Income is the new defence

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One year ago, an investor with A$1 million allocated to a cash fund would receive an income of A$10,000 per year.

Today, that A$1 million allocation would only return A$1,000 per year.

Let's talk about income.

Investors have had to navigate many twists and turns during the COVID-19 crisis; and with the immediate impacts and after effects still playing out, the stressors of liquidity needs and deteriorating income profiles will not be dissipating any time soon.

This backdrop has driven today's institutional investors to bolster their liquidity levels from a tactical and strategic perspective while also seeking higher-yielding strategies given the precipitous fall in interest rates.

Strengthening income will be a crucial element for strategies aiming to deliver strong, risk-adjusted returns and account for a rise in volatility of income and capital.

Fixed income traditionally plays a defensive role within an investor's portfolio. Historically, as equities and other riskier assets have fallen, fixed income has increased in value to help dampen the losses and volatility of investors' portfolios. Today, fixed income yields are now close to zero – and negative in some countries – leading many investors to question how much lower yields can go, and whether fixed income can still be an effective defensive play.

BALANCING THE UPSIDE AND DOWNSIDE

To boost income, two options are available.

The first is to increase the term money is "locked up" for. For instance, "locking up" money for five years instead of one will earn more income. The catch is if interest rates rise in the next year, investors are unable to reset yield, earning a lower income.

The second option involves increasing the risk of not receiving "money back". In this scenario, investors can increase the risk of capital loss by investing into lower quality corporate bonds, which in times of economic turmoil have a significantly diminished chance of survival.

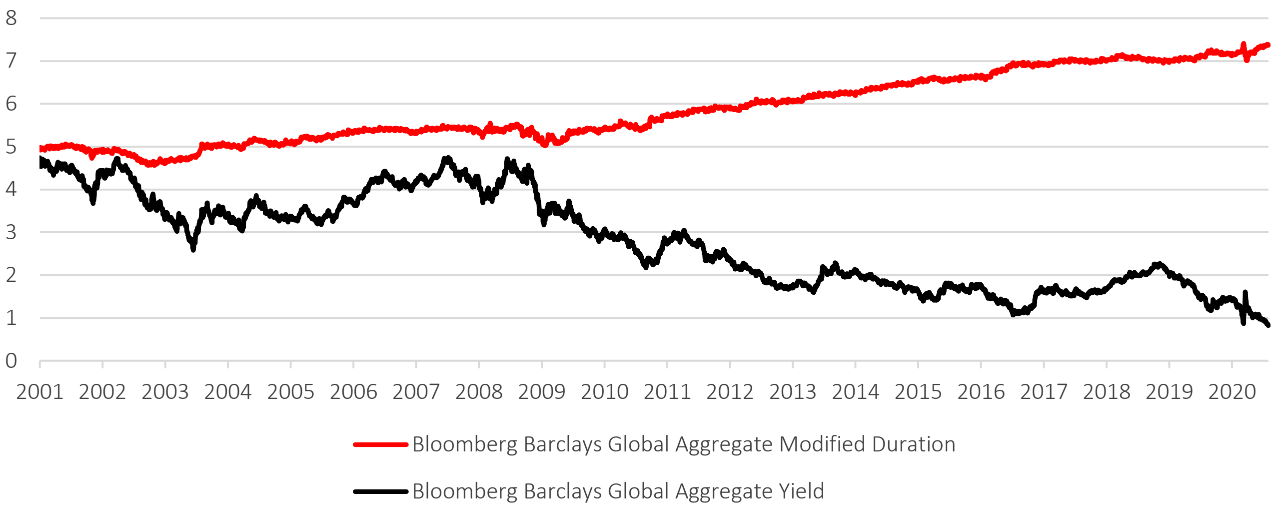
Bonds have exhibited strong outperformance in absolute terms over the last 40 years. However currently, yields have consistently fallen to the point where nominal yields are negative across many countries. This has resulted in a double-edged sword for investors: by lending money for longer time frames they enhance their yield, but at the increased risk exposure to interest rates rises.

