



### How do we deliver effective income solutions in today's environment?

Investors need to think more creatively and cast their nets wider if they are to deliver effective income solutions. Many areas of the market are priced at a premium relative to their long-term averages. Global government bond yields remain historically low, despite their recent rise, and equity valuations are near historic highs in various parts of the market, reinforcing the importance of managing potential downside risk.

The search for income is being further complicated by an environment of low growth, low interest rates and low volatility. Aside from investing in traditional higher yielding corporate bonds and emerging market debt, investors are looking towards niche sectors and more esoteric instruments as another approach to help deliver a steady income stream, without necessarily compromising on total return.

Within our own income portfolios, we have been investing in the following areas:

- **Equity overwriting strategies** involve one investor selling to another the optionality to buy a stock at a fixed price above the current market price. As equity markets have pushed higher, we have subsequently increased our exposure to this area of the marketplace for its ability to keep us invested (and not be forced into holding cash, which yields zero), deliver a steady income stream and lower portfolio volatility in times of market stress.
- **UK mid- and small-cap equities:** Historically, these companies have shown appreciably more dividend cover than their large-cap counterparts, and have also been able to grow those dividends at a faster rate. However, acknowledging that this is a more difficult climate for domestically exposed smaller companies against the backdrop of 'hard Brexit' political noise, we have re-orientated our exposure within this segment of the market to focus on US dollar earners and sectors that we consider oversold. UK homebuilders, for example, have meaningfully underperformed the broader UK equity market over the last year, but the fundamentals remain sound. The UK continues to have a chronic shortage of housing and we expect demand to outstrip supply.
- **Niche lending strategies:** The pickup in bond yields and focus on inflation have created a weaker backdrop for traditional areas of the fixed income market, such as government bonds and investment grade corporate bonds. Over the last year, we have broadened our search by capturing the theme of bank retrenchment: investing in those areas of the market where lending would historically have been supplied by commercial banks.

Specialist private investors are now finding opportunities in niche lending strategies. In our portfolios, we have direct exposure to funding infrastructure projects and supplying loans to small- and medium-sized enterprises secured against assets. These strategies offer a yield premium over higher yielding corporate bonds, often have lower default and recovery rates, and typically have a low correlation to equities and bonds. Indeed, as bond yields have risen over the past few weeks, the performance of direct lending strategies has been resilient.

- **Targeted commercial property exposures:** UK commercial property has been beset by a number of headwinds this year, as a maturing investment cycle has endured the uncertainty created by the UK referendum result. While recognising these risks, we are maintaining a reasonable weighting in property



## Contact

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but targeting exposures in specific areas: regions outside of London less affected by 'Brexit'; industrial sites and warehouses; and smaller 'lot sizes'. These markets have not experienced significant yield compression and investment activity remains resilient, despite the UK's vote to leave the European Union.

### Diversifying into niche areas provides more levers

In our view, the key to a successful income strategy is to generate consistent and stable pay-outs over the long term without taking unnecessary risks. Diversifying exposure into niche areas of the market provides income investors with more levers, helping to deliver and fulfil the investment mandate without over-promising.

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