Income investing

Where can investors find the best sources of income?

In conversation:
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Where can investors find the best sources of income?

Income has always been a crucial part of institutional investors' portfolios, but finding it has never been more challenging than in the current lower-for-longer world where yield is scarce.

For trustees, income is available in a number of forms, from liquid income-yielding equities through to the more illiquid markets of high yield bonds and real assets such as infrastructure, property and alternative forms of credit.

But knowing where to start is difficult and deciding which route to take requires thorough due diligence, which is not always possible for smaller schemes with constrained governance budgets.

In the UK, a number of big companies have slashed dividends in recent months (see feature on p4) meaning it has become necessary to implement a wider, global search for corporates that pay dividends but also exhibit capital value stability.

For real assets, scale and liquidity are barriers to entry. Plans are underway to pool assets among Local Government Pension Schemes in England and Wales, a move that is expected to address the scale issue by collectively enabling participating schemes to be bigger players in these markets. But what about the private sector defined benefit schemes? What options do they have?

In the defined contribution (DC) space, income will play an increasingly important role as large numbers of scheme members stay invested throughout retirement and depend on income to fund their lifestyles. But this is easier said than done in an area where daily pricing continues to loom large and asset managers are still working on suitable products to meet this need.

In markets where everyone is searching for yield, there is always the danger of bubbles forming as well as a lack of liquidity – demonstrated by the actions of certain UK property funds in recent months – so investors need to be aware of the risks before pursuing these strategies.

This panel discussion sees a group of asset managers and consultants discuss income investing, from the importance of income in portfolios and the barriers to accessing income-yielding asset classes through to its role in DC and how it might be affected by a move in interest rates.

Sebastian Cheek

deputy editor, *portfolio institutional*

UK dividends: what goes up, must come down

Dividends have always been a barometer for company strength. So should investors be worried about the ongoing trend for cutting shareholder payouts? *Emma Cusworth* investigates.

Dividends form a hugely important part of investors' long-term returns from equity investing. In the UK, they account for the vast bulk of shareholder returns, research suggests. For long-term investors the trend towards dividend cuts by UK companies should therefore prove worrying, especially in light of growing dividends globally.

Traditionally, dividends are seen as far less volatile than stock prices because companies have proven reluctant to cut, preferring instead to absorb pressure on their profit and loss accounts. Dividend cuts have traditionally been seen as a very public sign a company is in trouble.

However, what goes up, must eventually come down – even in the world of dividends – and investors need to prepare themselves for the consequences of falling dividends in the long term. The irrefutability of Isaac Newton's predictive prowess has played out in the headlines over recent months as British companies have made sweeping cuts to payouts. Rio Tinto ditched its long-standing promise not to cut its dividend, Rolls-Royce chopped its dividend in half in the first cut to dividends in a quarter century, while Barclays and Centrica have also cut pay-outs.

UK CUTS DEEP

According to data from Henderson Global Investors, UK dividends fell 5% on a headline basis in the first quarter of this year and the asset management firm warned of more cuts to come later in the year. In stark contrast, global dividends rose 2.2% on the same basis and are expected to rise

3.9% to $1.18trn this year.

Chris Reid, fund manager of the Majedie UK Income fund, also sees more cuts for UK investors. "We are expecting to see further high profile dividend cuts," he says, adding they will fall into two categories. "Firstly, there are companies which effectively put their dividends at risk years ago, by milking their existing businesses for too long and using debt to overpay investors. The dividend cuts merely confirm that these companies have been backed into a corner; as investments they should generally still be avoided. Secondly, there are companies where a dividend cut can provide a breather to gather their strength and to change course; the core businesses importantly remain unimpaired and these dividend cuts reflect decisive and positive management action, with the companies often emerging stronger for the experience. Aviva is a good example, having cut its dividend a few years ago but now, as a much healthier business, growing it again fairly aggressively."

TOO MUCH CONCENTRATION

The relatively deep cuts in UK dividends, however, have also stemmed from the concentration of resources stocks listed here. UK equity investors are heavily reliant on oil, banks and mining companies, which account for almost half of the country's equity income. The top 10 UK stocks, which include the likes of BHP Billiton, Rio Tinto, Shell and BP, make up 54% of FTSE 100 dividends.

"The UK has become the market of choice for mining companies to list," says Ben Lofthouse, an equity fund manager at Henderson. "Once a market develops a specialism, companies go where they are best understood and there are other comparables," he says, as those markets can prove more accommodating in terms of liquidity and the ability to raise capital.

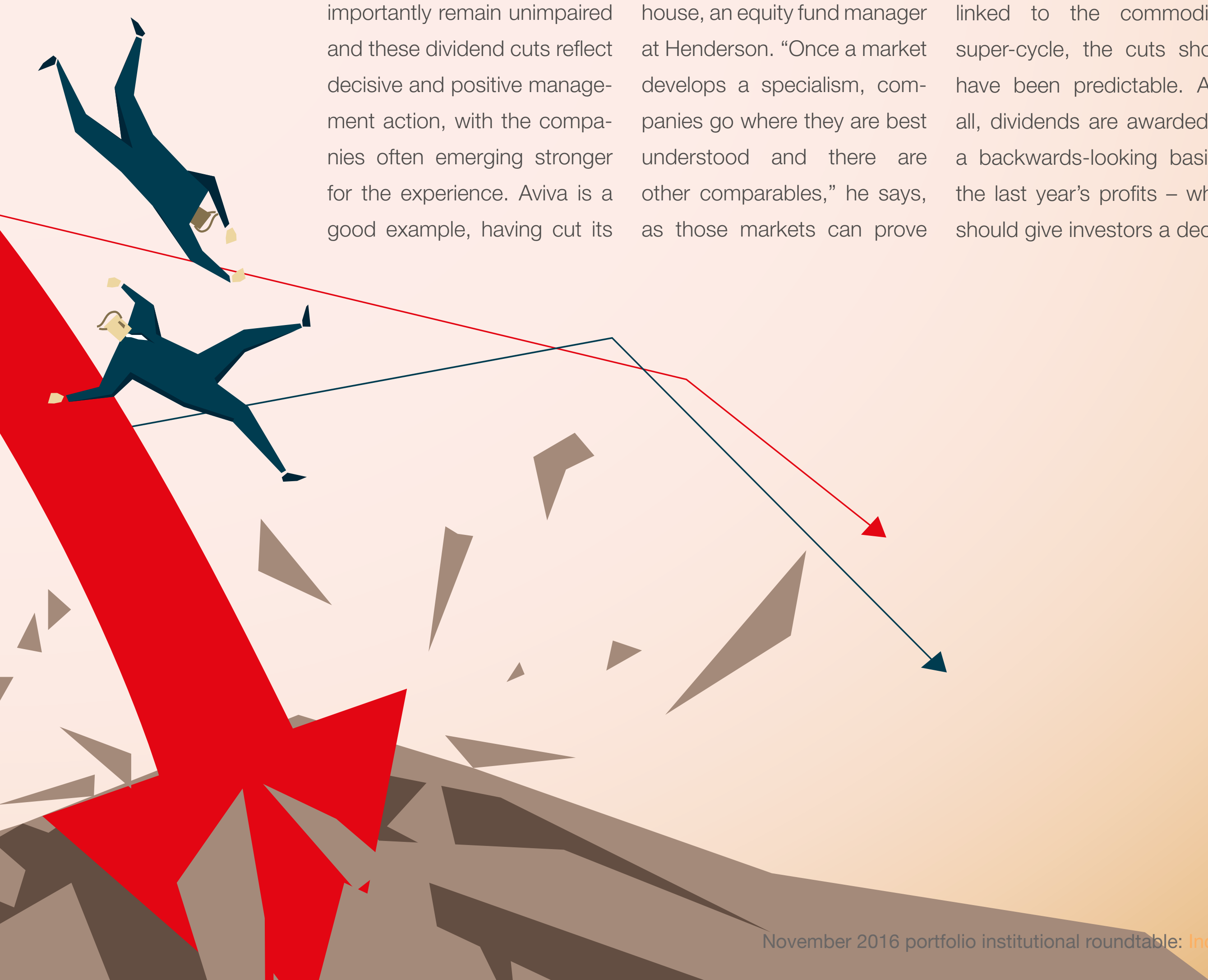
The result of the overweight position in commodity-based companies is a natural correlation to the commodities super-cycle.

