsulates high-yield bonds, as well as asset-backed securities, alternative financing such as aircraft leasing and real assets including real estate, social and renewable infrastructure that are independent of equity returns and offer an illiquidity premium.

Private credit or direct lending is also gaining momentum. "We have seen non-bank lending grow to over 20 per cent of the total market," says BlackRock's managing director, head of European middle market private debt for the global credit team Stephan Caron. "In the past, if a company needed for example £100 million of financing it would go to four or five banks but today they access funding from a single fund with money raised by investors. The benefit for them is senior secured financing, which is in the form of floating rates notes that can provide a yield pickup and structural protection as well as a hedge against inflation."

Although multi-asset class income investing is at the nascent stage, J.P. Morgan Asset Management's EMEA head of pensions solutions and advisory Sorca Kelly-Scholte believes that investors should be developing a cashflow-driven investing (CDI) strategy, which includes many of the alternative asset classes but is an investment framework that is explicitly oriented around cashflow needs. "For example, infrastructure and real estate could be divided into core that offers stable and steady streams of income, opportunistic such as new projects in untested areas and those that add value over the long term," she adds.

Janus Henderson head of secured credit Colin Fleury believes there is no-one-size-fits all CDI solution, but instead there are many different flavours, depending on what stage the client is at. CDI, however, can sit next to an LDI strategy. "For example, with an existing bond portfolio, investors do not have to look at it from just an income perspective but also consider the maturity profile of the bonds and how they can generate the cash flows they need over a say five to 15 year horizon," he says. "Although CDI strategies are likely to be mainly developed in segregated accounts for larger clients initially, I can see pooled solutions in time."

Written by Lynn Strongin Dodds, a freelance journalist

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