Heartwood
Investment Management

Investment Insight

Finding income in a brave new world

Two things about income are obvious: first, that many clients need it, and second, that it can be tough to find.

Historically, investors looking to receive a regular pay out without dipping into their investment capital could turn to a small range of reliable options, including bonds and even high interest returns on saved cash. Today, with bond yields (in the developed world at least) and interest rates close to historic lows, and likely to remain relatively low for the foreseeable future, even beating inflation is a challenge for these traditional products.

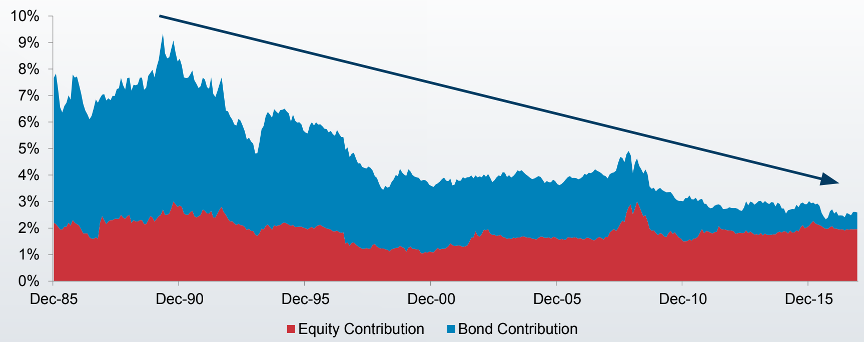
New investors coming to the market have increased demand for income products; these are the retirement savers now able to access and control their own pension savings. With this pickup in demand for yielding solutions, sources of income are under pressure.

Where can we look for income today?

In the aftermath of the global financial crisis, the most attractive places to find income have shifted. The chart below shows the income level derived from a portfolio where holdings are divided equally between UK government bonds and UK equities. It's clear that from the mid-1980s to the early 1990s, bonds provided attractive yields and were the prime source of income for investors. For the last 10 years, though, equity dividends have provided the lion's share of income streams.

Bonds have lost the top spot as a driver of income

Income from a 50:50 UK equity and government bond portfolio



Source: Heartwood

Falling yields from bonds has increased the appeal of dividend paying companies. But, broadly speaking, this means investors are more reliant on a risker asset class. Meanwhile, for multi asset portfolios, bonds no longer serve their former purpose. A decade of quantitative easing has squashed yields and raised valuations, making capital risks, if interest rates rise, greater than ever.

Well-known segments of credit markets like investment grade or high yield have become crowded, but more niche areas can offer appealing income opportunities. Indeed, the wide asset class known as 'alternatives' can add significant value to income portfolios. A good example is infrastructure lending, where investors can expect better resilience over the economic cycle, and where higher yields can compensate for their more illiquid nature. Property is another interesting area, and a wide spectrum in its own right, although selectivity is key. Areas like inflation-linked and long-lease property may hold up better over the cycle.

These areas can offer some capital generation, but the primary attraction is their generous income streams. Elsewhere, other alternative assets like gold and

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specialist protection strategies complement these income generating alternatives by providing defensive characteristics and diversification.

What does this mean for investment risk?

Income investors have to face risks on multiple fronts, not only securing an appropriate level of income, but also managing wider factors like volatility (as not all sources offer sustainable income) and inflation (which creates a risk that the real value of the income stream could fall as the cost of living rises). Another key consideration is the risk to the investment capital itself: if the core capital of a portfolio is damaged, then it becomes more challenging to generate a robust level of income, no matter how sound your investment decisions thereafter.

In building an income-oriented total return solution, multi asset investors have the ability to deploy traditional investments alongside a diverse range of other specialist and alternative holdings. With the flexibility to switch between asset classes and geographies, multi asset funds with a global scope can help to smooth the return path for income seeking investors. Income investors need not increase capital risks to achieve a particular level of income.

In combatting such a broad range of risks to both income and capital, though, diversification is crucial. Spreading the opportunity of reward and the possibility of loss is key to many investment styles, but arguably it is nowhere more important than in investing for income.

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