The dramatic fall in the oil price since the start of last year has wreaked havoc on UK dividends as a result.

"During the first quarter, the overarching theme for dividends has been the weak commodity prices," Lofthouse says, adding that the trend will continue to play out in the coming 12 to 18 months depending on where the oil price ends up.

PREDICTABLE?

Of course, if dividends are linked to the commodities super-cycle, the cuts should have been predictable. After all, dividends are awarded on a backwards-looking basis – the last year's profits – which should give investors a decent



opportunity to predict the likely direction of dividends in the future.

The cuts by resource stocks have been on the horizon for a while, according to Kames Capital UK equity income fund manager, Douglas Scott, who says: "The writing has been on the wall for some time. Commodities companies have been over-distributing for a multi-decade period."

The cyclical nature of dividends also makes common sense – paying out dividends to shareholders instead of investing for growth leaves a company less able to ensure it can continue to increase its dividend in the long term. This has played out over the last two decades as the corporate lifecycle brought with it changes in the business and dividend landscape over time.

Twenty years ago, UK dividend income was heavily dominated by large industrial conglomerates. In 1998, for example, BTR, one of the largest conglomerates with £9.5bn in sales in 1997 and over 1000 business units worldwide, cut its almost ever increasing payouts to shareholders after earnings slowed and the company reached breaking point resulting from years of under-investment.

As the old conglomerates died off, their role as income generators has been assumed by a new set of companies whose dividends have increased as their businesses matured. Banks were the big dividend payers until the financial crisis and have since been replaced by commodities companies. And so the cycle continues…

"Maybe some of today's companies have had their time as the income generators of the day as they have ceased to be the reliable income players they were before," says Scott Meech, co-manager of the UBP European Equity Income fund.

A WORRYING TREND?

The irony is clear: cutting back on capital expenditure to maintain dividends means less investment to generate enough revenue to keep paying the dividends. Resources companies have been replaced in many income-focused portfolios by other sectors. Kames' Scott, for example, says: "The vast majority of UK equity income funds have not been reliant on mining stocks for a large part of their income."

According to research by Societe Generale, pharma companies have become the dominant part of the income generation story globally as Pfizer, Roche and Johnson & Johnson have become the three largest holdings among global income funds. But even here, the signs are pointing increasingly towards cuts.

One of the best measures to determine the likely direction of pay-outs is the dividend cover, which compares earnings per share with dividends per share. A cover of two (which means profits are twice what the company is paying out in dividends) is typically regarded as comfortable, suggesting little risk of an immi-

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nent cut. Cover ratios have been steadily declining for pharma companies in recent years and many now sit well below the comfort threshold.

DIVIDEND COVER

Pfizer's cover, for example, has fallen from just shy of four on 30 June 2013 to one at the end of March this year. Although less dramatic, the same trend is true of many of the other big UK and global pharma stocks: Roche's cover has decreased from 1.8 to 1.3 over the same period. Johnson & Johnson has seen its cover fall consistently since September 2014 when it was 2.2, to 1.8 by the end of March this year. Merck stood at 0.9 at the end of March, down from two last September.

The UK's GSK has seen its cover fall every year since 2011 from 1.63 to 0.95 at the end of last year while AstraZeneca currently stands at 0.8, above its low of 0.57 in June 2014, but well below its 2.69 in September 2011. The cover ratio for the FTSE 100 as a whole in February this year was the lowest this century at just over one, a third of what it was five years ago.

WILL DIVIDENDS REBOUND?

Although the dividend cycle has proven cyclical in the past, the outlook for the medium to long term is also downward for the UK's largest companies.

Today, falling dividends are a signal that companies are broadly struggling to generate growth as a result of under-investment over the last decade, rather than a sign they are investing their revenues into boosting future growth. Capital expenditure levels have remained consistently low since the financial crisis as geopolitical risk and uncertainty prevailed and productivity gains have stagnated.

Yet, without that investment, companies will find it increasingly hard to generate revenue growth in the long term, especially as the competitive landscape becomes more challenging in the future.

"In a world where interest rates are low and excess capital is looking for yield, companies' margins will come increasingly under pressure in an ultra-competitive environment, especially where returns are looking stable," says David Hutchins, head of multi-asset pension strategies at AllianceBernstein (AB). "The first sign of this is a fall in the dividend cover ratio."

Hutchins describes the lack of investment as "the most worrying cycle we've been through", and points to the lower return on equity investors can expect in the future.

THE IMPORTANCE OF DIVIDENDS

Under-investment on a grand scale has a marked impact on the future return on equity. Studies have shown dividends account for the vast bulk of long-term returns on equity. According to research by three London Business School professors, Elroy Dimson, Paul Marsh and Mike Staunton, capital gains only account for around a third of real annual total returns on US stocks since 1900. Reinvested dividends make up the rest.