ASSESSING INTEREST RATE RISK

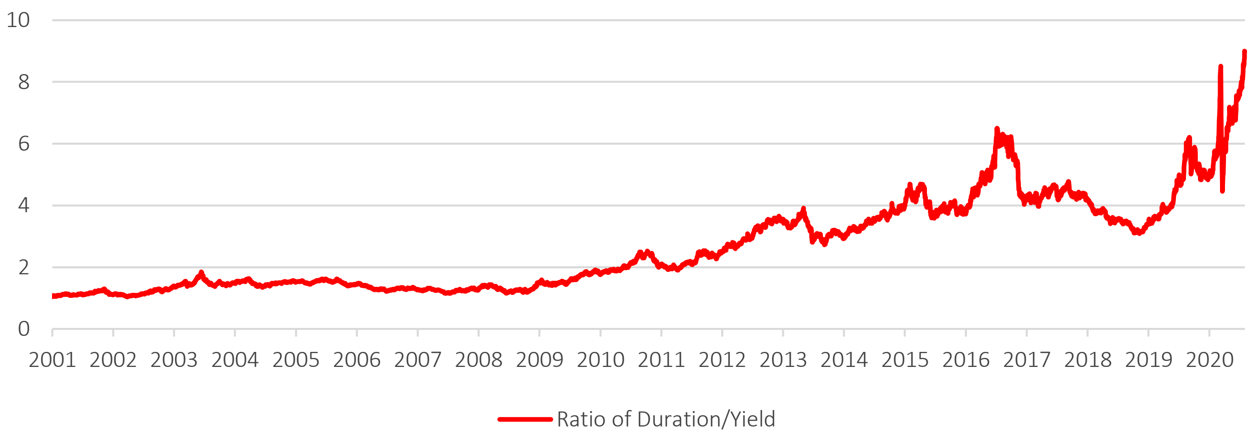
One simple approach to assess this interest rate risk is to divide the index duration by the index yield (shown separately in the chart immediately below), to show duration as a multiple of the yield (shown in the second chart below).

As an example, if yields rise by 1 per cent then investors would lose nine years' worth of income (assuming an instantaneous shift of 1 per cent). In other words, an investor would immediately lose all income and not regain it until 2029.

Global Bond Indexes - Duration vs Yield



Ratio of Duration vs Yield



Source: Bloomberg. Data from 1st January 2001 to 31st July 2020.

Another option to enhance income lays in increasing vulnerability to the economic/credit cycle. This approach can result in illiquidity challenges and potential capital losses should the economy take a downturn. In the last few years, the economy has seen sharp rises and falls in yields and assertion that the Australian economy always grows has recently been significantly challenged.

ISSUER QUALITIES KEY TO CAPTURING THE OPPORTUNITY

Any solution will require investors selecting an issuer with expert qualities in the following:

1. The ability to choose the winners to generate yield
2. Capability to allocate between fixed income asset classes
3. Able to extract value from selective bottom-up credit selection
4. Proprietary fundamental credit research.
5. A clear ability to effectively manage refinancing risk during COVID
6. Access to more than ample liquidity sources
7. Flexibility over costs and capex

With these capabilities, investors can capture a solution which **concentrates on bonds offering high-quality interest income opportunities.**

IN PURSUIT OF A SOLUTION

In the pursuit of higher incomes and uncorrelated returns, many investors see large drawdowns and unpredictability. While unexpected outcomes manifest during stress periods, market volatility will remain a fact of investing, especially as COVID plays out.

Yet navigating these risks can be achieved through the simplest and most predictable attribute of fixed income – income.

Income is predictable, and when a bond does not default, it is repeatable, planned and consistent.

Arriving at this destination should not be complex, employ excessive leverage, be illiquid or expensive. An income solution will need to focus on the production of income objectives with a greater degree of predictability which means giving some of the upside, to avoid downside risks.

An Investor Checklist: Income is the New Defence

Investors who are seeking to improve their income prospects in the coming years need to focus on their income predictability, positive returns, with low volatility and low drawdowns.

✓ Focus on a diversified portfolio of high-quality bonds producing interest income in a predictable and repeatable approach
✓ Have skilled, detailed and robust credit analysis to "pick the winners"
✓ Have short-term maturity to protect from sharply higher moves in yields
✓ Identification of robust scenario analysis hedges to dampen volatility
✓ Strong focus on a nimble approach to remain liquid and flexible

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