Heartwood
Investment Management

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Investment Insight

Weekly Insight

Where are we looking for income?

The search for income is becoming more challenging in a low growth, low yield environment. Equities continue to trade at expensive valuations and bond yields remain at historic lows. Investors can still find pockets of value in traditional higher yielding assets, such as high yield corporate bonds, though selectivity is essential. However, as many areas of the market are priced at a premium relative to their long-term averages, investors are being increasingly steered to finding income opportunities in more esoteric instruments.

Within our own income portfolios, we have been widening the opportunity set across the following areas:

• **Equity overwriting strategies:** Here, the yield from a diversified equity portfolio can be enhanced via a strategy of selling call options. This involves one investor selling the optionality to another investor to buy a stock at a fixed price above the current market price. Selling call options adds incremental income to the portfolio. This strategy also helps to lower the portfolio's volatility, while increasing the yield.

• **UK small-cap equities:** Historically, compared with large-cap equities, UK small-cap equities have shown appreciably more dividend cover. They have also been able to grow those dividends at a faster rate. Moreover, small-cap stocks are typically less affected by global pressures, such as global deflation, China and commodities, given their domestic demand focus. This is an important consideration if investors take the view that the current low growth, low yield environment is likely to persist for some time yet.

• **Infrastructure debt:** Since banks have retreated from lending under increasing regulatory pressure, opportunities are now opening for specialist investors to enter into the economic infrastructure debt market, which includes industries such as transportation, utilities and telecommunications. Infrastructure debt can offer several advantages over corporate bonds. As well as providing higher yields, the default rate post the construction phase of an infrastructure project has been lower than for corporate credit, and the recovery rates are meaningfully higher. Furthermore, from a portfolio construction perspective, infrastructure typically has a low correlation to equities and bonds, therefore offering investors an alternative return stream.

• **Targeted property exposures:** Rather than taking broad market exposure, we are now targeting our exposure in individual holdings where we hold the highest level of conviction. For example, we are taking exposure to vehicles that invest in smaller 'lot sizes' and where yields are more attractive. Such parts of the market have not experienced the same amount of yield compression seen in larger lots, as a result of institutional buying. Prime London property remains an important focus, but we are also investing in opportunities outside of London within offices, industrials and warehouses.

Widening the opportunity set to deliver stable income

In our view, the key to a successful income strategy is to deliver consistent and stable pay-outs over the long term without taking unnecessary risks. For this reason, we have diversified some of our exposure into the niche instruments as described above, with a view to reducing portfolio risk and also taking profit in areas where valuations now look less compelling. In the current environment, being able to access a wider opportunity set provides income investors with more levers, helping to deliver and fulfil the investment mandate without over-promising.

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