Meanwhile, research from Societe Generale Cross Asset Research (SGCAR) shows the compounding effects of dividend yield has been more dominant in the long term returns on UK equities between 1970 and 2015 than they have been for the US, France, Germany, Canada and Japan. The dividend yield accounted for around 4% of the 4.8% total annualised returns in the UK over the studied period.

Lack of investment will limit companies' ability to pay out dividends on the same scale in the future as they have in the past, which will take its toll on the ability of investors to generate compound returns through the dividend yield. And, based on SGCAR's findings, that trend is likely to hit UK investors relatively hard.

"Investors who buy dividend paying stocks on the basis they will get the dividend and won't need to touch the capital will see falling income or capital value (all else being equal)," says AB's Hutchins. "Once the beta bull market of the last five years runs out of steam, passive investors will find themselves very exposed to low returns."

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"A lot of the dividends in the equity market are being funded by increases in debt, not CAPEX, etc. So it is effectively eating into the future capital to repay your debt today." Nick Clay

Why is income so important for pension funds and institutional investors at the moment?

Simon Hill: The vast majority of defined benefit schemes are now closing to accrual, so they are increasingly coming into a run off situation. So they start to think much more like an insurance company, in terms of cash flow management and what sort of portfolio they need to have at some defined point in the future which will then run off.

John Walbaum: They need income but they also need growth. You look at many of the cash flow sheets that we are all processing and at how much of those are going to be paid out in the next 10, 20 and 25 years. Funds will spend a lot of capital in that time and have to make sure they spend it sensibly.

Simon Levell: Some are saying, "Actually, we're just going to sell assets to meet the need as it arises." But there is an increasing awareness of this event risk or sequencing risk. You don't want to be a forcer in a downmarket and often in the downmarket, the things that hold up well aren't liquid.

James Tarry: During downturns in the market, assets you thought were liquid can be badly affected.

Hill: Trustees have to grapple each year, each quarter with the question "What are we going to sell? How much are we going to sell?" Returns are low generally. So, there is not even the capital gain to consume.

Nick Clay: You could argue low returns are about the only certain thing you have got today. Because where valuations are, there is 100% correlation with likely future returns for the next 10 years.

Hill: If you are an optimist you could say at some point with interest rates this low, the big new thing is going to come. It might be medical technology, robotics that will set off the next big phase of growth and that money will go into it in the same way that development of steel and car making and so on, and telephones did a hundred or so years ago.

Where can investors find income? From real assets?

Walbaum: Look at the portfolio 10/15 years down the road when everybody has retired. That is what it needs to look like. You can then build back and start filling up the gaps. Infrastructure assets and equities have a part to play, private debt markets and real estate probably have a part to play and so on.

Then you ask, "How do I build into that sort of portfolio over time?" It also helps not be a forced seller of an asset. So, it is a discipline that pension funds haven't had because they thought about an end game and thought about it purely from a balance sheet perspective, not in a cash flow perspective.

Hobbs: In the private asset classes, there could be around \$10trn across private equity, infrastructure, real estate and private debt. Of that, probably only about 40% is really providing a good yield. So of that \$10trn you have got private equity, opportunistic real estate which doesn't give you a yield (around 30% of the total) and you have also got listed infrastructure or REITs which give you a pick up on broader equity yields, but they don't give you a big yield (another 30%).

So then you have got quite a small, albeit \$4trn, in yielding real assets of core real estate, infrastructure, and private debt. So you are probably at about \$4trn, most of which is core real estate and infrastructure is tiny, still. So you have only got a very small amount of market to play in and that is the big reason why those bubbles are appearing because it is a small market and everyone is searching for yield.

Tarry: Around £35bn a year of infrastructure debt is issued annually in the UK, while real estate debt transaction volumes can range from £40bn to £50bn a year.

Those are pretty big numbers. Add in UK corporate debt issuance of around £300-odd billion, the private corporate debt market and other structured finance opportunities and the private markets start to look pretty sizeable. But pension funds can't really access these markets very efficiently.

Peter Hobbs

What is preventing pension funds from accessing these markets?

Tarry: Traditionally these markets have been dominated by the banks, but capital constraints are making it more difficult for banks to lend into these markets. That is clear in the UK real estate finance market where banks once accounted for 80% to 90% of the market. That figure has fallen to 75% and is still shrinking. The alternative lenders are taking more market share. Whether it is a supermarket or a local authority looking to raise finance, it's now becoming natural for them to talk to alternative lenders. Just as their reflex would have been to go to a bank in days gone by, they are now thinking, "Well actually this is now another real financing option that we can add to the list." But, if you're trying to access alternative lending opportunities on the asset side then it's not always straightforward. Certainly in the wider wholesale markets in terms of the senior lending side, you have to have a specialist platform in order to be able to access the product. We have done that for 30-odd years for our life insurance annuity book, but that requires a pretty chunky platform with 80 to 85 people working every day to keep that machine running. A pension fund may think, "I like the look of this opportunity and would like to get into this market." However, it's not always straightforward to access these opportunities, even once they've identified a particular asset class and wish to invest, they may not have the appropriate governance budgets to be able to decide whether and how they are going to access the market. Many investors don't move particularly quickly and researching one private debt class alone takes time. Opportunities in private debt markets also change.

Walbaum: If you are a large pension scheme with big pools of assets and a consequently higher governance budget and the ability to employ experts, that market becomes much more accessible.

Hill: We will go through a period when, gradually, people will get more and more used to these ideas. The structures will create the specialists. People will convert, they will stop being active equity managers perhaps and they will become private finance people or whatever it is.

The problem is 'in the meantime', and the meantime can be very long, it is expensive or it is difficult and you get periods where, as it is perhaps happening in infrastructure at the moment, it is just expensive. So on valuation grounds it is not attractive, even if in the long-term you think it is the right thing to be in, you are held back by a valuation.

Levell: A client of ours is a CFO of a medium-sized enterprise in Italy, he is getting calls every day from institutions, an asset manager who is begging to lend him money. So there is a lot of money chasing this. Part of the test of whether it can make this long-term shift in the capital markets, which is a very interesting way of framing it, is there are going to be blow ups, but they haven't really happened yet. Actually, how they get dealt with when they happen will be the real acid test.

Hobbs: The scale of the investor is important as with small allocations it is hard to build expertise. If you move to a billion euro/sterling per asset class then it becomes possible to build a sophisticated programme. But a key issue for investors, whatever the size, is implementation risk. For liquid equities and bonds, the implementation risk is relatively low, but one Swedish pension fund investor told me recently that implementation risk for private asset classes is around 70% of the risk given the lack of transparency and complexity of the asset classes. This is reinforced by the relative illiquidity which means it is hard for investors to get out of their exposures, unlike the more liquid asset classes.


