

# Income investing in a yield-challenged world

Having a diversified portfolio will stand investors in good stead

BY STEVE BRICE



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**Y**IELD-HUNGRY and risk-averse investors worldwide have traditionally parked their money in bonds to achieve their financial objectives. The challenges in today's environment stem from interest rates being at rock bottom. This often fails to generate sufficient income, exposes investors to the negative effects of inflation and increases the risks of semi-permanent capital losses should interest rates start to rise. This suggests a more diversified approach to income investing is warranted.

Stepping back from the Greek crisis for a moment, there are a lot of positives out there for equity investors. The US economy has emerged from a rough winter (yet again!) and deflationary pressures in Europe have waned. Even China is stepping up the defence of its 7 per cent growth forecast/target. Earnings estimates are also being revised higher in Europe and Japan.

However, what is good for equities is not always positive for bonds. Indeed, we saw bond markets sell off significantly in May/June as markets became more confident in the global economic outlook and started pricing in higher US interest rates.

This is turning traditional income-investing on its head. Investors have to consider the possibility that bonds may actually be riskier in the short term than equities. While rising interest rates may hit both asset classes in the short term, equities may recover the losses more quickly, at least until monetary policy starts focusing on controlling inflation rather than supporting growth – something we believe is unlikely for the next 12 to 24 months. Therefore, we need to look for sources of regular income which are likely to better navigate rising volatility while preserving the value of their investment.

To do this, we believe holding a diversified basket of traditional and non-traditional income-generating assets is

key. At the risk of simplification, we categorise the different income-generating assets into three segments.

The first is seen as “preservation” assets. These generally offer the lowest yields and consist mainly of traditional “safe havens” such as high grade developed market (DM) government bonds and high quality corporate bonds. As we have discussed above, these may not be the safest asset class in the current environment, but they do offer significant diversification benefits.

The second area, we call “maintenance” assets and these consist of a mix of traditional – for example high grade emerging market (EM) US dollar and local currency bonds – and non-traditional income assets, such as real estate investment trusts (Reits), convertible bonds and dividend-paying stocks from the US and Europe.

#### Trade-offs

These generally offer a slightly higher level of yield, but this comes at the price of higher potential volatility. Of course, the equity component has the important attribute of being able to increase the yield over time as dividends rise and, over long periods of time, tend to offset the negative impact of inflation.

The final area is what we term “aspirational” assets. These pay the highest yields and consist of high-yielding corporate bonds from developed markets and Asia, including Indian rupee-denominated corporate bonds, as well as some non-traditional income generators such as preferred stocks.

For an investor ready to accept moderate risk, a potential basket may contain around two-fifths in bonds and other traditional fixed income securities, a fifth in non-core income assets and another two-fifths in dividend-paying equities. So far this year, the strongest performance has come from high dividend yielding equities, while the traditional bond areas have lost value in many cases.

Looking forward, we expect equities to be a key driver of income basket returns and continue to suggest an overweight allocation here. Still-benign inflation worldwide means central banks are likely to stay accommodative, keeping interest rates on traditional fixed income assets lower than their long-term averages. While the Fed is expected to hike rates, this is expected to be a gradual process.

On the other hand, there are two areas that we are more concerned about. First, we believe investors should consider reducing holdings in interest rate-sensitive sectors such as Reits in favour of non-traditional hybrid securities such as convertible bonds and preferred shares.

Second, given that we believe the traditionally “safe” preservation assets offer less protection against rising interest rates, we suggest a reduced allocation here. One potential alternative is high grade yuan-denominated bonds. We expect returns here to remain relatively healthy, while offering significant portfolio diversification benefits due to their low correlation with other asset classes. The latter is often an under-valued attribute by many investors, but one we believe is key to staying the course and managing investors' emotions given the inevitable volatility that we see in financial markets.

Income investing has been a key theme for us since 2012. However, our approach has become more nuanced as we factor in the ever-changing macroeconomic/policy forces as well as valuations. Income investing looks set to be more challenging in the next 24 months than it has been over the past three to four years. However, we believe having a diversified basket as outlined above will enable investors to generate reasonable yields in a sustainable manner over time. ■

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