John Walbaum

Levell: There are a couple of structural points in the industry that really tie people's hands. I would love to see a similar [pooling of schemes] in the corporate sector because you have got these tiny pension schemes all over the place that are run by voluntary trustee boards. Actually the level of sophistication of what they can do from an investment point of view is just very, very limited.

Hill: Governments, central agencies at least have a real role to play here. Because one of the big problems around this is how you share a risk and this is why investors coming together is attractive to investors in sharing a risk.

It will be very interesting to see how governments respond to this. I mean the political tide is absolutely against that currently because everybody is hung up about governments borrowing too much. There are people in Number 10 and the Treasury who are making this connection and have been making it for a long time. The problem is it has got to be sold not only to political masters but also, ultimately, to the electorate. Ultimately the electorate has got to buy into this and that is a difficult thing to do.

James Tarry

"In the UK real estate finance market... banks once accounted for 80% to 90% of the market. That figure has fallen to 75% and is still shrinking."

James Tarry

Walbaum: One way or the other the government is the insurer of last resort, this would just be a more overt way of doing it.

Hill: One of the concerns about creating a large sovereign wealth fund to crack some of these issues for pension schemes is there is a great worry about statist solutions. They see this idea of pooling and political influence as being a big step down a road they absolutely don't want to go down. I am sure you remember in the US the huge debate about public pension boards funding pet projects in the infrastructure area, to work for their particular precinct or district or whatever.

When I was looking at that pooling of the local authority pension schemes for infrastructure, I thought my big worry would be as a free market operator, how much is that going to distort things? You would get these big chunks of money controlled by a few people and there are only so many projects coming up. I am advising private sector pension funds mostly, where is that going to leave me? I am going to get the short stick here, aren't I?

Hobbs: Now with size comes sophistication and then the realisation you don't want to invest in pet projects and you want to invest globally. So I don't see there is such a worry about them investing just in UK infrastructure. For the diversification and the benefit and in debt as well, they should be investing across Europe and globally.

What are income projections for assets in liquid markets?

Hobbs: There remains a spectrum in all asset classes so even in public equities and fixed income there are opportunities for higher yields. Given this spectrum there is an increasing focus on understanding the risks associated with the different strategies and the ability to execute.

Walbaum: And even if you look at the straight forward index, you are still looking at an equity market where yields have held up pretty well. Dividend yields are pretty consistent: 2½ globally, 3½ in the UK.

Clay: A lot of the dividends in the equity market are being funded by increases in debt not CAPEX, etc. So it is effectively eating into the future capital to repay your debt today. But quite frankly that has always been the case. If you look at high yielding equities over time, mainly they are rubbish, they have got a high yield for a reason. It is because those dividends are not sustainable and they will cut those dividends.

"The big reason why these bubbles are appearing is because it is a small market and everyone is searching for yield."

Peter Hobbs

So the problem that is facing us in the equity market is exactly the same as you are finding everywhere else because of the demand for yield. The desire to promise something that is unsustainable, having created structures around it which are ultimately unsustainable, like, call overwriting and all these things, which can work for a period of time until they eradicate too much capital. Then eventually the thing falls over.


Simon Levell

"There is this middle ground of high yielding fixed income, such as emerging market debt, that can throw off 7%/8% yields."

Simon Levell

Walbaum: There is another issue here which is fashion which is a real driver of behaviour. Things like diversified growth funds are a really good example. Those of us who are long enough in the tooth to remember the days of the old balanced funds, we know that in those days nobody asset allocated because it was bloody difficult to get right. It hasn't got any easier to get asset allocation right, if anything it has got harder to get right and yet that has been presented as a panacea for many investors.

Hill: One of the real problems pension schemes have is because the cash flow profile for a pension scheme is that it goes up for a while and then it comes back down – they have got this humped shape. The 'armadillo' shape as some people call it. The problem is you don't just want a flat income stream, you want something that will have defined peaks. One of the features that LDI is able to give is that kind of tailoring so you can get your hedging profile to match with the profile of your liabilities.

If you can buy an asset now that will start to generate income in seven years and will stop generating income in 20 years, that might be a rather good fit with this shape. Now we are only at the very early stage of looking through how we can do this and a lot will depend on how debt markets develop as well as equity capital markets or equity-type capital markets.

Levell: If you have got something that gives you a growing income stream, that can be built into the mix and help tailor those cash flow profiles. The way we think about it is just a very simple income spectrum and at one end of the spectrum you have got things like government bonds and corporate debt that is very safe but very, very low yielding. The other end you have got illiquid assets, alternative credit, private debt – those sorts of things that have got lots of attractive attributes but they are illiquid so they can't be in all of your portfolio.

We think there is this middle ground of actually high yielding fixed income, things like high yield emerging market debt, that can throw off 7%/8% yields there which in a very, very low yielding environment globally isn't too shabby.

And, just coming back to equity income the growth of income that you get, you can get from equities, if you don't just fixate on the jump in the high yield end, but if you think about companies who pay a growing dividend as well. So you don't get locked into that end of the equity spectrum, I think that can play a role in portfolios. Yes, you don't get the capital to value stability and you don't get contractual income – again it is back to what price are you willing to pay for certainty.

Walbaum: It is going to come increasingly important to play volatility correctly. So, for example, when you get an opportunity to sell an asset because it has realised its potential and you recycle that asset into something else that has got more potential to come. That rebalancing discipline has always been value additive and will continue to be value additive if you have a disciplined approach to doing it.

Clay: If you have got some certainty over the income sustainability because you have chosen the right company, because it generates returns in the right way. Then the volatility thing doesn't become an issue because you are very comfortable. Your Microsoft is still going to be paying you your dividend even if its share price halves.

Hill: In the dim and distant days, actuaries used to look at the expected flow of dividend and income and didn't care about capital values, but that world has gone.

Clay: I would also take issue with the assumption that bonds are safe. There are many ways of defaulting. There is the Greek way where you just don't get your money back or, there is the way people are talking about now in Japan: just issuing a 1,000-year bond at zero coupon. That is defaulting.


Simon Hill

Walbaum: There are defaults happening all over the world at the moment.

Clay: Every country in its history has defaulted at some point on its debt. So this natural assumption that they might be low yield but at least they are still safe. That is a dangerous assumption to be making.

Hill: That is why we think this whole issue of capital value stability is important and we don't just think about it in terms of equity risk. But we think bonds are also risky in exactly the same way because they will react to changes in yield as well as the risk of default and so on.

Walbaum: A thing about quite a lot of the private markets and private debt markets in particular is that although they are illiquid and so on because of redemptions, the stream of capital is quite visible. Subject to default, but it is quite visible over a relatively short period. If you take the view of low for longer for, let's say, a decade, then there is quite a reasonable amount of visibility in some of that stuff. You probably reckon that default is always the big issue but you have the option at least to, as you see things developing in markets to turn the taps off and stop reinvesting capital. As long as you are aware of all this then it can form part of a portfolio.

Hobbs: One of the nice things about private debt is you can insulate yourself against the capital volatility.

So with private debt you can get a 2% IRR through to 15%.

Tarry: So the probability of default is, all else being equal, much lower. And your loss given a default is going to be so much higher.

Clay: But are we seeing again this massive rise in covenant-lite, like all those safety things which were put in have been taken out because people are just desperate.

Tarry: Not in our market. I don't see that at all. Not in real estate.

Hill: It is bound to be the case that when there is excessive demand for an asset class that to some extent the merits of that asset class will get corrupted. We have seen it time and time again. We have seen it in equities, we have seen it everything else.

All these issues raise the question of active manager risk. Because it is all very well if you are going for your 15% IRR, you have still got to make sure that it is a good investment at the end of the day.

For how long will the need for daily pricing stop DC accessing real estate and infrastructure?

Walbaum: It is not easy to do but it is doable. The problem is if you have a lot of people with very small fund vehicles then it is very difficult to manage that.

Hill: It has been a hiding place for some people in the investment management world to say, "Oh we can't do that because you guys all want liquidity." Well, I don't think it is necessary for DC investors very often.

Walbaum: In a world where you don't have to buy an annuity you can see through that two-month volatility quite happily.

Clay: ETF funds will be the next thing. ETF funds into emerging corporate debt or something like – turn a very liquid, daily traded vehicle into a very illiquid end thing and see as everyone panics, they will all close.

Hobbs: Isn't one of the solutions there fitting your private equities into these end date funds or fixed funds because then you have got a particular duration. You know when you are going to get paid out and then you can shift the allocation. You can have a lot of, maybe your liquid assets early on and then growth assets early on and then shift them over time.

Levell: At an individual level or individual pension scheme level or an individual asset manager level, are there pockets of opportunity? Are there still companies that are growing and growing their dividend? Are there still areas of the world that offer growth higher rates? There are if you look in some emerging markets.


John Walbaum

Hobbs: If you contrast the Australians, the Dutch and the Canadians they have probably got 25% now in private asset classes. We are, in the UK, probably still 5% in real estate, nothing in infrastructure, so really it is still very small. The Dutch and the Australians have a tiny economy compared to the UK and they invest in globally. So if the UK pension funds would think about themselves, it should be "let's be proactive" and also then you are diversifying away from the risks in fixed income. So you have got that benefit as well.

Walbaum: You look for the pockets of value and you do some sensible portfolio construction. So you don't decide the private markets are going to solve every single problem for me because they are clearly not. So you asset allocate in a sensible way.

But where we have got to in the UK is that the balance is wrong. The balance has been wrong, probably, forever. It was far too dominated by equities for a long period. It is now becoming far too dominated by


Peter Hobbs

"One of the nice things about private debt is you can insulate yourself against the capital volatility... you can get a 2% IRR through to 15%."

Peter Hobbs

things like diversified growth funds which are not a panacea for anything. We are light in the areas of real assets.

We need to be building up our exposure to real assets because real assets will protect us against some of the things that the private markets can't. So it becomes sensible portfolio construction.

Tarry: What is stopping funds from doing enough in private markets?

Walbaum: In the last couple of years we have seen significant increase in supply of product. You have to be very discerning. You need to be investing in decent quality and the price markets.

Hobbs: It is incremental. You don't want to go from 1% to 5% overnight, so it is important to build understanding and familiarity. But, right now, there is huge demand for private debt as investors seek to lock into an asset class that provides a relatively high and resilient yield. We're seeing this from investors across the world, whether in the UK, North America, across the eurozone and Asia Pacific.

Hill: This is exactly right. The issue is about gradual familiarisation as well as increasing availability.

Those allocations for example to emerging markets from Dutch pension funds, I was involved in the early stages of that and they started off at zero and it was 20 years ago – probably slightly more. Then it took one or two big pension funds doing it and then gradually it built up and developed and equally the private market developments of ABP, PGGM and those kind of institutions.

Our experience with clients is very much the same, we have been talking to them about this subject for


John Walbaum, Simon Hill and Simon Levell

"If it is true that long-term rates of return are low because growth is in long-term decline globally, then retirement saving is a very expensive thing to do."
Simon Hill

quite a long time. We have been talking to them about how it would fit with, for example, if you have got a LDI programme, how some of these ideas might fit in with those. How you deal with the issues around private markets, that you may not see much return for a long time. The fact that there is a cycle in private market returns as well. Anyone who has done anything in private equity knows the booms years and the boom decades and the very weak decades as well.

So you have got to get pension schemes used to that. All big changes take far longer than many ever think. Think about passive index tracking investment, it took 20 years at least to become bread and butter.

Walbaum: For decades nobody managed the balance sheet, then LDI came along because we realised we needed to. There were early adopters, slower adopters. There are still people who haven't adopted LDI in any meaningful context, and look at the mess they are in because of it. Private markets are probably another case in point.

Tarry: We are about to launch an open-ended fund which invests in real estate debt, infrastructure debt, private corporate debt and structured finance. If you are a smaller scheme you may only have just begun to understand some, if not all, of these asset classes – this gives the opportunity to invest across them.

Walbaum: This is just a fundamental reality that if you have a bunch of people who are largely well meaning amateurs with some professional expertise attached to it, it is going to take time for this to happen. It is inevitable it is going to take time. Even professionals take time to get involved in this stuff.

A lot of that is available now if the packages could be put together in a way that would make a lot of sense for DC investors to start taking slices of our big pie.

What are interest rates likely to do in the short to mid-term?

Hill: Any change of rates has to be different from what is already priced into the market for it to have any bearing, considering markets are pricing-in rising rates as you go along the yield curve.

Secondly, the impact depends on whether the rise is in nominal or real interest rates or a mix between them. That is absolutely crucial.

One of the interesting things about pension schemes looking at the cash flow and long-term cash flow is they have actually become slightly less fixated around this yield and interest rate problem.

Levell: Trustees find that discussion about cash flow and income much more intuitive than calculating the MPV of your LDI portfolio.

Hill: Yields are low because that is the expectation. It is not the other way around. I know people think that somehow banks see this. The long term real rate of interest has fallen, it would appear, but certainly nominal rates are low for the reason that expected returns were higher. If corporates thought the markets were wrong and they were going to get better returns on their investment, then they go out and invest and they borrow and they would be competing in the market with government debt. You would be where you were in the '70s and the '80s where there was a crowding out problem.

There is absolutely no crowding out. This is what people have completely misread. It is part of the whole pattern. If you look at one bit, you can say, "Yes, it's circular." But it is a whole problem and it is not one thing causing it. It is not governments causing it. People are not investing because they expect returns to be lower and there are logical reasons why they might expect returns to be lower – we are getting older, we are now drawing down capital broadly. Western economies are very mature and, so, the question is how is that going to manifest.


James Tarry

If it is true that long-term rates of return really are low because growth is in some long-term decline globally, then retirement saving is a very expensive thing to do. That is the fact. We can't wish it a way. If you are not getting returns on investment – saving for the future... there becomes no point.

Hobbs: Those two scenarios are really important – and how income yielding assets will perform. Because in the first scenario then all this weight coming into yield at the moment is going to look a poor decision because there is growth.

If it is the second scenario, then it will be a very wise thing to have got in even at these low yields. So, what is the macro outcome will determine whether this is a wise move in terms of such good yields.

In search of income – the lessons pension funds can learn from insurers

By John Dewey, head of investment strategy, global investment solutions, Aviva Investors

With many pension schemes becoming cashflow negative, an increased focus on income generation and cashflow management is required. Given that insurers have been facing the same challenges for many years, what can be learnt from their experience?

Defined benefits pension schemes face a myriad of challenges. The low bond yield environment, coupled with the heightened volatility of growth assets, such as equities, means that strategic investment decisions around liability hedging, tactical and strategic asset allocations are tougher than ever to make.

These challenges are further compounded for a growing number of pension schemes that are close to, or are becoming, cashflow negative, i.e., they are paying out more in pensions than they receive in contributions. Half of FTSE350 schemes already fall into that category, paying out £13bn a year more than they receive in contributions, a figure that is set to rise to £50bn by 2030. [1]

In particular, the decisions around cashflow management and income generation should be factored in to avoid situations where pension schemes become forced sellers of assets to meet any shortfalls. Although cashflow negativity is a new challenge for an ever-growing number of pension schemes, insurers have been managing their assets on this basis for many years with the focus on income generation and robust risk management.

How do insurers invest their assets?

Out of all the different types of insurers, the liabilities facing an annuity provider most closely represent those incurred by a pension scheme. An annuity provider structures an investment strategy that hedges and closely matches liability cash flows. The overarching objective is to ensure that all the pensions are paid while enough profit is generated to cover longevity risk, pay ongoing costs and deliver a profit for shareholders.

A typical annuity provider will structure its portfolio to invest in income-generating assets with a derivatives overlay to hedge out any remaining interest rate and inflation risk. The entire portfolio is managed on a 'buy and maintain' basis with the objective of matching and beating the liabilities, unconstrained by any benchmark indices.

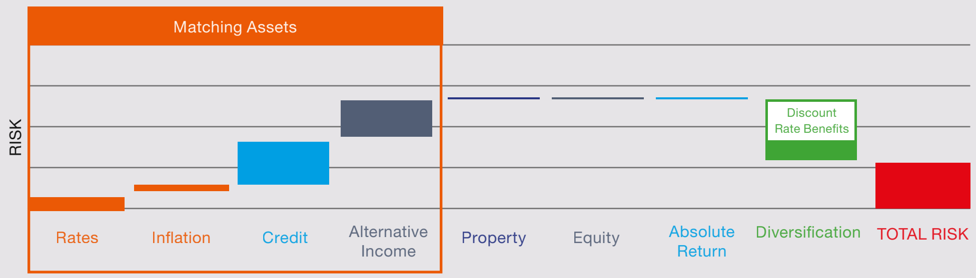
The assets can be classified into the three broad categories listed below.

Asset class/strategy	Description
Credit	• Publicly-traded credit • Long-duration, designed to help manage cashflow needs • Focused on defensive companies • Investment grade (typically around 'A-' rating on average)
Alternative Income Assets	• Privately-traded assets • Designed to produce stable and predictable income from a range of alternative income assets and strategies • These include infrastructure debt, private corporate debt, real estate debt and structured finance • Investment grade (or equivalent internally-produced rating)
Liability Driven Investing (LDI)	• An overlay of highly-liquid fixed income instruments, government bonds, repos, swaps and cash • Primary function is to hedge interest rate and inflation exposure • The overlay takes into account the hedging contribution from credit and alternative income assets • Assets are managed to optimise the use of collateral and to seek opportunities to implement the hedge in the most efficient manner

Source: Aviva Investors – for illustrative purposes only

[1] Source: Hymans Robertson FTSE350 pension risk analysis report, October 2015

For a typical annuity portfolio, akin to a pension scheme, the total investment risk (represented by the red bar, and which could be defined as Value at Risk) can be broken down into the main underlying risk factors as shown below. For completeness, a typical breakdown of the main risks run by a pension scheme is shown. These include property, equity and absolute return exposures.



Source Aviva Investors – for illustrative purposes only

As the focus of the annuity portfolio is on income generation (as opposed to having any exposure to growth assets, such as property or equities), the major investment risks are equally split, in broad terms, between credit and alternative income with small interest rates and inflation positions. Most of the return contribution (versus liabilities) is expected to come from credit and alternative income.

What can pension schemes learn from this approach?

There are lessons that pension schemes can learn from the insurer's approach. In particular, for schemes that are, or are about to become, cashflow negative the following steps could be taken to improve their investment strategies:

1. **Make extensive use of alternative income and credit assets -** The assets that can be used for cashflow management and predictable income generation purposes still form only a modest proportion of most pension scheme portfolios. Traditionally, pension schemes have invested in gilts and some also used LDI to target their liabilities. To make the most of the insurer approach, pension schemes should embrace the use of assets that produce predictable cash flows at higher yields than gilts. A range of strategies could be employed, including long duration buy-and-maintain credit as well as a wide range of alternative income assets that provide a higher return than traditional fixed-income, whilst also increasing diversification. Pension schemes, by virtue of the fact they are not subject to onerous insurance regulations, can take advantage of an even wider asset universe than their insurance counterparts.

2. **Move away from investing relative to market benchmark and focus on the outcome that matters -** The use of benchmark indices and the calculation of added value relative to such benchmarks are entirely artificial given the key objective for pension scheme of generating sufficient income to pay liability cashflows. Indeed, in the case of market-weighted bond indices, investors are effectively placing their biggest bets on the most indebted companies. We believe that by embracing this approach, a pension scheme can more efficiently meet its needs for returns, risk management and delivering reliable cashflows to meet its liabilities.

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Mind the gap!
How the overlooked middle ground could help solve the cash flow challenge

By Simon Levell, head of consultant relations, Capital Group

Defined benefit (DB) pension schemes are rapidly moving into cash-flow-negative territory. As their members grow older, it's time to make good on those pension promises. Unfortunately, we find ourselves in an ultra-low yield environment – the flow of income that gilts and corporate bonds traditionally provided has slowed to a trickle – creating a gap between the cash flow required and that being generated. The new challenge for DB investment is thus not what are the liabilities of the scheme, but how will those liabilities be paid, now and in the future?

Moving from a balance sheet to a cash flow approach

When considering the income that assets need to generate, there are broadly three main issues to address:

1. **Cash flow today** – Today's ultra-low yields, compressed by central bank intervention in markets and increased demand from pension funds, are forcing investors to look further afield. This is especially the case once schemes turn cash-flow negative and need to start selling assets. Some investors have focused their attention on alternative fixed-income assets such as infrastructure debt. However these are often illiquid, capacity constrained and expensive to access.
2. **Cash flow tomorrow** – So why not simply begin selling assets? Unfortunately this leaves you at the mercy of markets; if you need to raise cash to pay an income, you risk becoming a 'forced seller' – having to accept whatever the market price is for your assets on that day. This is known as 'sequencing risk' – if you have to sell assets the day after the market has taken a downturn, you risk permanently impairing your capital pot, giving you fewer assets to generate an income from in the future.
3. **Cash flow for a long time in the future** – Improving longevity poses an ever greater risk to pension funds – can the assets last long enough to provide an income to your healthiest pensioners? If you have had to sell assets rather than just taking an income from them, there is a stark danger that the pension pot may simply run dry.

Look at your assets in a new light – do they generate income?

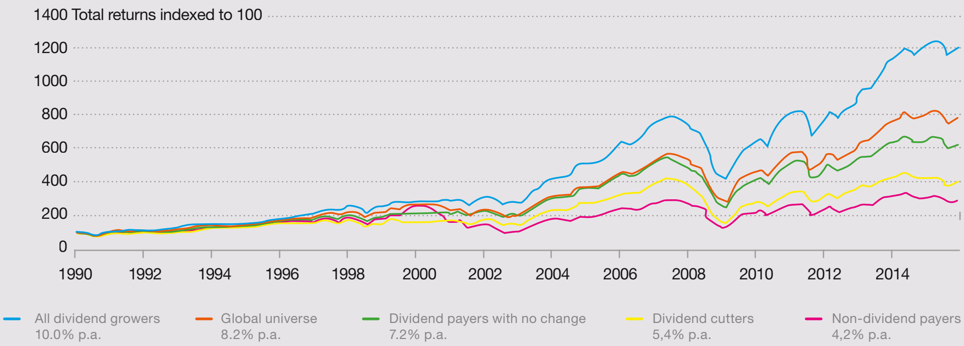
It's clear that we need a new framework for thinking about the purpose assets serve within a portfolio. In a 'lower-for-longer' interest environment, these risks are persistent, and capacity constrained alternative assets such as infrastructure or private debt can only partially close 'the income gap'.

In our view, the answer is to reconsider the role that all of your assets play in income generation – and particularly 'the forgotten middle ground'. These are the higher-yielding areas of fixed income as well as equities – an asset class that has been out of favour with pension schemes for a considerable period as it is perceived to involve too much risk and there is a lack of matching with liabilities. In an environment where certain good quality equities offer more yield than investment-grade bonds, as well as future growth potential to counter mortality risk, it may be time to reconsider what is a 'risky asset' based on what it can do to counter the cash flow challenge. By diversifying your sources of income in the same way you diversified your liability matching and growth assets, you could find a sensible solution to closing the income gap.

Equities – really? But what about the volatility?

'De-risking' has been the fashionable goal in pensions for a long time, so to consider equities as part of the solution may feel like an uneasy answer. But let's consider the question of volatility – in equities the movement tends to come from the capital return rather than income return; the income stream can be robust and consistent as long as short-term capital movements can be tolerated. It also depends on the type of equity – dividend-paying equities tend to be less volatile overall. By repurposing growth assets to dividend-paying equities, the overall volatility of the funding ratio could potentially be reduced. Furthermore, dividend-paying stocks have demonstrated greater resilience than their non-dividend-paying counterparts in bear markets and lower volatility overall, making a significant positive impact on cumulative investment returns over the long run (see chart). Evidence also shows that companies that have been able to grow their dividends over a number of years have generated superior total returns compared with those that pay flat dividends, declining dividends or no dividends at all. Growing dividends over time tends to be a sign of good allocation of capital; the need to pay dividends may mean that company managers select only the highest returning projects.

Dividend growers have historically provided superior long-term returns around the globe



Past results are not a guarantee of future results. Invested capital is at risk; funds may seek to provide positive results over the long term, although there is no guarantee that this will be achieved over that or any period.

Note: Returns are based on the weighted average of total returns in USD (with gross dividend reinvested) of a global universe of companies. The universe consists of the 1,000 largest companies in the S&P BMI Global Indices for North America (50% weight), Europe (25%), Japan (10%) and the 500 largest companies for Emerging Markets (10%) and Pacific excluding Japan (5%) from December 1989 to December 2004; and the 1,000 largest companies in the MSCI Investable Market Indices (IMI) for North America, Europe and Japan, and the 500 largest companies for Emerging Markets and Pacific excluding Japan, thereafter. The universe constituents are rebalanced quarterly. Volatility reflects annualised standard deviation of monthly total returns. Data from 31 December 1989 through 31 December 2015.

Sources: FactSet, Compustat, Worldscope, MSCI, Capital Group

As lifespans expand, asset classes like equities that can be owned in perpetuity and do not carry re-investment risk have clear advantages. In addition to current dividends, equities offer the potential for dividend distributions to grow in the future and for capital values to increase. Although inflation may currently seem a distant prospect, the potential for a degree of inflation protection through owning the rights to earnings from productive assets has long-term attractions. Conclusion – investors should consider dividend-growing equities.

In summary, with many UK DB pension schemes becoming increasingly mature and moving to cash-flow-negative territory, there is a need to reconsider investment strategy and to prioritise income and cash generation rather than simple capital appreciation, or return over a benchmark. We would suggest that the ‘forgotten middle ground’ could offer income without compromising on liquidity, transparency and capacity.

It is worth reconsidering equities, which now offer in many cases higher yields than bonds. Although equities are generally more risky than bonds, this could be mitigated to some extent by adopting a strategy that invests in dividend-growing equities rather than simple ‘high yielders’. This approach has historically exhibited less volatility than equity markets in general and has held up well in down markets, making it particularly attractive for pension schemes that need to liquidate assets on a regular basis.

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Equity income: taking a global perspective

By Nick Clay, portfolio manager, global income strategy, Newton Investment Management

Dividend-paying equities may offer significantly higher levels of income than bonds and cash, but many investors have often not followed a dividend approach. This is perhaps because equities have traditionally been associated with income volatility, as well as a perception that the growth potential of such a strategy may be limited.

However, by focusing on companies with a disciplined approach to capital allocation, we believe a global equity income strategy can provide returns that remain relatively stable and additional capital protection in down markets, as well as the prospect of attractive long-term capital growth.

Fresh look at dividend culture

Company managements, particularly in the US and Japan, are rethinking the role of dividends. After years of strong earnings, coupled with lower capital spending and hiring compared with what has been typical during previous economic expansions, many companies have significant amounts of cash on their balance sheets. Increasingly, they face pressures to either pay or increase dividends or to buy back stock, and many are recognising they will be rewarded more for increasing their dividends than for conducting stock buybacks.

Buying back stock delivers a one-time benefit, but increasing a dividend may improve stock valuations in the longer term, particularly in an environment of slow economic growth where traditional drivers of earnings growth cannot be relied upon to support share prices.

With many developed economies deeply mired in debt and, to our mind, likely to grow slowly for the foreseeable future, opportunities in dividend-paying stocks may lie with businesses which possess stable growth and little or no debt – in, for example, the consumer staples, utilities, telecommunications, and health-care sectors.

US opportunities

US dividend-paying stocks may have been considered expensive relative to the overall S&P 500 over the last few years, as investors have increasingly come to view equity-income assets as substitutes for bonds. However, the way investors evaluate dividend-paying stocks relative to other equities, as well as to fixed income, may be changing, making US equity income yields appear to us increasingly attractive compared with global bond yields. At the same time, as some investors reassess the role of dividends in their portfolios, US companies are also shifting the way they think about payouts.

As of 1 April 2016, 60% of S&P 500 companies that paid dividends had yields above that of the 10-year US Treasury note. Twenty-five years ago, only 6% of companies paid dividends higher than 10-year Treasuries, which at the time paid 8.5% compared with less than 2% today, according to US Treasury data.[1] With the current lower interest-rate environment widely expected to persist for some time, we think equity income increasingly looks like a favourable place for an income-oriented investor.

Over the last five years, the overall level of US payout ratios has also risen. That's partly because the market appears to have rewarded companies that have higher payout ratios with higher equity valuations. Historically, when CEOs of US companies have had to choose between either investing cash to grow their businesses or paying higher dividends, they've often opted to invest for growth. Now, with more subdued global growth expectations, US management teams may increasingly see raising dividends as one of a limited number of moves they can make to gain investors' favour. In the US, raising dividend payments has historically been viewed as an acknowledgment that a company's end markets have matured, which has tended to depress equity valuations.

However, we observe that US companies are increasingly setting this belief aside and looking more at the potential benefits for their stock prices that can accompany raising dividends. Indeed, for investors, the belief that an inevitable trade-off exists between dividend payments and stock-price growth may indeed be unfounded. Studies of US and other equity markets have found positive correlations between companies' payout ratios and subsequent earnings growth.[2]

[1] Source: Bloomberg data, August 2016

[2] See, for example, Arnott and Asness, "Surprise! Higher Dividends = Higher Earnings Growth", Financial Analysts Journal (2003).

These studies suggest that the payment of a dividend actually encourages greater capital discipline. Contrary to popular belief, we believe many companies are poor at allocating capital, seeking growth rather than returns. If capital is allocated correctly, we think there is a better chance of supporting and sustaining returns on invested capital.

European approach

While the same demographic factors and low bond yields driving demand for equity income in the US are, to our thinking, also present in Europe, we believe European companies continue to approach dividend payments differently than those in the US. Dividend payment is a more common practice for most European companies, which in turn affords income-seeking investors diversification across sectors. We see the greater prevalence of dividend paying in Europe as partly reflecting the fact that the families of many European company founders still hold significant stakes in the companies and rely on the dividends for income. The presence of these shareholders may help increase the likelihood that companies will continue to pay dividends, even under circumstances where management in other regions might choose not to do so.

The prevalence of dividend-focused companies across various sectors makes the European equity-income investible universe somewhat broader than other markets, but that breadth may disguise a lack of depth. We would emphasise that not all of Europe's dividend paying stocks are equally attractive.

Of greater concern for international investors may be the concentrated nature of European stocks. According to a Société Générale study, the 20 highest-dividend paying companies in the UK, France, Germany and Switzerland represent 70% or more of the total dividends paid out in each of those markets. That compares with less than 40% in the US and a global average of 20%.[3]

In recent years, some of Europe's most popular income-producing companies, in sectors such as consumer staples and health care, have become more expensive and investors may choose to seek opportunities in more cyclical sectors that have greater potential to benefit from both expanding quantitative easing and more competitive export markets owing to the weakening euro.

Asia and Japan

In recent years, some of the world's highest dividend yields have come from emerging markets and Asia,[4] also home to some of the world's lowest stock valuations. Of crucial concern for investors, we think, is the question of whether the companies paying those high yields will be able to continue to do so over the longer term. Like dividend-paying stocks in Europe, we see equity income in emerging Asia as being susceptible to the impact of currency exchange rates. Asian economies also face risks from inflationary monetary policy, which lowers the value of the local currency in which dividends are paid, the effect of commodity price swings in countries that depend on commodities, and various geopolitical risks.

One of these risks may be posed by China, whose slowing growth and abrupt policy shifts weigh heavily on regional economies. Besides China, we believe the pace of US Federal Reserve rate increases is a significant concern for Asian companies, particularly those in defensive sectors such as consumer staples, utilities and health care.

In anticipation of those higher rates, we observe that international investors are increasingly shifting exposure to companies with rising dividend payouts and away from stocks they view as more likely to be affected by future US interest-rate hikes. The presumed greater growth potential and lower valuations of companies such as Chinese state-owned enterprises (SOEs), Indian banks and Taiwanese technology firms, to our mind, make them more likely to raise payouts over time, in contrast to traditional dividend-paying companies in mature industries such as telecommunications and utilities.

[3] The Economist, 21 January 2016
[4] Source: Bloomberg data, September 2016

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